The Dichotomy between the Host State’s Non-Compensable Regulatory Measures and Indirect Expropriation in International Investment Law

Submitted to
School of Law

in Partial Fulfillment of the Requirements for the Degree of Doctor of Juridical Science (JSD)

by

ZHAO Sining

May 2015
ABSTRACT

The conflict, between a sovereign State’s right to regulate its domestic matters and its responsibilities for unfairly interfering with foreign investment, has always been a major concern of international investment law.

While State regulatory measures are commonly enforced for social, environmental, economic, and/or other reasons, such measures are universally accepted as a part of State sovereignty, they may, in various ways, adversely affect the interests of foreign investment. It has already been established that once State interference is involved, a specific State measure may be found liable for compensation even without any transfer of legal title from the individual to the State, but the question of how to accurately distinguish such compensable State interference from a State’s general (and non-compensable) exercise of its regulatory power remains.

In this context, how to distinguish a non-compensable State regulation from a compensable exercise of State regulatory power is an issue that has been widely and intensely debated over the past decades; unfortunately, there is still no principled formulation for conclusively resolving this issue. One particular type of State measure – indirect expropriation - will be
emphasized in this thesis with the purpose of drawing a fair line between it and a State’s exercise of non-compensable regulatory power. Against this background, the main task of this thesis is to elaborate on how to distinguish these two kinds of measures from each other and how to identify the appropriate means for accomplishing that purpose.
TABLE OF CONTENTS

INTRODUCTION ................................................................. 1

Chapter I. State Sovereignty: State’s Power to Regulate ................. 10

1.1 State Sovereignty as the Cornerstone in International Law .......... 10

1.1.1 Territorial Sovereignty Connotes the Ultimate Power of the State in its Jurisdiction ..................................................... 13

1.1.2 State’s Power to Regulate under Sovereignty ...................... 18

1.2 State’s Sovereign Power to Regulate Foreign Investment .......... 23

1.2.1 General and Non-Compensable Regulatory Power: Supervision and Administration .................................................. 23

1.2.2 Specific and Compensable Regulatory Power: Nationalization and Expropriation .................................................... 29

Chapter II. Limitations and Responsibilities associated with Host State’s Power to Regulate Foreign Investment .................... 37

2.1 Limited by Applicable Legal Framework: Substantive and Procedural Limitations ......................................................... 40

2.1.1 Substantive Limitations: What Law to be Followed? ............. 41

2.1.1.1 National Laws and Regulations should be Obeyed ............ 41

2.1.1.2 International Law has to be Respected .............................. 43

2.1.1.3 National Law Applied Alongside International Law to Determine Host State’s Liability ........................................... 46
2.1.2 Procedural Limitations: At What Forum to Claim? ........................................ 48

2.1.2.1 National Jurisdiction as an Expression of Sovereignty ............ 49

2.1.2.1.1 The Territorial Principle of Jurisdiction is the Key ............. 51

2.1.2.1.2 Nationality Principle of Jurisdiction Neutralized by State Immunity ................................................................. 52

2.1.2.1.3 Calvo Doctrine and Clause ....................................... 53

2.1.2.2 Modern Treaty Practice vs. Sovereignty: International Tribunals are Accessible for Seeking Redress .......................... 56

2.1.2.2.1 Elevated Claims to International Investment Arbitration through ‘Consent’ .................................................... 57

2.1.2.2.2 Mixed Jurisdictions: Exhaustion of Local Remedies Rule Applied as Precondition for Accessing to International Investment Arbitration ............................................. 62

2.2 The State’s International Responsibilities in Regulating Foreign Investment .................................................................................................................. 68

2.2.1 The Responsibility for General Supervisory and Administrative Measures: A Brief Introduction ............................................................... 68

2.2.1.1 Minimum Standard of Treatment in Customary International Law .............................................................................. 69

2.2.1.2 Modern Treaty–Based Treatments ....................................... 72

2.2.2 The Responsibility for Nationalization and Expropriation: Legality Requirement ......................................................................................... 84

2.2.2.1 Public Purpose .................................................................. 85

2.2.2.2 Nondiscrimination ................................................................ 87
Chapter III. Between Right and Wrong: Tension between the State’s Power to Regulate and Expropriation (Indirect) Claims

3.1 Simplified Provisions vs. Diversified Reality

3.2 Unreconciled Arbitral Decisions vs. Expected Legal Consistency, Predictability and Stability

3.3 The Cause of this Problematic Situation: Unclarified Boundary between Non-Compensable State Regulatory Measures and Indirect Expropriation

Chapter IV. Forms of Expropriation in Practice and Their Legal Definitions

4.1 Recognizing Expropriation in its Distinctive Forms

4.1.1 Direct (or Formal) Expropriation

4.1.2 Indirect Expropriation: Expansionary Trend of Traditional Expropriation

4.1.2.1 De Facto Expropriation

4.1.2.2 Creeping Expropriation

4.1.2.3 Consequential Expropriation

4.2 Recognizing Expropriation by its Legal Definitions

4.2.1 State Practice in Recognizing Indirect
Chapter V. Competing Doctrines in Determining Indirect Expropriation: Legal Definition Demands Practical Guidance........ 176

5.1 Police Power Doctrine: Protecting the Host State’s Power to Regulate.................................................... 176

  5.1.1 Recognized by International Practice................................. 177

  5.1.2 Problematic Situation of the Police Power Doctrine in International Investment Law................................. 181

    5.1.2.1 Undefined Scope of Police Power................................. 181
5.4.1.1 *Azurix Corp. v The Argentine Republic* ........................................ 233

5.4.1.2 *Metalclad Corporation v The United Mexican States* .............. 236

5.4.1.3 *Marvin Roy Feldman Karpa v United Mexican States* ............ 238

5.4.2 Summary ................................................................................... 245

Chapter VI. The Proposed Approach: Identification and Suggestion.. 249

6.1 Purpose of the State’s Measure .................................................... 250

6.1.1 Nonactions and Omissions of the Host State ............................ 253

6.1.2 Enriching the Host State .......................................................... 256

6.1.3 Deliberate Targeting at the Investor ........................................ 259

6.1.4 Promoting General Welfare ..................................................... 262

6.1.4.1 Regulating Public Order ....................................................... 264

6.1.4.2 Protecting Human Health and the Environment ................... 265

6.1.4.3 Regulating Taxation ............................................................ 270

6.2 Degree of Interference with Investor’s Property Rights ............... 275

6.2.1 Severity of the Economic Impact ............................................. 276

6.2.1.1 Arbitration Practice in Indirect Expropriation Cases ......... 280

6.2.2 Duration of the Interference .................................................... 287

6.2.2.1 Arbitration Practice in Indirect Expropriation Cases ......... 287

6.3 Proportionality Test ................................................................. 292

6.3.1 Proportionality and International Investment Law .................. 293
6.3.2 Proportionality: Standard Criteria

6.3.2.1 Suitability

6.3.2.2 Necessity

6.3.2.3 Proportionality Stricto Sensu

6.3.2.4 Summary

6.3.3 Arbitration Practice of the Proportionality Test in Indirect Expropriation Cases

6.4 Legitimate Expectations of Foreign Investors

6.4.1 Legitimate Expectations and International Investment Law

6.4.2 Legitimate Expectations: Standard Criteria

6.4.2.1 Criteria for the Investor

6.4.2.2 Criteria for the Host State

6.4.2.2.1 Specific Representation and Assurance

6.4.2.2.2 Contractual Commitment or License

6.4.2.2.3 General Administrative Regulation and Amendment of Law

6.4.3 Arbitration Practice of Legitimate Expectations in Indirect Expropriation Cases

6.5 Other Considerations: Transparency, Nonarbitrariness, Nondiscrimination, Due Process and Denial of Justice

6.5.1 Other Considerations and International Investment Law

6.5.2 Standard Criteria for Other Considerations
6.5.2.1 Nondiscrimination............................................. 347
6.5.2.2 Due Process..................................................... 350
6.5.2.3 Nonarbitrariness.............................................. 352
6.5.2.4 Denial of Justice.............................................. 353
6.5.2.5 Transparency............................................... 355

6.5.3 Arbitration Practice of Other Considerations in Indirect Expropriation Cases................................................ 359

CONCLUSION............................................................... 366

BIBLIOGRAPHY............................................................. 379