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The Role of Investor's Due Diligence in International Investment Law: Legitimate Expectations of Investors

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In interpreting one of the most contested investment treaty protection standards – fair and equitable treatment – arbitral tribunals have increasingly referred to the necessity for an investor to conduct a due diligence investigation before investing in a host state. Foreign investors have been required to assess not only commercial, but also general socio-political risks. The investor's due diligence in the context of the fair and equitable treatment standard (FET) goes beyond the risk-based business due diligence performed by a foreign investor for its own benefit. It has implications for a state's right to regulate in the public interest and also contributes to a broader notion of business responsibilities. This post elaborates on this issue.

An investor's due diligence and the fair and equitable treatment

A breach of the FET standard is one of the most frequent bases for investor-state dispute settlement (ISDS) claims. Presently, the protection of the legitimate expectations of an investor constitutes a central element of the FET standard. Under the concept of legitimate expectations in international investment law, states are required to maintain a certain degree of stability and predictability in their regulatory framework, which is relied upon by investors when making investments. Tribunals have considered there to be a breach of an investor's legitimate expectations where a host state makes substantial changes to the legal framework which result in serious financial losses being suffered by the investor.

In this regard, many states are concerned with their right to adopt and change their laws for public good, as these regulatory changes may trigger investment claims. Currently, a significant number of ISDS claims relate to state changes to renewable energy policies. Spain, Italy and the Czech Republic are among the respondent states that are currently facing investment claims because of alterations to their regulatory frameworks for renewable energy. In these cases, the investor's due diligence has been a significant factor in the assessment of the FET standard and the determination of a state's liability by investment tribunals.

The notion of investor due diligence in the context of FET extends beyond the risk-based business due diligence performed by a foreign investor for its own benefit. The investor's responsibility to conduct an investigation into a state's regulatory framework, as emphasised in numerous investment decisions, has an impact on a state's ability to regulate in the public interest. To what extent a state can change or adapt its laws and policies in the public interest without violating the FET standard depends on how tribunals balance the notion of stability against other factors, e.g. the investor's due diligence.

Tribunals have consistently held that an investor cannot expect the legal system to freeze. Laws always evolve and will always change. The challenge appears to lie in being able to pinpoint the extent to which a regulatory change is permissible under the FET standard.

To balance the obligation of stability, some tribunals, including in renewable energy cases, require an investor to exercise proper due diligence and to conduct a risk assessment when considering whether to invest in a host state. The threshold for the violation of the legitimate expectations is whether the state's contested regulatory changes were not foreseeable by a prudent investor. The extent to which regulatory changes will be deemed to have been foreseeable will depend on the form and content of due diligence and efforts undertaken by an investor to assess the risks of change.

The role of due diligence in the assessment of a FET claim

Tribunals differ regarding the role of due diligence in the overall assessment of an FET claim, and concerning the criteria used to assess the due diligence that must be conducted by an investor. In some cases, tribunals have held that exercising due diligence is a prerequisite for an investor to have its legitimate expectations protected under the FET standard. For example, in *Stadtwerke Munchen and others v. Spain (2019)*, the tribunal held that for an investor's expectation to be reasonable, it 'must also arise from a rigorous due diligence process carried out by the investor.' In *Antaris v. Czech Republic (2018)*, the tribunal denied the investor's claim for the protection of legitimate expectations, as there was 'no evidence of any real due diligence.' In *Belenergia v. Italy (2019)*, the tribunal found that the due diligence reports presented by the investor had not concerned the Italian regulatory risks in regard to the feed-in tariffs. A tribunal emphasised that a '"prudent" investor was required to examine Italian PV laws and regulations, which suggest a clear trend toward incentives' reduction.' Hence, the due diligence conducted by the investor was deemed insufficient.

However, in other awards, e.g. *SolEs Badajoz v. Spain (2019)*, *Cube Infrastructure v. Spain (2019)* and *Novenergia v. Spain (2018)* the role of an investor's due diligence has been limited in an overall appraisal of a breach of the FET standard. In *SolEs Badajoz v. Spain* and *Cube Infrastructure v. Spain*, the tribunals indicated that there was no requirement to conduct a formal due diligence process, such that this process was not considered to be a pre-condition to a successful claim for the protection of legitimate expectations. This being said, the tribunals nevertheless noted that some due diligence efforts are expected from an investor.

The form and extent of the due diligence required

There are also no specific criteria regarding what constitutes adequate due diligence for the purpose of a claim based on the instability of the regulatory framework. Only a few tribunals such as *Stadtwerke Munchen and others v. Spain (2019)* have accepted that some type of formal written legal advice about the potential impact of changes to the regulatory framework was necessary to constitute acceptable due diligence.

In other cases, sources such as general legal opinion not specifically directed at the analysis of disputed legislation, information from officials, or general knowledge about a regulatory framework were considered to be sufficient to meet the required level of due diligence. In *Foresight v. Spain (2018)*, the tribunal provided that a general legal advice from a law firm may constitute sufficient due diligence. In that case, the advice did not include a complete legal analysis of the Spanish regulatory framework, but the tribunal nonetheless found that the investor was kept informed about the legal developments by its law firm, it being 'reasonable for an investor to assume that its legal advisors would have raised a red flag had they detected any risk of fundamental change to the regulatory regime.'

In *Operafund Eco-Invest v. Spain (2019)*, the tribunal concluded that two legal opinions provided to a bank that loaned money to an investor were enough to constitute sufficient due diligence. Even though these legal opinions did not include an assessment of the risks related to the possible changes laid down in the measure at issue in that case (Article 44(3) of RD 661/2007), the tribunal came to the conclusion that the investor's due diligence was proper under the circumstances at the time of investment.

In some Spanish renewable energy cases, the judgments of the Spanish Supreme Court have played a role in the assessment of the investor's due diligence efforts. In referring to decisions of the Supreme Court, Spain argued that the changes to the renewable energy regime were predictable and that an investor could not expect more than a reasonable rate of return on its investment. In *Charanne v Spain*, *Isolux* v. *Spain* and *Stadtwerke Munchen and others v. Spain* tribunals concurred with Spain and stressed the relevance of some of the Supreme Court decisions in predicting regulatory changes in assessing the due diligence efforts by an investor. However, in some other cases, e.g. *OperaFund v. Spain* and *Cube v. Spain*, tribunals questioned the relevance of these judgments. A majority of the tribunal in *OperaFund v. Spain* asserted that 'judgments rendered before investment are not relevant for interpretation of Article 44(3) of RD 661/2007 and cannot be applied thereto by analogy.'

Conclusion

The notion of investor due diligence has evolved as one of the relevant considerations in assessment of an investor's legitimate expectations under the fair and equitable treatment obligation. Currently, as demonstrated by the case law discussed above, the requirements as to the form and content of due diligence are not clearly defined. The due diligence process is not a formal legal requirement. The central criterion for many tribunals in evaluating due diligence process is whether an investor has conducted an assessment of risks concerning a regulatory framework it relied on at the time of its investment. For several tribunals however, a due diligence report or opinion that did not contain an assessment of a disputed regulatory regime was still be accepted as evidence of adequate due diligence.

Divergence on the scope of the required due diligence observed in the jurisprudence creates uncertainty regarding the existence and the extent of an investor's responsibility to act with diligence while investing in a host state. This gap creates risks for opportunistic investment claims. This is particularly problematic for weak political regimes or economies in transition, where the possibilities of regulatory changes are very likely. A clarification in IIAs of the conditions for protection of investor's legitimate expectations including an investor's duty to conduct a due diligence can contribute to development of more consistent approach regarding the extent of the required due diligence.

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