PARIS ARBITRATION WEEK

2023 PAW Recap – Day 5: The Power of "Proportionality" – A Sleeping Giant of a Concept in Investment Arbitration?

Natalia Rodriguez Alvarez, Sabina Nurbagandova, Antoine Cottin (Assistant Editor for Europe) Lubarde Law and Mihaela Tarnovschi (ICC International Court of Arbitration) | **April 4, 2023** | **Leave a comment**

Investor-state dispute settlement (ISDS) issues were again in the spotlight on the very last day of the Paris Arbitration Week (PAW). A panel discussion was organized by **Fieldfisher** on **"The power of "proportionality" – a sleeping giant of a concept in investment arbitration?"**. The panel was composed of **Jacob McArthur** (Fieldfisher) as moderator, **Alexandra Underwood** (Fieldfisher) as speaker, and **Tracey Ann Wright** (Fieldfisher) as moderator. The panel touched upon a range of issues relating to proportionality, including its emerging status in investment law, its influence as well as its origins and future, as summarized below.

General Definition of Proportionality

As explained by Jackie McArthur, broadly speaking, proportionality is a tool that is used to assess whether a state's act is justified. It provides an analytical framework to assess the balance between, on the one hand, a public interest and, on the other hand, individual rights or interests that might have been harmed when the state pursued that public interest.

Proportionality works on two different levels. It provides a framework for (i) states to make sure that, when pursuing a public interest, they counterbalance the harm done to the rights of individuals and (ii) the reviewing court or tribunal to assess the state's measure and to avoid giving one-sided consideration to either competing interests. The goal of proportionality is to give a framework for identifying all relevant considerations and placing them properly in relation to each other.

Proportionality is not widely used in ISDS, but is firmly applied in other areas of law, especially in human rights law. Its application varies amongst the systems, but the European Court of Human Rights ("ECtHR") three-step analysis is commonly accepted. It requires:

- *First*, to identify a policy interest that the state deems to have justified the measure. This step provides the ground for decision-makers to understand what the state is trying to achieve and justify the measure by a public interest. Depending on how defensive a reviewing tribunal/court is, it may either accept what the state identifies as a public interest or require further evidence.
- *Second*, to determine whether the measure truly corresponds to the public interest put forward. The theory is that proportionality works on two different levels. It provides a framework (i) for the actual decision makers to be sure that when pursuing a public interest, they counterbalance harms that might be caused to individuals and (ii) for the reviewing court or tribunal to assess the decision maker measure and to avoid giving one side consideration to either competing interests. The goal of proportionality is to give a framework for identifying all relevant considerations and placing them properly in relation to each other.
- *Third* to balance the public interest justification and the measure's effects on an individual or a group of individuals who say that the measure in question has harmed them. This is the step which lies at the core of the notion of proportionality. Depending on the degree of deference given to the state by a reviewing court/tribunal, there can be different approaches to this step. *If a high degree of deference is afforded*, the court or tribunal may say that the decision would only be unfair and unlawful if it is manifestly without a reasonable foundation. *A medium level of deference would involve* balancing the importance of the public interest against the seriousness of harm caused. *If there is a low degree of deference*, the tribunal/court may also question if the state could have achieved the public interest goal in any other way.

Finally, Ms. McArthur noted that the degree of deference is crucial to determine how rigorous a proportionality analysis will be in a given case. The deference or margin of appreciation refers to the extent to which courts/tribunals reviewing a measure will accord "second-guess" the choices of the state. Deference to a state may be justified by (i) its legitimacy as a decision maker and (ii) its better institutional capacity to assess the public interest.

Proportionality in Investment Arbitration

In the context of ISDS, Lucas Bastin KC explained that there are four ways in which proportionality comes up.

First, proportionality can be used to determine whether a disproportionate measure taken by a state pursuing a public interest can by itself constitute a breach of the fair and equitable treatment ("FET") and lead to an award on damages. Tribunals have answered this question disparately. Nonetheless, it has become more accepted that proportionality is a standalone component of the FET standard. What is still difficult is defining what constitutes a breach of proportionality. In contrast to other systems, in investment arbitration tribunals have not articulated a consistent proportionality standard.

In *Charanne v. Spain* (the tribunal attempted to define proportionality on the basis of other concepts including capriciousness, necessity and the degree to which a state measure changed the grounds on which an investor had operated. While subsequent tribunals "nodded" to the *Charanne* definition, it was not endorsed.

Mr. Bastin noted that the most recent case that started to elaborate on the notion of proportionality is *RWE v. Spain*, in which the test relied on (i) suitability to measure will be proportionate if it is suitable, i.e., there is a connection between the goal pursued by the state and the implemented measure) and (ii) necessity, which is a more demanding element requiring an analysis of whether there were any less restrictive means to achieve the same outcome.

Second, as to the determination of whether an indirect taking of property has resulted in breach of an expropriation provision, the tribunal in *Tecmed v. Mexico* confirmed that when there is an indirect taking, the measure that substantially imposes the burden on the asset, that measure needs to be proportionate to the public interest behind it. In turn – *third* –, precision of wrongfulness is determined on the basis of the concept of necessity, which found its direct place within investment arbitration (see Argentina cases related to the 2000's economic crisis).

Finally, proportionality in ISDS can be found in the assessment of countermeasures. In general international law, countermeasures are found in Article 51 of the draft articles on **Responsibility of States for Internationally Wrongful Acts** of. It provides for a number of criteria, including the notion of "commensurate". "Countermeasures must be commensurate with the injury suffered, taking into account the gravity of the internationally wrongful act and the rights in question." Commensurateness often requires proportionality (see *Corn Products v. Mexico*).

Proportionality and FET Analysis

Against this background, Lucas Bastin KC explained that proportionality fills a gap in the FET standard. In the early days of investment arbitration, arbitrators tried to clarify FET using both diagnostic tools (analytical tools that enable the determination of a breach of primary rule) and proxy rules (primary rules surrogating the content of FET). The usage of proportionality has been able to grow because it is a diagnostic tool and a method of analysis suitable to prove a breach. Therefore, diagnostic tools such as proportionality or legitimate expectations encourage a rigorous analysis of FET breaches.

Alexandra Underwood added that in the context of FET, proportionality provides a framework to distill cultural differences between arbitrators and agree how investor's rights should be balanced against the state's right to regulate. However, for the time being, tribunals have no uniformed practice to rely on in this regard.

Jackie McArthur illustrated how the typical steps of the proportionality analysis fit in the FET assessment. First, tribunals often identify the legitimate interests at stake. For instance, in *EDF v. Romania*), there was a public interest in harmonizing domestic laws with EU requirements. In this case, the tribunal assessed the extent to which the measure was suitable to achieve the examining contemporaneous legislative materials. Second, tribunals look for a connection between the measure and the public interest at stake. In **Watkins Holdings v. Spain**), the tribunal found that tariffs on wind energy played a marginal role in the public interest the state was said to be pursuing, and questioned the connection between the measure taken and the public interest pursued. Third and finally, tribunals attempt to balance the public interest and the harm caused.

Proportionality and Police Powers

Alexandra Underwood added that a key area in which proportionality can be used is the analysis of a state's police powers in expropriation cases. The police powers exception is found in Article 10(1) of the **Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens**), a provision in which tribunals refer to. In **Saluka v. Czech Republic**), the tribunal held that an uncompensated taking of property shall not be considered wrongful provided (i) it is not a clear and discriminatory deprivation of a law of the state; (ii) it is not the result of a violation of articles 6 or 8 of the Harvard Convention (denial of access to a tribunal and denial of hearing); (iii) is not an unreasonable departure from the principles of justice recognized in the principle legal systems in the world, and (iv) it is not an abuse of power depriving an alien of its property. Proportionality comes into the first step of the test. However, **Philip Morris v. Uruguay**) set up an alternative test. To avail itself from a police powers defence, the state measure must (i) *Assess Bona fide* for the purpose of protection of public welfare, (ii) non-discriminatory, and (iii) proportionate.

In most of the cases where a police powers defense is raised, tribunals have been able to dismiss it without assessing the proportionality element of the test. In Ms. Underwood's experience, the reasons for this defence's failure include, amongst others, making claims for reasons, *ex post* facto justifications of the measure, and lack of contemporaneous evidence.

Will the Giant of Proportionality Wake Up?

Lucas Bastin KC observed that investment arbitration is suffering a backlash that concerns, first and foremost, the FET standard. This reaction can be traced back to **Tecmed v. Mexico** ((see para 154), in which the tribunal portrayed the breach of the standard through a yes/no dichotomy. Although the proof that serves to a more nuanced existence can e.g., **Rumeen v. Italy**), Mr. Bastin regretted that the proportionality came into the picture "a little bit too late".

In this regard, the use of proportionality could have been an improvement in the early days of investment arbitration and FET breaches. It might already be too late in the current development of the system, as the backlash has happened and the consequences are unfolding. But all is not lost. Maybe, as a reaction to the backlash, we will see greater movement towards a balancing and nuanced analysis and the enhancement of diagnostic tools. Alexandra Underwood said that the greater use of a proportionality tool might contribute to ameliorating that concern as it measures states of the methodology under which their measures will be evaluated.

Arbitrators' Role in the Proportionality Assessment

Balancing public interests and individual rights is a complicated task. For Lucas Bastin KC, expecting arbitrators to manage proportionality may be too much. The type of experience needed is rather there in Strasbourg, where people are trained in human rights litigation and are able to understand concepts of public interest and the degree of deference that is afforded to a sovereign state. Arbitrators are currently not equipped to do so. Alexandra Underwood opined that counsel also played a key role in the application of proportionality as they could help arbitrators by providing them with the necessary analytical tools to deal with proportionality.

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