LIMITING INVESTOR LEGITIMATE EXPECTATIONS IN FOREIGN INVESTMENT TO ENSURE STATE ECONOMIC SOVEREIGNTY

IMPLEMENTATIONS OF THE PRINCIPLE IN INDIAN METALS & FERRO ALLOYS (IMFA) V REPUBLIC OF INDONESIA

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ABSTRACT

The need of the foreign investment for the developing countries in modern times is increasing rapidly. In line with the increasing need for foreign investment, the potential for disputes between countries and foreign investors is even higher than ever before. The principle of legitimate expectations in foreign investment disputes is often used by transnational companies as a claim against losses which arise from changes in rules and regulations by the Host State. This principle is increasingly being used and creates anxiety to the Host State in creating its national regulations. The principle is sometimes limited explicitly in the international investment agreements at the bilateral level or regional level. There are a lot of debates among legal experts about whether this principle should be protected for the interests of foreign investors or not. Meanwhile in the arbitral practice, the use of this principle continues to develop through disputes and arbitral award. The decision of the arbitral tribunal is the key to the development of this principle in the arbitral practice. This research, by examining prior writings by legal experts, aims to elaborate a solution for the developing countries which are in need of foreign investment in order to avoid the anxiety in creating national regulations caused by the increase of legitimate expectations claims on the investment arbitration. The elaboration will be done with case study of the Indian Metals & Ferro Alloys v. the Republic of Indonesia (PCA case No. 2015-40). The case covers claim of violations of the legitimate expectations under the fair and equitable treatment standard.

Keywords: Arbitration, Investment Law, Investment Principle, Fair and Equitable Treatment, Legitimate Expectations.

BACKGROUNDS

The legitimate expectations principle back in the few years until now has been frequently invoked by claimant in the tribunal (Potestà, 2014), this raises the difficulty bar to a state when it creates its national regulations. It is an error to state that there is a general principle of law when a violation give rise to substantive remedies (Sornarajah, 2013). According to a research done by Sornarajah, this violation does not appear to be an issue in English law. It is unlikely that such a rule can be maintained in any system. This violation exactly happened and was developed in the recent ICSID cases which declared it to be a substantive rule, justifying the award of damages for its breach. The administration would become difficult if at each change of policy to suit new circumstances, the state had to pay damages to affected parties (Sornarajah, 2013).

Sornarajah defines that the precise use in the context of investment law is defined by the tribunal in International Thunderbird Gaming Corp. v Mexico as follows: *"the 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 to act in reliance on the said conduct, such that a failure by the Party to honor those expectations could cause the investor to suffer damages"*. However, it has not been used in this sense hitherto in international law. There are a few references to the idea of legitimate expectations in the literature of international law. It does not appear that these past references indicate the formulation of any particular legal principle (*Thunderbird Gaming Company V Mexico*, 2006; Sornarajah, 2013).

The lack of regulations to limit the legitimate expectations principle is a serious problem to a state because the principle is invoked in many cases of foreign investment dispute. The host state will have a rough passage to take benefit from foreign investment as a development tool, especially for developing states. In this case, Indonesia is not an exception. As a developing state, Indonesia is striving to promote foreign investments (direct or indirect) in order to increase the investment flow from foreign investors.

This reseacrh was done by examining prior researches and literatures by the legal experts, cases, books, and journals. Over the years, many researches have been done by legal experts or organizations concerning the principle of legitimate expectations. The book written by Professor Muthucumaraswamy Sornarajah covers various aspect of foreign investment law, including the principle of legitimate expectations. The book written by Professor Robert Thomas elaborates the principle of legitimate expectations in municipal administrative law as well as various kinds of journals, studies, and critiques about the principle of legitimate expectations.

A. LEGITIMATE EXPECTATIONS

Legitimate Expectations principle is a part under of the principles of fair and equitable treatment (Sornarajah, 2013). Even though the principle can be invoked in the context of indirect expropriation, it is under the fair and equitable treatment standard that legitimate expectations have enjoyed more prominence and a safer chance of success (Potestà, 2014). This shows that legitimate expectations have a strong relation with fair and equitable treatment standard in the arbitral practice, particularly in the international investment field (Potestà, 2014). Legitimate Expectations are believed to originate from the national legal system and this is a general principle of law (F. Orrego Vicuña in Sornarajah, 2013). The main purpose of protecting these legitimate expectations is to enable foreign investors to make rational business decisions based on the circumstances of the host state (Schreuer & Kriebaum, 2009).

1. THE ORIGIN OF LEGITIMATE EXPECTATIONS PRINCIPLE

Outside the international investment law, the possible origin of these legitimate expectations is that they are developed in administrative law. Robert Thomas stated *"the principle of legitimate expectations concerns the relationship between public administration and the individual. It seeks to resolve the basic conflict between the desire to protect the individual's confidence in expectations raised by administrative conduct and the need for administrators to pursue changing policy objectives. The principle therefore concerns the degree to which an individual's expectations may be safeguarded in the face of a change of policy which tends to undermine them. The role of the administrative court is to determine the extent to which the individual's expectation can be accommodated within changing policy objectives"*(Thomas, 2000).

The development of legitimate expectations can be traced back in the civil law and common law systems. In the civil law system, the European Court of Justice has included legitimate expectations in its review of legality since 1970 and recognized legitimate expectations as parts of the legal community order. This principle is inspired by a *"Vertrauensschutz"* (German) principle which means "the protection of trust". The principle of legitimate expectations is used to ensure that the administration achieves its objectives while, as far as possible, protecting the individual's expectations. By using law as a means of administration, a balance is achieved between the public interest and the individual's expectations (Thomas, 2000).

The complete illustration of legitimate expectations is provided by the *Mulder case* (*Mulder v. Minister van Landbouw en Visserij*, 1988). At the time Europe was suffering for surplus milk productions, the government in 1977 adopted measures to resolve this problem. Furthermore, these regulations introduced "co-responsibility levy" for all milk processing. These measures did not solve the problems and the government took stricter measures in 1984 by introducing "super levy" on top of the "co-responsibility levy". This levy was imposed to milk producers when the milk deliveries exceeded a "reference quantity". The reference quantity was calculated from the basis of milk productions in the previous year (Thomas, 2000).

In *Mulder case*, the applicant was a Dutch farmer who had made an undertaking in 1979 to cease milk production for five years following the government regulations in 1977. Towards the end of this period, he intended to resume production and applied for a reference quantity. However, this was refused because he did not produce any milk in the reference year, 1983. He had missed out on a reference quantity because he had suspended production following the non-marketing undertaking. The applicant claimed that the reference quantity scheme violated his legitimate expectations. When he agreed to suspend production in 1979 it was unforeseeable that he would not be awarded a reference quantity since the system was not introduced until 1984 (Thomas, 2000).

The court invalidated the regulation as it breached the producer's legitimate expectations. The expectation was that the ability of the producer to resume production would not be restricted because he had made the undertaking. The case demonstrates the European Court's concern that policy objectives are implemented fairly and equitably. Legitimate expectations compel the administration to be trustworthy since an individual may have little choice and rely upon government conduct (Thomas, 2000).

In English law, the modern origins of the phrase stem from its use by Lord Denning M.R. in *Schmidt v.Secretary of State for Home Affairs*. As Robert stated in English law, this case is cited quite often as the foundations of legitimate expectations. In Schmidt's case, the phrase "legitimate expectations" by Lord Denning's use has a quite different meaning in European law. The phrase legitimate expectations in this case was intended to give further procedural protection to the applicant if his permits had been revoked before expiry. However, the Schmidt's case is considered by experts to be unclear since the procedural protection basis in English law is applicant interest. Another case cited as support of legitimate expectations is the Liverpool Taxi's case. However, it is submitted that the development of the principle from the early 1980s onwards has been influenced in part by the existence of the same principle as interpreted in European law. In 1977, Lord Diplock acknowledged the need to assimilate the European principle into English law (Hansard H.L in Thomas, 2000).

In the international investment, the principle is quite the same. It requires the host state to act properly in creating its regulations. It requires that regulation to be trustworthy and as much as possible protect an investor's interest while exercising public interest through regulations. Sornarajah explained that there were two possible bases for the origin of the notion of legitimate expectations in international investment law. One of them was in the idea of good faith. The awards in *Tecmed* and *Thunderbird v. Mexico* find the origin of legitimate expectations in good faith. However, this does not seem plausible since finding bad faith in investment law is difficult even if the host state had applied its own law incorrectly. In the end, he considered that the good faith origins did not provide a credible explanation of the 'legitimate expectations' term (Sornarajah, 2015).

2. THE ELEMENT OF LEGITIMATE EXPECTATIONS

According to a research done by researcher, the elements of the legitimate expectations principle in foreign direct investment are:

- **a.** Arise from administrative conduct; (Thomas, 2000).
- **b.** The expectations come from administrative conduct by the Host State; (Sornarajah, 2013).
- **c.** It can be derived from contractual commitment, unilateral promise, and legislations; (Palombino, 2017).
- **d.** Legitimate expectations provide only procedural protection; (Sornarajah, 2013).
- **e.** Legitimate expectations should not be violated unless a hearing is given to the person who has those expectations; (Sornarajah, 2013).

3. REQUIREMENT TO THE LEGITIMATE EXPECTATIONS IN ORDER TO BE CONSIDERED AS LEGITIMATE

The principle of legitimate expectations needs to fulfill some “requirements” before it is considered as legitimate:

- **a.** Objective terms, the investor is required to take into account all circumstances. These include the political, socioeconomic, cultural, and historical conditions that exist in the host state (Palombino, 2017).
- **b.** Subjective terms, the expectations of the investor are required to not be conflicted with other knowledge that the individual has about the law and/or the representation made by the host state (Tellez in Palombino, 2017). This will prevent different interpretation about the law and regulations that prevail in the host state by the investors.

THE CASE

Indian Metals & Ferro Alloys v. The Government of the Republic of Indonesia (*PCA Case No. 2015-40 Indian Metals & Ferro Alloys (IMFA) v. The Government of Republic Indonesia*, 2015), An Indian company, Indian Metals & Ferro Alloys Limited (hereinafter referred as IMFA) through its sub-subsidiary, Indmet Mining Pte. Ltd. Singapore signed a term sheet to acquire 70% shares of PT. SRI on September 18, 2009, with a value of USD 8.75 million. Indmet Mining Pte Ltd. Singapore on June 7, 2010 signed a share purchase contract with PT. SRI until the acquisition process was completed on October 27, 2010 and the final payment was made on November 4, 2010.

One year before PT. SRI’s share was purchased by IMFA, East Barito Regent on December 31, 2009, issued the production of IUP (*Izin Usaha Pertambangan*) No. 569 of 2009 for PT. SRI with an area of 3,674 Ha with a validity period of ten years and it could also be renewed twice as effective as of December 8, 2009.

As foreign corporations own a large portion of PT. SRI's shares, PT.SRI submitted a request for conversion of status to a PMA (*Penanaman Modal Asing*) company on August 5, 2010. Therefore, the Investment Coordinating Board of the Republic of Indonesia or BKPM (*Badan Koordinasi Penanaman Modal*) determined that PT. SRI was a PMA company on August 10, 2010. IMFA later found that PT.SRI's IUP apparently overlapped with another company's IUP. IMFA went to the Minister of Energy and Mineral Resources and obtained a map of its concession permit showing that most of PT. SRI's IUPs were outside the area of East Barito and outside the Central Kalimantan Province. The map also showed that PT. SRI's IUP area overlapped with six other companies' IUPs. Later in October 2013, IMFA again found that PT. SRI's IUP overlapped with another mining company, making the total to seven companies.

According to the government of Indonesia, by 2011, the problem of overlapping mining concessions was a common well known problem. This problem has happened since the beginning of Indonesia’s attempt to decentralise the authority in 1999. Therefore in May 2011, the Minister of Energy and Mineral Resources obtained data from various regions in Indonesia and announced that of 8,475 IUPs which were issued pursuant on Law No. 4 of 2009 (Law No. 4 of 2009 Concerning Mineral Mining and Coal, 2009), there were only 3,971 IUPs declared as "Clean and Clear" while the remaining 4,504 were not. The Ministry has also published a list of companies that have obtained Clean and Clear IUPs and their criteria on the official website of the Ministry of Energy and Mineral Resources. To be categorized as Clean and Clear, an IUP may not overlap and is valid for those issued before May 1, 2010.

Later in 2015, Minister of Energy and Mineral Resources issued a regulation (Minister of Energy and Mineral Resources Regulation No. 43 of 2015), stating that there was a provision that every company IUP was required to be Clean and Clear, and therefore the IUP owned by PT. SRI could not be used. This situation made IMFA suffer damages. IMFA claimed that Indonesia had violated legitimate expectations under the standard of fair and equitable treatment due to systemic failures, mistakes, and errors in providing mining concessions to investors by the government, as well as the Government Regulation number 24 of 2012 in particular to the divestiture regulations.

Regarding the issue of what state’s conduct constitutes a breach of the standard of fair and equitable treatment, while the tribunal agrees with the tribunal on the *Crystallex International Corporation v. Venezuela* case that *“the state’s conduct needs not be outrageous or amount to bad faith to breach the fair and equitable treatment standard”*, it is important to note that not every inconsistency or lack of transparency of the host state will automatically result in the breach of the standard of fair and equitable treatment. The tribunal notes with agreement based on the conclusion reached by the tribunal in the *Joseph C. Lemire v. Ukraine* case regarding the content of the standard of fair and equitable treatment.

The Clean and Clear regulation considered by tribunal did not violate the standard of fair and equitable treatment, as Sornarajah said in his view, the problem of overlapping licenses was already known when the Claimant made its investment, which could only be described as a useless investment in light of the overlapping licenses. Therefore, the Claimant could not have had any legitimate expectations in the context of the standard of fair and equitable treatment obligation and the Claimant could not complain as to how the problem of overlapping licenses was dealt with by the Respondent.

The tribunal then concerned about divestiture regulations (Government Regulation No. 24 of 2012) in the absence of a contractual stabilization clause or an express commitment by the Respondent and the Claimant could not have had any legitimate expectations that the laws of Indonesia would remain exactly the same throughout the life of its investment. In any event, the effect of Government Regulation No. 24 of 2012 would not operate until after five years of coal production. Furthermore, the regulation was provided for a sliding scale for the next five years and therefore would not reach full effect for ten years and in any event compensation was provided for. Therefore, the tribunal concluded that the Respondent did not breach the fair and equitable treatment standard as elaborated in Articles 3 (2) and 4 (1) of the BIT (Bilateral Investment Treaty of India-Indonesia, 1998) and with the rejection of fair and equitable treatment standard, the claim of legitimate expectations was also rejected by the tribunal.

1. ANALYSIS

a. AN INDIRECT INVESTMENT

IMFA case is an indirect investment. It can be seen from the purchase of share done by the sub-subsidiary of IMFA to PT. SRI. Sornarajah gave a clear definition and differences between foreign direct investment and foreign indirect investment,*"Foreign investment involves the transfer of tangible or intangible assets from one country to another for the purpose of their use to generate wealth under the total or partial control of the owner of the assets".* This direct investment is in contrast to the indirect investment which, *"… Normally represented by a movement of money for the purpose of buying movement of money for the purpose of buying shares in a company formed or functioning in another country. It could also include other security instruments through which capital is raised for ventures. The distinguishing element is that, in portfolio investment, there is a separation between, on the one hand, management and control of the company and, on the other, the share of ownership in it"* (Sornarajah, 2013).

b. COVERED BY THE BIT

IMFA investment in Indonesia is covered by the BIT between India-Indonesia. The tribunal stated that this was the result of a very broad meaning of investment in the BIT (*PCA Case No. 2015-40 Indian Metals & Ferro Alloys (IMFA) v The Government of Republic Indonesia 2019.*, 2015). Similar wording in the BIT can be found in Netherlands-Venezuela BIT (Bilateral Investment Treaty of the Kingdom of Netherlands-Venezuela, 1991), both of those BITs include "every kind of asset" in the scope of their investment protection. In the Venezuela Holdings B.V. (*Mobil Corporation, et al. v. Bolivarian Republic of Venezuela Decision on Jurisdiction*, 2010) the tribunal considered that the investment of the claimants were covered by the Netherlands-Venezuela BIT due to a very broad meaning in describing the scope of investment.

JEOPARDIZING THE ECONOMIC SOVEREIGNTY OF THE STATE

The increasing number of legitimate expectations invoked by claimant in the investment arbitration is dangerous to the host state because investors have the rights to be protected but on the other hand, the host state has sovereignty, economic sovereignty in particular. As Sornarajah stated above, it is an error to state that there is a general principle of law that violations of legitimate expectations give rise to substantive remedies and administration would become difficult to the state (Sornarajah, 2013). States are able to use and regulate foreign investment for development tool and if an unqualified endorsement of protection by the tribunal of the principle arises, it will be counterproductive to the states (Hodu, 2013).

As a sovereign state, Indonesia has the right to create its national regulations, including in the economic field. Sovereignty in creating economic regulations both internally and externally is regulated in the Charter of Economic Rights and Duty of the States (CERDS). The state has an obligation to protect and promote the prosperity of its people through good economic regulation in harmony with the situation. Article 2 (2) (a) provides this protection for the state (Charter of Economic Rights and Duties of States, 1974).

The charter is apparently considered no longer binding by developed countries, primarily for the countries that did not support the charter at the time it was formed. The lack of support and recognition from developed countries rendered CERDS charter only a mere declaration. In *Texaco case,* the state invoked the CERDS article was not endorsed by the tribunal (*TEXACO Overseas Petroleum Co. v. Libyan Arab Republic*, 1977).

Today, CERDS is considered "dead" among the international communities. Western experts no longer study or consider CERDS in their research. However, it cannot be said that way. Huala Adolf stated that; *first*, the UN as the organization that established CERDS had never stated or stipulated or decided that the CERDS charter was no longer valid or invalidated. *Second*, the CERDS charter served as a philosophical basis for other conventions, for example, it was included in the preamble of the United Nations Convention on Contracts for the International Sale of Goods (CISG). *Third*, the UN in various sessions often cited or included the CERDS charter as one of the important components for making policies or comparisons (Adolf, 2011). CERDS retains the traditional territorial aspects of sovereignty (Waller & Simon, 1985). Therefore, it should be taken into consideration in protecting state economic sovereignty.

The *Charanne B.V.* case, where the change of economic regime rendered investor to suffer damages and claim for violation of their legitimate expectations (*Charanne B.V. & Construction Investments S.A.R.L. v Spain*, 2016), the changing of economic regime was something that could not be guaranteed to be very stable by a state as the government changed. Another illustration was shown in *Parkering-Compagniet AS* case, where the claimant claimed that the instability of the host state had violated his legitimate expectations. (*Parkerings-Compaginet AS v. Republic of Lithuania*, 2007).

Indonesia also encountered a similar problem. As the new order (*Orde Baru*) fell over, Indonesia struggled from severe economic and monetary problems. The reformation era rose and put a lot of efforts in almost every section of the state to remedy the losses. One of those efforts is establishing a bilateral investment treaty with another state to promote foreign direct investment. Indonesia tended to rush the establishment of a bilateral investment treaty at the time, resulting in the lack of safeguard provision for Indonesia itself. An additional problem also occurred. As the reformation era went on, the government made changes of regulations that had a tremendous impact on foreign investors, leading them to claim for damages. Indonesia's attempt to resolve overlapping licenses in IMFA case is an example of it.

HOW TO OVERCOME

1. LIMITATION OF THE LEGITIMATE EXPECTATIONS THROUGH INTERNATIONAL INVESTMENT AGREEMENT (IIA)

Bilateral Investment Treaty (hereinafter: BIT), or investment agreement between two countries, was formed to protect transnational companies yearning to invest between the two BITs-forming countries. According to Sornarajah, massive development of the BITs was in the 1990s. Even, the World Bank examined that there were 700 BITs made in 1994 (Sornarajah, 2013) and up to more than 3000 BITs in 2016 (Dixon et al., 2016).

The states create BIT because they consider that it is important for a number of reasons, primarily to promote the flow of foreign investment in their countries (Sornarajah, 2013). Although BITs are made between states, the scope of BIT has a different dimension, in which the subject of the BIT is the investor between BIT-making states (United Nations Conference on Trade and Development, 2007). It is said that BIT in the perspective of developing countries is "trading sovereignty for credibility" (Neumayer, 2005). The state sovereignty in dealing with foreign investors is not the same as the state sovereignty in a pure sense anymore, yet it needs to be a little "sacrificed" to gain the trust of the foreign investors (Louis Henkin in Adolf, 2011).

The role of BIT is crucial in dispute resolution between parties in international investment. Therefore, the creation of a BIT between two states must be clear and detailed to the articles regarding fair and equitable treatment and its limits. In some cases, the fair and equitable treatment was completely avoided by the parties. For example, Southern Africa Development Community (SADC) Model BIT chose for "fair administrative treatment" rather than the "fair and equitable treatment" in which legitimate expectations derived article 5 (a)(2) at p. 23 (SADC, 2012). Consequently, if for some reasons, expected returns from an investment are not realized or an investment is completely wiped out as a result of political upheaval, economic instability, or host government measures to stabilize the economy, then it will be unrealistic from a developing country perspective for an investment to rely on legitimate expectations (Hodu, 2013).

2. LIMITATION OF THE LEGITIMATE EXPECTAIONS THROUGH THE FAIR AND EQUITABLE TREATMENT STANDARD

The legitimate expectations in the present-day have arguably gone too far to embody the general principle under the fair and equitable treatment standard (Palombino, 2017). The principle tends to succeed under the fair and equitable treatment standard (Potestà, 2014). Therefore, limiting the fair and equitable treatment standard into a certain scope will affect the application of legitimate expectations by investors. NAFTA seems to have another solution to overcome the fair and equitable treatment standard "problem" on investment dispute. The article 1105 (1) of NAFTA agreement(North American Free Trade Agreement, 1994) gives limitation to FET standard as a minimum standard of treatment. This provision is already known by international society. Over the years, many awards have been done through this provision and the application keeps being contention in investor-state dispute (Kläger, 2011). The development through FTC Note also came in later in the NAFTA award concerning the fair and equitable treatment standard, for instance in *Metalclad Corporation v. Mexico,* the tribunal did not elaborate on the debate concerning the fair and equitable treatment standard and the Minimum Standard of Treatment. Tribunal preferred to define the standard by another method and referred to the preamble and article 102 (1) and chapter 18 of NAFTA was particularly appreciated by the tribunal as an important objective of NAFTA. The Metalclad tribunal thus incorporated the obligation to ensure transparency, as laid down elsewhere in the agreement, into the concept of fair and equitable treatment (Kläger, 2011).

CONCLUSION

The principle of legitimate expectations under the fair and equitable treatment keeps developing through cases as the international investment goes on. Still, the scope of legitimate expectations remains unsettled. Some efforts come from regional areas in Bilateral Investment Treaty and cases to try to limit or set the scope of legitimate expectations in order to avoid anxiety by the host state but it still endeavors to provide fair protection for the investors.

The claim for violation of the legitimate expectations principle from IMFA to the Republic of Indonesia was not endorsed by the tribunal. This was the result of the investor's failure to consider all circumstances which prevailed in Indonesia before making investment. The case illustrated that the legitimate expectations was frequently invoked by investors. Providing a clear limitation of fair and equitable treatment and legitimate expectations by a developing country such as Indonesia is necessary and should be taken into priority in the making of contract with other states or foreign investors.

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