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"Legitimate Expectations" in the Vattenfall Case: At the Heart of the Debate over ISDS

Laura Yvonne Zielinski · Tuesday, January 10th, 2017

Criticism of the Investor State Dispute Settlement ("ISDS") system is common these days. Protesters demonstrate against "secretive tribunals of highly paid corporate lawyers" as which the mainstream media increasingly portray arbitral tribunals. ("Investor-state dispute settlement – the arbitration game", *The Economist*, 11 October 2014)

A Controversial Doctrine

Central to the general public's opposition to ISDS is the concept of legitimate expectations. The German magazine Der Spiegel, for instance, criticizes arbitral tribunals' broad interpretation of the concept to mean quasi-comprehensive insurance for investors. ("Schiedsgerichte – Die Kläger-Clique", *Spiegel Online*, 16 April 2016)

Rooted in domestic administrative law, the standard of legitimate expectations has been introduced into international investment law through the prism of good faith, (*Tecnicas Medioambientales Tecmed S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, 29 May 2003, para. 154) It "is now considered part of the [fair and equitable treatment (the "FET")] standard" and is "firmly rooted in arbitral practice". (*Crystallex International Corporation v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/11/2, Award, 4 April 2016, para. 546)

"[T]he concept of "legitimate expectations" relates […] to a situation where a Contracting Party's conduct creates reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the [Contracting] Party to honour those expectations could cause the investor (or investment) to suffer damages." (*International Thunderbird Gaming Corporation v. The United Mexican States*, Arbitral Award, 26 Janaury 2006, para. 147) Over time, the contours of the concept have been refined to take account, for example, of the socio-economic situation of the host State and of the investor's conduct. (*Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007)

Invoked in a Controversial Case

Opposition to ISDS is particularly vocal in Germany where it was sparked by popular outrage over *Vattenfall AB and others v. Federal Republic of Germany* (ICSID Case No. ARB/12/12), an investment arbitration proceeding brought under the Energy Charter Treaty. The Swedish company Vattenfall, together with others, is reportedly claiming €4.7 billion as compensation for losses allegedly suffered due to Germany's decision to shut down all nuclear energy production.

The companies claim that it is not so much the decision itself to stop the production of nuclear energy in Germany that caused their losses, but rather the unexpected political changes in this regard. In 2002, the governing Social Democrats and Green parties decided to phase-out all nuclear power plants but allocated limited nuclear energy production volumes to companies that these would still be allowed to produce. Subsequently, in 2010, Angela Merkel's government amended the Atomic Energy Act ("AEA") to postpone the shutdown and allocated additional energy volumes ("11th Amendment"). However, only a few months later, following the Fukushima disaster in March 2011, the same administration performed a political U-turn and enacted another amendment to the AEA ("13th Amendment") aiming to accelerate the phasing-out by imposing fixed shutdown dates for all nuclear reactors, irrespective of the remaining energy production volumes that had been allocated previously. To justify its decision, the government invoked the protection of public health and the environment.

Also in 2012, Vattenfall, RWE and E.ON. ("Energy Companies") challenged the same legislation before the German Federal Constitutional Court ("Court").

In a decision of 6 December 2016, further analyzed in a post by Nikos Lavranos previously published and available here, the Court dismissed the Energy Companies' expropriation claim, but held that Germany had violated their legitimate expectations.

Interpreted by the German Federal Constitutional Court

The Court held that the 13th Amendment to the AEA constituted a breach of *Vertrauensschutz* (Article 14(1) of the German Constitutional Law) – the domestic German equivalent of the protection of legitimate expectations – insofar as it did not provide for any transition periods or compensation for investments in nuclear power plants which declined in value following the 2011 reduction of the production volumes that had been allocated in 2010. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 369)

Article 14(1), under specific circumstances, protects legitimate expectations of stability of the legal framework as the basis of investments. It does not guarantee the fulfillment of all investment expectations, and does not generally provide protection against changes in the economic legal framework and resulting changes in the market position of an investor. It does, however, provide for compensation in cases in which the State directly prevents or substantially limits the use of investments undertaken in justified reliance on a specific legal framework. Nevertheless, the State has broad powers in determining how to compensate and is not obliged to spare investors from suffering any burden at all related to the changes. (BVerfG, Urteil des Ersten Senats, 6 December 2016, paras. 371 and 372)

Following the postponement of the phasing-out of nuclear power plants in 2010, the Energy Companies had legitimately expected their investments in the production of additional energy production volumes to be protected. Investments seemed to have been encouraged and it had not been foreseeable that the government would change its position again within the same legislative period. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 376)

However, the Court also stated that legitimate expectations could only have arisen during the period between the enactment of the 11th Amendment on 8 December 2010 and the letter of 16 March 2011 from the Federal Environmental Ministry announcing a nuclear moratorium. Legitimate expectations could have neither been created by the government's declaration of intent of 26 October 2009 to postpone the nuclear shutdown, nor by the presentation of the corresponding draft law of 28 September 2010. While the introduction of a draft law can destroy legitimate confidence in the continuing existence of a specific legal framework, it cannot create legitimate expectations of future changes. Compensable expectations can only arise once the parliament has passed a law. Consequently, the Court held that no legitimate expectations could continue to exist after the publication of the letter from the Federal Environmental Ministry of 16 March 2011, as this letter had clearly cast doubts on the government's continued willingness to support the nuclear energy industry. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 377)

Additionally, the Court held that the creation of legitimate expectations was not put into question by the fact that the constitutionality of the 11th Amendment to the AEA in 2010 had been disputed for years. The Court recalled that general discussions around the constitutionality of a law, outside of the Constitutional Court that is competent to decide on such matters, are common and therefore do not erode a law's function as the basis for legitimate expectations. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 378)

While the Court stated that the public interest justifications that motivated the enactment of the 13th Amendment to the AEA are of particular importance, they could not free the State from the consequences of the violation of the legitimate expectations it had itself created by enacting the 11th Amendment to the AEA. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 379)

Finally, the Court held that, while any detriment to the aim of the acceleration of the nuclear shutdown should have been avoided in compensating the Energy Companies' losses, the government's broad powers in determining the scope of compensatory measures would have been sufficient to provide a form of compensation that would not have endangered the aim behind the 13th Amendment to the AEA. (BVerfG, Urteil des Ersten Senats, 6 December 2016, para. 382)

Concluding Remarks

The Court's analysis of *Vertrauensschutz* contains interesting indications of what should and what should not be considered to create legitimate expectations in the investment context. Balancing the State's aim to protect the public interest and the investor's justified reliance on legal stability, it draws the line between mere political

statements and legal realities. Thus declarations of intent or draft laws cannot create legitimate expectations but laws passed by parliament can. Investors should not rely on simple controversies surrounding a law, but can legitimately base their investment decisions on a competent court's decision on a law's constitutionality. *Vertrauensschutz* cannot function as an insurance against all business risk, but the State should take investors' interests into account in changing the legal framework and should use its broad powers to provide for compensatory measures that do not sacrifice a law's public interest purpose.

As mentioned above and as recently held by the Crystallex tribunal, in international investment law, "protection of legitimate expectations under the FET standard [already] occurs under well-defined limits." (*Crystallex International Corporation v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/11/2, Award, 4 April 2016, para. 547) Nonetheless, the Court's use of and definition of the concept could further inform its content by way of reference to principles of law embodied in domestic legal systems. Such further delimitation of the concept of legitimate expectations through a comparative approach might contribute to renewed legitimacy of the FET standard, and thus of ISDS itself.

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