CITY UNIVERSITY OF HONG KONG
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The Dichotomy between the Host State's Non-Compensable Regulatory Measures and Indirect Expropriation in International Investment Law
論國際投資法中東道國的非補償性管制措施和間接征收的劃分

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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.

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LIST OF ABBREVIATIONS

AUSFTA	Australia-US Free Trade Agreement
ASEAN	Association of South East Asian Nations
BIT	Bilateral Investment Treaty
CERDS	United Nations General Assembly Resolution 3281 (XXIX) Charter of Economic Rights and Duties of States
CUP	Cambridge University Press
DSB	Dispute Settlement Body
ECtHR	European Court of Human Rights
EU	European Union
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICC	International Chamber of Commerce

ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes
IIA	International Investment Agreement
IISD	International Institute for Sustainable Development
ILA	International Law Association
ILC	International Law Commission
MAI	Draft Multilateral Agreement on Investment
MFN	Most-Favored-Nation
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North American Free Trade Agreement
NIEO	United Nations General Assembly Resolution 3201 (S-VI) Declaration on the Establishment of a New International Economic Order
OECD	Organization for Economic Co-operation and Development
OUP	Oxford University Press
PCA	Permanent Court of Arbitration

PCIJ	Permanent Court of International Justice
PRC	People's Republic of China
SPS	Sanitary and Phytosanitary
UK	United Kingdom
UN	United Nations
UNCITRAL	United Nations Commissions on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organization

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INTRODUCTION

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. 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.

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 thesis, one particular type of State measure will be emphasized with the purpose of drawing a fair line between it and a State's exercise of non-compensable regulatory power. This measure is a type of expropriation, but it

has its own unique way of interfering with foreign investment; such interference is indirect and can be described as regulatory, constructive, consequential, disguised, *de facto*, or creeping expropriation. However, whatever mask this measure wears, its occurrence has actual influences that adversely affect foreign property and thus needs to be compensated.

Apparently, both the State's non-compensable regulatory measures and indirect expropriation are rooted in the concept of State sovereignty: this means that the host State exercises both. Exercised by the same types of individuals and through the same channels (e.g. administrative, legislative, or judicial) to materialize sovereign power, these two kinds of measures are easily mixed up in some situations.

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.

To gain a general picture of this subject, several issues need to be raised before we move on to the main body of the thesis. These questions are as follows: 1) What are the natures of these two kinds of measures? 2) What are their characteristics? 3) What does the applicable law say on this issue (i.e. the legal definitions of the two types of measures)? 4) What are the legal responsibilities

regarding these two kinds of measures? Is there any difference between the two in this regard? 5) What makes this a hot issue in international investment law? 6) Why are these two types of measures difficult to distinguish? 7) What existing methods can be applied to draw a line between them? 8) What are the criteria for determining these methods? 9) Is there any method that can reconcile the chaos in international investment law regarding this issue? 10) Is this method feasible, reasonable, and practical? 11) Does this method make any academic or practical contributions to the field of international investment law?

Each of the above questions will be given a comprehensive answer that is as in-depth and detailed as possible. A well-measured balance of interests between the State and the foreign investor is the key to drawing a fair line between the two types of measures and to answering the above-listed questions. In this regard, the rules and principles on indirect expropriation should not diminish or alter to any degree the ability of host States to regulate in the public interest; at the same time, and even more importantly, State regulatory measures must not be used as a disguised mechanism for expropriating foreign property.

The current situation is that although most international investment treaties (IIAs) and free trade agreements (FTAs) do contain expropriation provisions covering indirect expropriation implicitly or clauses with similar effects, the language in these documents is vague and open-ended. In reality, international courts and

tribunals have to determine the scope of these provisions on the basis of general rules of international law. Therefore, in order to conduct this research on a concrete and solid theoretical and practical basis, a range of research methods were adopted in order to make the research meaningful and valuable. Library-based research was important in finding the fundamental materials which form the foundation of this thesis. It is necessary to note that the general conceptual framework regarding indirect expropriation is grounded on customary international law and can be well framed by a number of treaties and arbitral awards, and so a wide range of treaties and arbitral decisions had to be located, classified, and reviewed using this research method. Comparative study is widely used in this thesis. A comparison of the approaches taken by different international arbitral tribunals in determining indirect expropriation and references to the experience of various jurisdictions allow us to obtain a comprehensive understanding of the similarities and differences of relevant theories in order to set the boundaries of the host State's regulatory power and to find out in what circumstances foreign investors could claim that the wrongs of host States violated their legitimate rights and interests. Last but not least, in order to support my arguments and strengthen the analysis, the case study approach is used throughout the thesis. The arbitral decisions are of great importance in finding the doctrines adopted in determining the occurrence of indirect expropriation, especially those factors that have been proved useful in the determination process. More importantly, they form the basis for establishing

the criteria standards for those factors necessary for identifying indirect expropriation.

This thesis is divided into six chapters. The first two chapters outline the legal basis of my research, which is rooted in the concept of State sovereignty and its corresponding limitations and responsibilities in accordance with international law. In international law, conflicts exist when (a) the host State has permanent sovereignty over its natural resources and all of its national economic activities but has an international responsibility with regard to injury to aliens; (b) the host State has the right to regulate in accordance with the Charter of Economic Rights and Duties of States but simultaneously has imposed on it the limitations and compensation requirements regarding increasing the threshold for enforcing such rights; (c) the host State is not only required to obey its domestic laws and regulations but also international standards of treatment in regulating foreign investments; (d) the host State is pursuing its own public policies but is alleged to have frustrated the legitimate expectations of foreign investors; and (e) investment disputes that should be resolved in the national tribunals of the host State are instead brought to an international arbitral tribunal by the investors to seek redress.

Chapters 3 and 4 identify the existing conflicts in international expropriation jurisprudence regarding the determination of the occurrence of indirect expropriation and the causes of these conflicts.

It is commonly recognized that the right of States to expropriate is a fundamental right, but putting such a right into practice always triggers disagreements. A direct taking, meaning the transfer of title and the outright seizure of property, is relatively easy to determine. However, an indirect taking is always confusing because a physical taking may not be necessary to determine that an indirect taking has occurred as long the taking deprives the property owner of the property's economic value, the right to manage the property, or the meaningful use of the property.

While the law defines the issue of indirect expropriation in a vague and general way, the reality is much more complicated. The issue becomes more confusing if we refer to previous cases for clarification since these cases were explained using different methods and focused on different interests. Given these circumstances, this thesis conducts a thorough analysis of what constitutes direct expropriation and indirect expropriation on the basis of their real effects and their unsatisfactory legal definitions. On the basis of this analysis, a helicopter view of the chaos is presented.

Against this background, Chapter 5 of the thesis classifies the existing methods of determining indirect expropriation into four categories: police power, sole effect, purpose and effect, and the balanced approach. These categories all have their own formulations and supporters in international law. Pros and cons analysis was conducted with the purpose of finding which approach is better. On the basis of this analysis, the balanced approach, which was first used in Canadian and U.S. model BITs, is believed to be the best approach.

Chapter 6 is concerned with identifying the factors that are necessarily linked to indirect expropriation, or more specifically, those factors that constitute the causal links between governmental acts which are claimed to constitute indirect expropriation and investors' losses resulting from such acts. As no such clear and detailed classification with sufficient criteria has been given before, this is one of the important contributions of this thesis.

According to this thesis, the balanced approach requires the following elements to establish a claim of indirect expropriation:

- First, the effects of a regulatory measure on the investor are the primary, though not the sole, criterion for determining whether an indirect expropriation has occurred.

- Second, the purpose of a government's regulatory measure should play a part in determining the issue because regulatory measures enacted for a public interest, such as public health or environmental protection, should not amount to an expropriation except where the effect of the measure is obviously disproportionate to that purpose.
- Third, the analysis should also look at the issue of the investor's legitimate expectations.
- Fourth, nondiscrimination, due process, nonarbitrariness, denial of justice, and transparency can constitute useful considerations in this determination process.

From the legal and reality perspectives, this thesis explores the foreign investment indirect expropriation risks. It also makes suggestions to sovereign States on dealing with indirect expropriation risks. Certainly, no one particular State can be used as a representative example for concluding all State concerns regarding indirect expropriation. The suggestions to strengthen the legality of States' own domestic regulatory measures and to improve their international treaty language for determining the occurrence of indirect expropriation, however, are lessons worth learning by all; they were formulated by taking into account all of the analyses conducted in this thesis and, in particular, the new generation of developments in international treaty law and customary international law. Given the needs of States and foreign investors participating in

the process of globalization and regional economic cooperation, knowing these new features of international investment law can help both prepare for the coming opportunities and challenges.

Chapter I State Sovereignty: State's Power to Regulate

The host State has the ultimate power to decide its political and economic system and which policies and laws to implement.[1] This power, however, is no longer unlimited and without restraints: It comes with corresponding restrictions that are created under the philosophy of protecting foreign investment from the State's illegitimate use of its sovereign power. In this chapter, the concept of sovereignty, the territorial sovereignty aspect of which is of great importance to our discussion, will be fully explored in terms of its definition, content, underlying philosophy, and limitations. Only by setting these considerations as the background can we have full knowledge of the legal basis of expropriation and its rationales, thus enabling us to further analyze the definition and criteria of expropriation in international investment law.

1.1 State Sovereignty as the Cornerstone in International Law

State sovereignty 'in the relations between States signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other State, the functions of a State'.[2] In the sixteenth century, the concept of 'sovereignty' was manifested as the ultimate, absolute, and unlimited power of a State in its territory.[3] As F. H. Hinsley commented in

[1] Kazuaki Sono, 'Sovereignty, the Strange Thing: Its Impact on Global Economic Order' (1979) 9 Ga J Intl & Comp L 549, 555.

[2] Andrea K Bjorklund, 'Reconciling State Sovereignty and Investor Protection in Denial of Justice Claims' (2004-2005) 45 Va J Intl L 809, 885.

[3] Timothy Zick, 'Are the States Sovereign?' (2005) 83 Wash U L Q 229, 239-40.

his book *Sovereignty*, 'at the beginning, at any rate, the idea of sovereignty was the idea that there is a final and absolute political authority in the political community'.[4] French thinker Jean Bodin, who is said to be the 'father' of sovereignty,[5] described this notion as 'legal and political authority constructed to be absolute and monolithic as a bulwark against social chaos'[6] and 'absolute and perpetual power within a State'.[7]

Although this definition has been criticized against the background of globalization and especially the formation of the European Union, the notion of sovereignty, to a great extent, maintains its significance in relation to the State's authority to exercise its right to regulate its domestic affairs. After all, sovereignty, at its most general, 'is about the power and the authority to govern'.[8]

State sovereignty has always been the most basic principle in public international law, and it is the most valuable feature reflecting the independency of a country.

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[4] FH Hinsley, *Sovereignty* (2nd edn, Cambridge University Press 1986) 26.

[5] Linda Popic, 'Sovereignty in Law: The Justifiability of Indigenous Sovereignty in Australia, the United States and Canada' (2005) 4 Indigenous L J 117, 124.

[6] Stephane Beaulac, 'The Social Power of Bodin's "Sovereignty" and International Law' (2003) 4 Melb J Intl L 1, 22.

[7] Zick (n 3) 239-40, quoting from Jean Bodin, *On Sovereignty* (Julian Franklin ed, CUP 1992) 1-4.

[8] Sean Brennan, Breda Gunn and George Williams, '"Sovereignty" and its Relevance to Treaty-Making between Indigenous Peoples and Australian Governments' (2004) 26 Syd L Rev 307, 311.

Solid proof established in UN General Assembly resolutions 1803 (XVII) Permanent Sovereignty over Natural Resources, in which it was firmly established that every State's sovereign right and economic independency should be fully respected,[9] and 3201 (S-VI) Declaration on the Establishment of a New International Economic Order (NIEO) confirms the full permanent sovereignty of every State over its natural resources and all its economic activities.[10] Furthermore, Resolution 3281 (XXIX) Charter of Economic Rights and Duties of States (CERDS) demonstrates the sovereignty of a State and its right to choose its economic, political, social, and cultural systems.[11]

Sovereignty is a complex doctrine that is capable of being understood from different perspectives and in different contexts. It thus has different meanings, dimensions, and attributes.[12] When touching upon the issue of a State's sovereignty in relation to its right to choose its own economic system and govern its economic activities, which is closely related to our concern in this thesis, the notion of territorial sovereignty frequently comes up, and thus it definitely deserves close examination.

[9] United Nations General Assembly Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources.
[10] United Nations General Assembly Resolution 3201 (S-VI) Declaration on the Establishment of a New International Economic Order (NIEO), art 4(e).
[11] United Nations General Assembly Resolution 3281 (XXIX) Charter of Economic Rights and Duties of States (CERDS), art 1.
[12] Dan Sarooshi, *International Economic Organizations and Their Exercise of Sovereign Powers* (Oxford University Press 2005) 1.

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

To correctly understand the notion of sovereignty, it is necessary and important to put it into the context in which it operates.[13] Territorial sovereignty operates within the framework of economic sovereignty, which 'relates mainly to a State's permanent resources, to its economic system and to the rules of engagement in international economic relations'.[14] As one important dimension of economic sovereignty, territorial sovereignty is the 'internal domain' of sovereignty known as internal sovereignty, which is a concept clarifying a State's ultimate administrative and legislative power to regulate affairs in its territory.[15] Thus, from the above-mentioned scope of economic sovereignty, the essence of territorial sovereignty, which comprises the power of a State over, amongst other things, its natural resources, nonnatural resources, economic activities, economic self-determination, and governance, can be extracted. As for the assets of this 'sovereignty', this concept is always used together with words such as 'permanent', 'inalienable', and 'full' which indicate the unquestionable and ultimate power of States to enjoy their belongings.[16] It is therefore perhaps

[13] ibid.
[14] Asif H Qureshi and Andreas R Ziegler, *International Economic Law* (3rd edn, Sweet & Maxwell 2011) 49.
[15] Luzius Wildhaber, 'Sovereignty and International Law' in RStJ MacDonald and DM Johnstone (eds), *The Structure and Process of International Law* (Martinus Nijhoff Publishers 1983) 436.
[16] Nico Schrijver, *Sovereignty over Natural Resources: Balancing Rights and Duties* (Cambridge University Press 1997) 262-63 (For more information about the treaties which use the wording 'permanent', 'inalienable', and 'full', please see footnotes 15-17).

appropriate to conclude that 'sovereignty is the rule and can be exercised at any time, that limitations are the exception and cannot be permanent, but limited in scope and time'.[17]

A. Natural Resources

It should firstly be acknowledged that every State has permanent sovereignty over its natural resources; this is a principle that has been confirmed for decades in international law.[18] On the basis of prior documents, UN General Assembly Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources declared '[t]he right of peoples and nations to permanent sovereignty over their natural wealth and resources' and went on to state that this right 'must be exercised in the interest of their national development and of the well-being of the people of the State concerned'.[19]

Article 2, paragraph 1 of CERDS states that '[e]very State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its … natural resources'.[20]

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[17] Georges Abi-Saab, 'Progressive Development of the Principles and Norms of International Law Relating to the New International Economic Order' (1984) in UN Doc. A/39/504/add1, 23 October 1984, para 58.
[18] HW Baade, 'Permanent Sovereignty over Natural Wealth and Resources' in Richard S Miller and Roland J Stanger (eds), *Essays on Expropriation* (Ohio University Press 1967); Edith Penrose, George Joffe and Paul Stevens, 'Nationalisation of Foreign-Owned Property for a Public Purpose: An Economic Perspective on Appropriate Compensation' (1992) 55 MLR 351.
[19] Resolution 1803 (n 9), art I, para 1.
[20] CERDS, art 2, para 1.

Article 1, paragraph 2 of the International Covenant on Economic, Social and Cultural Rights also regulates the same issue, stating that '[a]ll peoples may, for their own ends, freely dispose of their natural wealth and resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit, and international law. In no case may a people be deprived of its own means of subsistence'.[21]

B. Nonnatural Resources and Economic Activities

Second, every State also has sovereignty over the nonnatural resources and economic activities within its territory.[22] In this regard, CERDS states in its Article 2, paragraph 1 that '[e]very State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over *all its wealth* [emphasis added], natural resources and *economic activities* [emphasis added]'.[23]

C. Socioeconomic System and Self-Determination

Third, every State has the inalienable right to choose and conduct its own economic system, which reflects its right of self-determination and governance.[24]

[21] International Covenant on Economic, Social and Cultural Rights, art 1, para 2.
[22] Omar E García-Bolívar, 'Sovereignty v. Investment Protection: Back to Calvo?' (2010) Selected Works of Omar E Garcia-Bolivar, 4 <http://works.bepress.com/omar_garcia_bolivar/12> accessed 21 November 2012.
[23] CERDS, art 2, para 1.
[24] Sono (n 1) 555.

This right is confirmed in several international treaties, of which CERDS is of greatest importance. Article 1 of this treaty points out the independency of a country's economic sovereignty, stating that '[e]very State has the sovereign and inalienable right to choose its economic system as well as it political, social and cultural systems in accordance with the will of its people'.[25]

In addition, Article 1, paragraph 1 of the International Covenant on Economic, Social and Cultural Rights stipulates the right of a State to develop its own economic and social system: '[a]ll peoples have the right of self-determination. By virtue of that right they freely determine their political status and freely pursue their economic, social and cultural development'.[26]

Another relevant document is UN General Assembly Resolution 2625 (XXV) Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in accordance with the Charter of the United Nations, in which it is made quite clear that, in accordance with the Charter, all States should respect the principle concerning the duty not to intervene in matters within the domestic jurisdiction of another State.[27] One distinctive aspect of this

[25] CERDS, art 1.
[26] International Covenant on Economic, Social and Cultural Rights, art 1, para 1.
[27] United Nations General Assembly Resolution 2625 (XXV) Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in accordance with the Charter of the United Nations.

principle is that '[e]very State has an inalienable right to choose its political, economic, social and cultural systems'.[28]

D. Noninterference from Outside

Last but not least, every State is protected from outside interference in its economic administration.[29] This principle has to be understood in terms of a State's right of self-determination and governance, which is why CERDS, after recognizing a State's sovereign power to choose its own economic system, goes on to state that this power should be exercised 'without outside interference, coercion or threat in any form whatsoever'.[30]

Similarly, Resolution 2625 (XXV) Declaration on Principles of International Law concerning Friendly Relations and Co-operation among States in accordance with the Charter of the United Nations regulates that a State's right to choose its economic system should be exercised 'without interference in any form by another State'.[31] More generally, this Declaration provides that '[n]o State or group of States has the right to intervene, directly or indirectly, for any reason whatever, in the internal or external affairs of any other State. Consequently, armed intervention and all other forms of interference or

[28] ibid.
[29] C Fred Bergsten and Edward M Graham, 'Needed: New International Rules for Foreign Investment' (1992) 7 Intl Trade J 15, 41.
[30] CERDS, art 1.
[31] Resolution 2625 (n 27).

attempted threats against the personality of the State or against its political, economic and cultural elements are in violation of international law'.[32]

The Charter of the United Nations also safeguards this right by providing that '[n]othing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state'.[33]

1.1.2 State's Power to Regulate under Sovereignty

Sovereignty lawfully creates the ownership and rights of a State under the authorization of international law.[34] The relevant treaties discussed above demonstrate, to a great extent, a State's sovereignty over its natural and nonnatural resources (including human resources) and the economic activities operated in its territory. Beyond these areas of sovereignty, a State is also empowered to choose and conduct its own economic system and, of course, govern the economic activities within it free from outside interference. However, this sovereignty, in order to be enforced, has to be equipped with detailed power for the State to regulate.

[32] ibid.
[33] Charter of the United Nations, art 2, para 7.
[34] *Kuwait v Aminoil*, 66 ILR 518, 21 ILM 976, 1982, paras 97-114.

A State enjoys the power and right to freely dispose, explore, exploit, use, market, and effectively control its natural resources, but it is subject to national laws and regulations (within the boundaries of the State's exclusively controlled economic jurisdiction) and international law.[35] This right has been well recognized in international treaty law and is closely related to the State's freedom to choose its own socioeconomic system in the interests of its national development.[36] In the case of *Texaco v Libyan Arab Republic*, the tribunal expressed their view on this point, which is of great value:

> Territorial sovereignty confers upon the State *an exclusive competence to organize as it wishes the economic structures of its territory and to introduce therein any reforms* which may seem to be desirable to it. It is an essential prerogative of sovereignty for the constitutionally authorized authorities of the State to choose and build freely an economic and social system. International law recognizes that a State has this prerogative just as it has the prerogative to determine freely its political regime and its constitutional institutions.[37]

[35] Schrijver (n 16) ch 9.
[36] Sono (n 1) 549.
[37] *Texaco v Libyan Arab Republic*, 17 ILM 1, 1978, para 59.

In this regard, the relevant treaties have provided States with a comprehensive structure of regulatory powers with the purpose of confirming their regulatory power in their territory.

Among the treaty law, CERDS, once again, emphasizes the State's right of 'possession, use and disposal, over all its … natural resources'.[38] This right is also established in Article 21 of the African Charter on Human and Peoples' Rights, in which the explicit words used are '[a]ll peoples shall freely dispose of their wealth and natural resources'.[39] In addition, the International Covenant on Economic, Social and Cultural Rights explicitly provides that '[a]ll peoples may, for their own ends, freely dispose of their natural wealth and resources',[40] as does the International Covenant on Civil and Political Rights, which includes the exact same provision in support of the State's power of disposition.[41]

The rights of States to freely explore and exploit their natural resources were particularly established in several international treaties. In UN General Assembly Resolution 626 (VII) Right to Exploit Freely Natural Wealth and Resources, the relationship between sovereignty and the State's rights of exploration and exploitation was strengthened in following words: 'the right of peoples freely to use and exploit their natural wealth and resources is inherent in their sovereignty

[38] CERDS, art 2, para 1.
[39] African Charter on Human and Peoples' Rights, art 21.
[40] International Covenant on Economic, Social and Cultural Rights, art 1, para 2.
[41] International Covenant on Civil and Political Rights, art 1, para 2.

and is in accordance with the Purpose and Principles of the Charter of the United Nations'. [42] Furthermore, UN General Assembly Resolution 2158 (XXI) Permanent Sovereignty over Natural Resources confirms the right of developing States to 'effectively exercise their choice in deciding the manner in which the exploitation and marketing of their natural resources should be carried out'.[43] In this regard, the 1982 Convention on the Law of the Sea confirmed the 'sovereign rights for the purpose of exploring and exploiting, conserving and managing the natural resources, … and with regard to other activities for the economic exploitation and exploration of the zone'.[44]

These rights are undertaken '[i]n order to safeguard these resources', and 'each State is entitled to exercise effective control over them and their exploitation with means suitable to its own situation'.[45] State sovereignty, therefore, should be 'exercised fully and effectively over all the natural resources' of the State.[46] Thus, it is being recognized that the rights of the State to freely dispose, explore, exploit, use, market, and effectively control its natural resources are essential rights derived from the principle of State sovereignty and thus have to be respected by others and by international law.[47]

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[42] United Nations General Assembly Resolution 626 (VII) Right to Exploit Freely Natural Wealth and Resources.
[43] United Nations General Assembly Resolution 2158 (XXI) Permanent Sovereignty over Natural Resources, art 1, para 3.
[44] 1982 Convention on the Law of the Sea, Exclusive Economic Zone, art 56.1 (a).
[45] NIEO, art 4, para (e).
[46] United Nations General Assembly Resolution 3171 (XXVIII) Permanent Sovereignty over Natural Resources.
[47] Qureshi and Ziegler (n 14) 56-57.

Other than the rights that have already been discussed, there are other regulatory rights belonging to the State that are derived from State sovereignty. These are the rights concerning the State's power to regulate foreign investment in its own territory, including the power to regulate foreign investment in general (supervising and administering foreign investment) and the power of the host State to expropriate and nationalize foreign investment. In this particular regard, the relevant laws are General Assembly resolutions 1803 (XVII), 2158 (XXI), and 3281 (XXIX), not to mention a multitude of bilateral and multilateral investment treaties.

The following analysis, which will concentrate on the State's power to regulate foreign investment from the international law perspective, will place the core issue of this thesis in front of us. It will touch upon the legal sources of a sovereign State's power to regulate foreign investment in its jurisdiction and, beyond that, the sources of the power for this State to nationalize or expropriate foreign investment according to international law. The internationally accepted legal rules and norms form the foundation for our discussion.

1.2 State's Sovereign Power to Regulate Foreign Investment

The State has the power to control and regulate the activities of foreign investors; this power is embodied in its sovereign power[48] and is closely related to its power to choose and conduct its own economic system and, of course, to govern its domestic economic activities. This regulatory power is aimed at making foreign investment activities conform to national laws and regulations as well as to the host State's economic and social policies.[49]

Sovereignty, as the cornerstone for a State to lawfully regulate foreign investment, gives a State authorization or a 'permit' to take necessary measures, either executive, legislative, or judicial.[50] In this context, this thesis will, with the purpose of classifying the State's regulatory power in two senses, explore the State's general power to supervise and administer foreign investment and its specific power to expropriate foreign investment.

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

Generally speaking, foreign investment needs to be regulated according to the national legal and social framework. As early as 1948, the promulgation of the

[48] Uta Kohl, 'Eggs, Jurisdiction and the Internet' (2002) 51 Intl & Comp L Q 555, 571.
[49] *ADC Affiliate Limited and ADC & ADMC Management Limited v The Republic of Hungary* (*ADC Affiliate Ltd. v Hungary*), ICSID Case No. ARB/03/16, Award, 2 October 2006, para 424.
[50] Schrijver (n 16) 283.

Havana Charter embodied provisions, which were titled 'International Investment for Economic Development and Reconstruction' (Article 12), for the State to regulate foreign investment, providing the State with the following rights:

> (i) to take any appropriate safeguards necessary to ensure that foreign investment is not used as a basis for interference in its internal affairs or national policies;
>
> (ii) to determine whether and to what extent and upon what terms it will allow future foreign investment;
>
> (iii) to prescribe and give effect on just terms to requirements as to the ownership of existing and future investments;
>
> (iv) to prescribe and give effect to other reasonable requirements with respect to existing and future investments.[51]

Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources stipulates that not only the exploration, development, and disposition of natural resources but also the import of foreign capital required for these purposes 'should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities'.[52] Emphasis has to be

[51] Final Act of the United Nations Conference on Trade and Employment (Havana Charter), art 12.
[52] Resolution 1803 (n 9), art I, para 2.

placed on the chosen words 'freely consider to be necessary or desirable' in that context: These words reflect the intention of this provision to leave the decision-making power to decide the rules and conditions to which foreign investment should conform to the State. Once an investment is imported, it and its interests 'shall be governed by the terms thereof [the authorization], by the national legislation in force, and by international law'.[53]

In Resolution 2158 (XXI) Permanent Sovereignty over Natural Resources, there is the implication of reliance on the State to regulate foreign investment. In pursuing the exploitation and development of natural resources, there has to be 'government supervision over the activity over the foreign capital to ensure that it is used in the interests of national development'.[54] To further confirm this statement, this resolution goes on to state that 'the exploitation of natural resources in each country shall always be conducted in accordance with its national laws and regulations'.[55]

Transnational corporations are the key players in global economic activities. They trigger most of the cross-boundary economic transactions and investments. In NIEO, it is provided that the State has the right to regulate and supervise 'the activities of transnational corporations by taking measures in the interest of the

[53] ibid art I, para 3.
[54] Resolution 2158 (n 43).
[55] ibid art 1, para 4.

national economies of the countries where such transnational corporations operate on the basis of the full sovereignty of those countries'.[56]

Article 2 of CERDS explicitly explains the State's right to supervise and administer foreign investment. First of all, the State has the right '[t]o regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities'.[57] Second, the State cannot be forced to provide preferential treatment to foreign investment.[58] Third, the State has the right '[t]o regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies'.[59]

In a similar sense, the 1985 Convention Establishing the Multilateral Investment Guarantee Agency (1985 MIGA Convention), as a treaty intended to remove the barriers impeding the growth of foreign investment, admits the supervisory and administrative rights of the State to regulate by requiring the Agency, in guaranteeing an investment, to satisfy itself as to the 'compliance of the

[56] NIEO, art 4 (g).
[57] CERDS, art 2, para 2(a).
[58] ibid.
[59] ibid art 2, para 2(b).

investment with the host country's laws and regulations'[60] and the 'consistency of the investment with the declared development objectives and priorities of the host country'.[61]

The authors of the 1987 ASEAN Agreement for the Promotion and Protection of Investments (1987 ASEAN Agreement) did not hesitate to legally establish the rights of the State to regulate. Article III (1) states the obligation of a foreign investment to 'be governed by the laws and regulations of the host country',[62] implying that all related activities of this investment should be under the administration and supervision of the host State. This Agreement further states that the 'rules of registration and valuation of such investments'[63] are also governed by the host State.

The State's power to regulate in the area of the energy industry can be seen in the 1994 Energy Charter Treaty. The State regulates matters such as the places in the area it controls that are available for exploration and development, the extent to which these areas are better exploited, the related financial and taxation issues, and the environmental and safety concerns regarding any exploration.[64] All of

[60] 1985 Convention Establishing the Multilateral Investment Guarantee Agency (1985 MIGA Convention), art 12 (e) (ii).
[61] ibid art 12 (e) (iii).
[62] 1987 ASEAN Agreement for the Promotion and Protection of Investments (1987 ASEAN Agreement), art III (1).
[63] ibid.
[64] 1994 Energy Charter Treaty, Miscellaneous Provisions, art 18 (3) ('Sovereignty over Energy Resources').

the regulations, however, have to be bound 'in accordance with and subject to the rules of international law'.[65]

The 1986 ILA Seoul Declaration is a treaty that fully respects the supervisory and administrative right of the host State and clearly states so. It provides that States have 'the right to regulate, exercise authority, legislate and impose taxes in respect of natural resources enjoyed and economic activities exercised and wealth held in their own territories by foreign interests subject only to any applicable requirements of international law' and that '[e]xcept as otherwise agreed by treaty or contract, no State is required to give preferential treatment to any foreign investment'.[66]

There are more BITs and FTAs that have incorporated provisions regarding the treatments and protections afforded to foreign investors and imposed the necessary obligations and restrictions on host States which, for the purpose of illustrating the legitimate power of the host State, can be utilized to verify the power of States to regulate foreign investment in a general sense.[67] This power has also been well accepted in general international law (human rights, etc.) with regard to the treatment of aliens.[68] These international instruments to a great

[65] ibid art 18 (1).
[66] 1986 ILA Seoul Declaration, principle 5.5.
[67] Please refer to the discussion regarding the host State's international responsibility for regulating foreign investment in Chapter 2 as well as the discussion in Chapter 5 examining the doctrine of police power.
[68] Schrijver (n 16) 281.

extent demonstrate that host States have the general regulatory power to supervise and administer foreign investment in accordance with their local laws and regulations subject to international law.

1.2.2 Specific and Compensable Regulatory Power: Nationalization and Expropriation

The terms 'expropriation', 'nationalization', and 'taking of property' have long been the subject of debate and controversy regarding their clarification. However, under certain circumstances, they are being used interchangeably,[69] most probably because they share the same legal basis and underlying philosophy in that all of them are acts depriving foreign investors of their investments, although not to the same extent and not using the same methods. Professor Schrijver has given his thoughts on these words, providing the most general and clear understanding with regard to the distinctions between these three similar but different expressions:

> 'Expropriation' is commonly understood to refer to unilateral interference by the State with the property or comparable rights of an owner in general terms, while 'nationalization' denotes the transfer of an economic activity

[69] ibid 282.

to the public sector as part of a general programme of social and economic reform. 'Taking of property' is the most generic term.[70]

Kronfol commented that the right of a State to nationalize or expropriate is 'an attribute of its sovereignty in the sense of the supreme power which it possesses in relation to all persons and things within its territorial jurisdiction'.[71] Even before the permanent sovereignty resolutions were adopted, the right of a State to expropriate or nationalize foreign investment was recognized as being derived from State sovereignty and being subject to certain conditions.[72] It can be seen from early international jurisprudence that this is a firmly established right in international law. In the case of *Texaco Overseas Petroleum Company v The Government of the Libyan Arab Republic*, the tribunal considered this right to nationalize to be an expression of a State's territorial sovereignty.[73] In another case, *Libyan American Oil Company v Libya,* it was determined that the right of a State to nationalize is a sovereign right,[74] and in the case of *Amoco Int'l Finance Corp. v Iran,* the tribunal held the same view, stating that the right to nationalize is 'fundamentally attributed to State sovereignty' and, with regard to

[70] ibid 285. In relation to some parts of this thesis, these three terms can be used interchangeably to express one meaning and to be understood in one sense, but in relation to certain other parts of the thesis, only one or two of these three terms can be used in such way. Explanations are provided in the thesis where necessary.
[71] Zouhair A Kronfol, *Protection of Foreign Investment: A Study in International Law* (AW Sijthoff 1972) 22.
[72] Ian Brownlie, *Principles of Public International Law* (5th edn, Clarendon Press 1998) 70; GC Christie, 'What Constitutes a Taking under International Law' (1962) 38 Brit Y B Intl L 307, 307.
[73] *Texaco Overseas Petroleum Company v The Government of the Libyan Arab Republic*, 17 ILM, 1978, para 59.
[74] *Libyan American Oil Company v Libya*, 20 ILM, 1981, 120.

foreign property, is 'today unanimously recognized, even by States which reject the principle of permanent sovereignty over natural resources, considered by a majority of States as the legal foundation of such a right'.[75]

Among the treaties of concern to our discussion, Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources carefully formulated its provision recognizing the right of a State to nationalize, expropriate, and requisition both domestic and foreign property.[76] This right also has to satisfy certain conditions for lawful performance: It must be 'based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests' and it must be associated with 'appropriate compensation'.[77]

However, and quite surprisingly, these conditions were missing from the 1974 resolutions NIEO and CERDS.

Article 4 (e) of NIEO clearly confirms the full permanent sovereignty of States over their natural resources and all economic activities and recognizes the right of States to effectively control them, including 'the right to nationalization or

[75] *Amoco Int'l Finance Corp. v Iran*, 15 Iran-U.S. Cl. Trib. Rep. 189, paras 179 and 222, para 113.
[76] Resolution 1803 (n 9), art I, para 4.
[77] ibid.

transfer of ownership to its nationals'.[78] The right to nationalize, as understood according to this Declaration, is 'an expression of the full permanent sovereignty of the State' and is not 'subjected to economic, political or any other type of coercion'.[79] By its very nature, this right has to be exercised 'free[ly] and full[y]'. Such efforts to provide free and full power for a host State to expropriate did not receive general support – especially not from the developed countries which had more capital invested abroad.[80]

On this point, Article 2 of CERDS confers on States the right '[t]o nationalize, expropriate or transfer ownership of foreign property', but, like the Resolution 1803 (XVII), it states that 'appropriate compensation should be paid by the State adopting such measures'.[81] However, the requirement relating to the State's purpose in expropriating is missing from CERDS.

In contrast with the 1974 resolutions NIEO and CERDS, the Resolution 1803 (XVII) has been well applied in numerous arbitral decisions and has been

[78] NIEO, art 4 (e).
[79] ibid.
[80] GW Haight, 'The New International Economic Order and the Charter of Economic Rights and Duties of States' (1975) 9 Intl L 591, 601-602.
[81] CERDS, art 2, para 2 (c).

accepted as part of customary international law.[82] The worldwide recognition of Resolution 1803 (XVII) is certainly evidence testifying to the legitimate power of States to expropriate or nationalize foreign investment. This conclusion was affirmed in *Texaco Overseas Petroleum Company v The Government of the Libyan Arab Republic*, in which Dupuy held in particular that

> Resolution 1803 (XVII) seems to this Tribunal to reflect the state of customary international law existing in this field. ... The consensus by a majority of States belonging to the various representative groups indicates without the slightest doubt universal recognition of the rules therein incorporated.[83]

NIEO and CERDS, however, seem not to have been accepted as part of customary international law and are thus not applicable in arbitral cases. *Texaco Overseas Petroleum Company v The Government of the Libyan Arab Republic* was directed at this issue and pointed out that '[w]hile Resolution 1803 (XVII) appears to a large extent as the expression of a real general will, this is not at all

[82] Tali Levy, 'NAFTA's Provision for Compensation in the Event of Expropriation: A Reassessment of the "Prompt, Adequate and Effective" Standard' (1995) 31 Stan J Intl L 423, 434 ('The General Assembly adopted it in 1962 by a vote of eighty-seven to two, with twelve States abstaining.'). In particular, the United States voted with the majority in accepting this resolution. For more information, see Stephen M Schwebel, 'The Story of the U.N.'s Declaration on Permanent Sovereignty over Natural Resources' (1963) 49 Am Bar Ass J 463.

[83] *Texaco Overseas Petroleum Company v The Government of the Libyan Arab Republic*, 17 ILM, 1978, paras 507-11.

the case with respect to the other Resolutions'.[84] The main reason for the different levels of recognition given to these three resolutions was the attitudes of capital-exporting or developed countries. Developed countries, including France, Japan, the United Kingdom, the United States, and West Germany, expressed their reservations in NIEO regarding the 'free and full' power of States to expropriate, and all 16 capital-exporting countries voted against the provision in NIEO regarding expropriation and its compensation rule.[85] The issue, then, is not about the right to expropriate; rather, it is its conditions and the compensation rule that are under debate.

More evidence can be observed from other treaties. Some treaties were formulated in negative terms to stipulate the conditions for expropriation. Nevertheless, they did not prevent the conclusion on the legitimate expropriating power of a State. These treaties include the World Bank Guidelines on the Treatment of Foreign Investment and the 1967 Draft OECD Convention on the Protection of Foreign Property. According to the World Bank Guidelines, the State's power to expropriate can only be exercised under certain conditions.[86] The 1967 Draft OECD Convention takes a similar approach in regulating the legitimate exercise of expropriating power, stating that '[n]o Party shall take any

[84] ibid para 592.
[85] Levy (n 82) 436.
[86] World Bank, *Guidelines on the Treatment of Foreign Direct Investment* (1992) s IV.1. Under the provision, an expropriation could be legitimately exercised if it is done 'in accordance with applicable legal procedures', 'in pursuance in good faith of a public purpose', 'without discrimination on the basis of nationality', and 'against the payment of appropriate compensation'.

measures depriving, directly or indirectly, of his property a national of another Party' unless certain conditions are satisfied.[87] Although they may not be imposed on the basis of the same expropriation conditions, almost all of the IIAs currently in force have so-called 'legality' criteria for host States to legitimately perform their expropriating power; these criteria will be further examined in the next chapter.

Instead of proposing the State's power to expropriate in negative terms, some international treaties explicitly and directly state this power. The Draft UN Code of Conduct on Transnational Corporations acknowledges the power of a host State to nationalize or expropriate foreign property in its territory,[88] and the ILA Seoul Declaration illustrates this power with full respect, providing that '[a] State may nationalize, expropriate, exercise eminent domain over or otherwise transfer property, or rights in property within its territory and jurisdiction'.[89]

[87] OECD, *Draft Convention on the Protection of Foreign Property* (1967) art 3 ('Taking of Property'). The conditions are as follows: (1) the measures are taken in the public interest and under due process of law; (2) the measures are not discriminatory or contrary to any undertaking which the former Party may have given; and (3) the measures are accompanied by provision for the payment of just compensation. Such compensation shall represent the genuine value of the property affected, shall be paid without undue delay, and shall be transferred to the extent necessary to make it effective for the national entitled thereto.

[88] United Nations, *Draft United Nations Code of Conduct on Transnational Corporations*, UN Doc. E/1990/94, para 55.

[89] 1986 ILA Seoul Declaration, principle 5.5.

In conclusion, a State's regulatory power is rooted in State sovereignty, which is an extensive and well-accepted legal concept. State sovereignty can provide the host States with the ultimate power to decide policies and laws that regulate their own affairs. According to this concept, a State has ownership over its natural and nonnatural resources and the economic activities conducted in its territory. More specifically, a State is empowered to choose and build its own economic system as well as to govern the economic activities within it, free from outside interference. Therefore, under the authorization of sovereignty, the host State can take necessary measures to lawfully regulate foreign investment. However, these measures are not legally the same; they can either supervise and administrate the foreign investment in a general sense that is seen as bona fide and non-compensable, or expropriate the foreign investment which has depriving effects and should be accompanied with compensation.[90]

[90] *ADC Affiliate Ltd. v Hungary* (n 49) para 423 ('The Tribunal cannot accept the Respondent's position that the actions taken by it against the Claimants were merely an exercise of its rights under international law to regulate its domestic economic and legal affairs. It is the Tribunal's understanding of the basic international law principles that while a sovereign State possesses an inherent right to regulate its domestic affairs, the exercise is not unlimited and must have its boundaries.').

Chapter II Limitations and Responsibilities associated with Host State's Power to Regulate Foreign Investment

On the basis of the previous chapter's review of the international documents, we can confidently conclude that the regulatory power of a State is an expression of its sovereignty and has to be respected by foreign investors; this is formally recognized around the world. The State's power to regulate foreign investment is of great importance to the development of a State and the welfare of its society and peoples. Some of the international treaties explicitly encourage national development as the main objective for States to explore and exploit their natural and economic resources and to regulate their economic system and activities. Other objectives have also been mentioned in several treaties, including environmental protection, the welfare of indigenous peoples, and cooperation in international development and the sustainable development of the world economy.

These objectives to a great extent demonstrate that the State's regulatory power needs to be exercised in good faith[91] and for a fair and legitimate purpose. Therefore, these objectives not only form the goals that a State should pursue but also the legitimate grounds for it to regulate foreign investment. That is to say, a

[91] States have the obligation to act in good faith; this will be further examined in Chapter 6. For instance, General Assembly Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources explicitly points out that 'agreements freely entered into by or between sovereign States shall be faithfully observed'. For more information, see Eduardo Jiménez de Aréchaga, 'International Responsibility' in *International Law in the Past Third of a Century* (Collected Courses of the Hague Academy of International Law, Martinus Nijhoff Publishers 1978) 305.

State may be held liable for the regulatory measures it implements in the pursuit of some goals, such as the prohibition of competition in certain industries, which could not be justified as national development or other legitimate objectives.[92] So this power to regulate foreign investment embodies both rights and duties.

In accordance with Resolution 626 (VII) Right to Exploit Freely Natural Wealth and Resources, States have the right to freely use and exploit their natural wealth and resources 'wherever deemed desirable by them for their own progress and economic development'. In Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources, it is stated that permanent sovereignty 'must be exercised in the interest of their national development and of the well-being of the people of the State concerned'.[93] This connection between the State's exercise of sovereign power and the preservation of the public interest continues with CERDS and NIEO. CERDS concentrates on the State's power to regulate foreign investment and transnational corporations, which has to be 'in accordance with its laws and regulations and in conformity with its national objectives and priorities' and has to 'comply with its laws, rules and regulations and conform with its economic and social policies' respectively,[94] while NIEO focuses on the State's economic

[92] For instance, in the *S.D. Myers* case, the Canadian Government declared that its prohibition on the export of a specific kind of waste was based on environmental concerns, but actually it was primarily intended to protect local industries from U.S. competition. For more details, see *S.D. Myers, Inc. v Government of Canada* (*S.D. Myers*), UNCITRAL Case, Partial Award, 13 November 2000.
[93] Resolution 1803 (n 91), art 1, para 1.
[94] Resolution 3281 (XXIX) Charter of Economic Rights and Duties of States (CERDS), art 2, para 2.

and social system, which should be chosen as the State 'deems the most appropriate for its own development'.[95] Also, the State must exercise its regulatory power to preserve the environment. In this regard, the 1972 Stockholm Declaration and the 1992 Rio Declaration have affirmed that sovereign rights should be performed 'pursuant to their [States'] own environmental policies'.[96] This nonexclusive list of treaties shows that there are implied underlying motives behind empowering States with regulatory power, namely to encourage national development and to improve societal welfare.

However, would it be fair for foreign investors to shoulder the consequences of whatever measures a host State implements in exercising its regulatory power? Legally speaking, 'nobody may be permitted to victimize others to further their own interests'.[97] States must be controlled by an appropriate mechanism that prevents them from abusing their economic power to infringe an investor's rights and interests. Therefore, while foreign investors are under an obligation to be regulated by this power and to structure their investments to conform to the national legal and policy system, they are also afforded the protection, which from the host State's view is a responsibility and a limitation, of being regulated only to certain degree and under certain conditions and of being provided with

[95] Resolution 3201 (S-VI) Declaration on the Establishment of a New International Economic Order (NIEO), art 4 (d).
[96] 1972 Stockholm Declaration on the Human Environment, principle 21. For more information, see Nico Schrijver, *Sovereignty over Natural Resources: Balancing Rights and Duties* (Cambridge University Press 1997) 274.
[97] Kazuaki Sono, 'Sovereignty, this Strange Thing: Its Impact on Global Economic Order' (1979) 9 Ga J Intl & Comp L 549, 549.

the opportunity to seek redress where appropriate. As a matter of fact, the State is required by law to take responsibility while exercising its regulatory power.

2.1 Limited by Applicable Legal Framework: Substantive and Procedural Limitations

This section aims to explore the legal framework of the State's responsibility in exercising its regulatory power over foreign investment. The discussion will involve a close observation of the issue from substantive and procedural perspectives, exploring what laws should be applied in the case of regulating foreign investments and in what forums. This discussion needs to be highlighted to establish the legal framework of this whole thesis, pointing out the relationship between the host State's domestic laws and international law in determining the nature of a governmental measure – whether it be an expropriatory or a legitimate regulation. A foreign investor should first consider bringing its claim to the national court or other domestic tribunals and then to the international tribunals. The doctrine of State immunity protects the State from being sued by a private party abroad except where it has given its clear consent, for example, where it is explicitly stated in the dispute resolution provision in IIAs.

2.1.1 Substantive Limitations: What Law to be Followed?

The State needs the law to allow it to take measures to regulate foreign investment and expropriate investments if necessary. As Montt argues,

> [t]he regulatory State in which we live today has the constitutional power, recognized by international law, to harm citizens, including investors. This does not mean that citizens and investors must always bear the consequences of State action or inaction. Yet, neither does it mean that all injuries must be compensated.[98]

The law authorizes this regulatory power of the State and imposes its legal boundaries. Inside a State, it is its constitution and other domestic laws which formulate the legal boundaries of the State; outside a State, it is international law which exercises this function. Therefore, it is both the State's domestic law and international law that limit the State's regulatory power over foreign investment.

2.1.1.1 National Laws and Regulations should be Obeyed

Once a foreign investment is admitted into the host State, just like domestic private property, it needs to be regulated according to the laws and regulations of the host State. In considering, while drafting the ICSID Convention, the primary

[98] Santiago Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional Law in the BIT Generation* (Hart Publishing 2009) 165.

source of legal rights and responsibilities which are national law, Chairman Broches made the following comment:

> [A]n international tribunal would in the first place have to look to national law, since the relationship between the investor and the host State is governed in the first instance by national law.[99]

Resolution 2158 (XXI) Permanent Sovereignty over Natural Resources stipulates that the exploitation of natural resources in each State has to 'be conducted in accordance with its national laws and regulations'.[100] Article 2 of CERDS clearly confirms that a State has the right '[t]o regulate and exercise authority over foreign investment within its national jurisdiction *in accordance with its laws and regulations*' and '[t]o regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities *comply with its laws, rules and regulations*'.[101] The 1985 Convention Establishing the Multilateral Investment Guarantee Agency (1985 MIGA Convention) requires that Agency to satisfy itself as to the 'compliance of the investment with the host country's laws and regulations'[102] in guaranteeing an investment, while the 1987 ASEAN Agreement for the Promotion and Protection

[99] Hege Elisabeth Kjos, *Applicable Law in Investor-State Arbitration: The Interplay Between National and International Law* (Oxford University Press 2013) 167, citing from *History of the ICSID Convention*, vol II-1, 571; see also vol II-2, 984.
[100] Resolution 2158 (XXI) Permanent Sovereignty over Natural Resources, art I, para 4.
[101] CERDS, art 2.
[102] 1985 Convention Establishing the Multilateral Investment Guarantee Agency (1985 MIGA Convention), art 12, para d (ii).

of Investments (1987 ASEAN Agreement) states the obligation of a foreign investment to 'be governed by the laws and regulations of the host country'.[103]

The host State's national laws should be applied primarily on the basis of State sovereignty. In the ICSID case *Siemens A.G. v Argentine Republic*, the respondent argued that the treaty did not provide the applicable law and there was no explicit agreement indicating it and so 'the Tribunal should apply the municipal law of Argentina'.[104]

In summary, the right of a State to regulate the resources in its national jurisdiction in accordance with its laws and regulations has been well accepted in the international community.

2.1.1.2 International Law has to be Respected

Territorial sovereignty can ensure that a State never loses 'its legal capacity to change the destination or the method of exploitation of [its] resources, whatever arrangements have been made for their exploitation',[105] but this right may be under certain restrictions if the State 'accept[s] obligations with regard to the exercise of such sovereignty, by treaty or by contract freely entered into'.[106] As

[103] 1987 ASEAN Agreement for the Promotion and Protection of Investments (1987 ASEAN Agreement), art III.1.
[104] *Siemens A.G. v Argentine Republic* (*Siemens v Argentina*), ICSID Case No. ARB/02/8, Award, 6 February 2007, para 74.
[105] Jiménez de Aréchaga (n 91) 297.
[106] 1986 ILA Seoul Declaration, principle 5.2.

pointed out by Dolzer and Schreuer, '[t]he problem that arises is that when private property involved is that of a foreigner, then the issue takes a whole different turn, leaving the respective constitutional domain of the nation involved, and reaches the field of application of international law'.[107]

The underlying principle here is that the host State is bound by its constitution and national legislation, but not only by them. It also has to be bound by the rules of international customary law and those international treaties and IIAs which it has agreed upon. Nevertheless, a State cannot rely upon its internal law to justify its failures to comply with its international responsibilities.[108]

The State's power to regulate must have 'due regard to the rights and duties of States under international law'.[109] This phrase has been repeatedly used in international documents; for instance, in General Assembly resolutions 837 (IX) and 1314 (XIII) concerning international respect for the right of peoples and nations to self-determination, it is stated that in exercising its right to permanent sovereignty, the State is obliged to follow this rule.

[107] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 165.
[108] Art 32 ('Irrelevance of Internal Law') of Responsibility of States for Internationally Wrongful Acts provides that '[t]he responsible State may not rely on the provisions of its internal law as justification for failure to comply with its obligations under this part'.
[109] See, for example, para 1 of United Nations General Assembly Resolution 837 (IX) Recommendations concerning International Respect for the Right of Peoples and Nations to Self-determination.

Furthermore, according to Resolution 1803 (XVII), once an investment is imported, it and its interests 'shall be governed by the terms thereof [the authorization], by the national legislation in force, and by international law'.[110] Resolution 2158 (XXI) implied the State's obligations under international law through its 'mutually acceptable contractual practices'.[111] Also, the 1966 Human Rights Covenants and the 1981 American Charter on Human and Peoples' Rights state that peoples have to dispose of their natural wealth and resources on the basis of international law.[112] In the 1994 Energy Charter Treaty, all of the regulations have to be bound 'in accordance with and subject to the rules of international law'.[113] Another multilateral investment-related treaty, the 1965 ICSID Convention, also manages the applicability of international law – the tribunal shall apply the law of the contracting State to the dispute and 'such rules of international law as may be applicable' where there is no mutually agreed applicable law.[114]

Quiet surprisingly, this international law obligation was missing from CERDS's provisions regarding the State's power to regulate foreign investments in general

[110] Resolution 1803 (n 91), art I, para 3.
[111] Resolution 2158 (n 100), art 1, para 5.
[112] Art 1 of the 1966 Human Rights Covenants states that '[a]ll peoples may, for their own ends, freely dispose of their natural wealth and resources … based upon … international law', and Art 21.2 of the 1981 American Charter on Human and Peoples' Rights uses the identical words of 'the principles of international law'.
[113] 1994 Energy Charter Treaty, Miscellaneous Provisions, art 18 (1) ('Sovereignty over Energy Resources').
[114] Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), art 42.

and to expropriate these investments. However, these provisions are subject to Chapter I of CERDS, which explains the fundamentals of international economic relations, two of which are of great importance – 'fulfillment in good faith of international obligations' and 'respect for human rights and international obligations'.[115]

2.1.1.3 National Law Applied Alongside International Law to Determine Host State's Liability

A State regulates foreign investment in accordance with its national laws to determine whether an investment is valid, whether there are conditions or assurances for this investment to operate, whether the owner of the investment is protected, and the like.[116] When touching upon the issue of whether there is any State measure that violates the treaty obligations, the determination reaches the threshold for applying international law.

In the case of *MTD Equity Sdn. Bhd. and Chile S.A. v Chile*, the tribunal expressed its opinion on the relationship between national laws and international laws in regulating the State's international responsibility:

[115] CERDS, Chapter 1 – 'Fundamentals of International Economic Relations', subparas (j) and (k).
[116] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Wolters Kluwer Law & Business, Kluwer Law International 2009) 93.

> The breach of an international obligation will need, by definition, to be judged in terms of international law. To establish the facts of the breach, it may be necessary to take into account municipal law.[117]

The tribunal, in concluding Chile's non-violation of the BIT, explained that 'the authorization to invest in Chile is not a blanket authorization' and thus should be followed with permits and approvals from different governmental authorities.[118] Therefore, 'the Government has to proceed in accordance with its own laws and policies in awarding such permits and approvals'.[119]

This approach to elaborating the applicable law was accepted by the *MTD* tribunal's ICSID *ad hoc* annulment committee. The tribunal explained its position:

> In considering the implications of the Foreign Investment Contracts for fair and equitable treatment, the tribunal faced a hybrid issue. The meaning of a Chilean contract is matter of Chilean Law; its implications in terms of an international law claim are a matter for international law.[120]

[117] *MTD Equity Sdn. Bhd. and Chile S.A. v Chile* (*MTD*), ICSID Case No. ARB/01/7, Award, 25 May 2004, para 204.
[118] ibid para 118.
[119] ibid.
[120] *MTD* (n 117), Decision on Annulment, 21 March 2007, para 75.

It is thus evidenced that national law should be applied alongside international law in determining the host State's liability,[121] with the exception, which is commonly accepted, that such national law must be reasonable and not lead 'to a result abhorrent to international law'.[122]

2.1.2 Procedural Limitations: At What Forum to Claim?

When a dispute, even one involving a foreign investment and investor, happens within the host State, it should be governed by internal tribunals except where there is mutual consent between the concerned parties about the method to be applied. Regarding the issue of jurisdiction, disputes require the appropriate place to be heard in accordance with national laws and regulations. It is not the birthright of foreign investors to bring a case against a sovereign State to an international arbitral tribunal. Bringing a case against a State needs to satisfy certain legal conditions, but, as IIAs have developed in recent decades, it has already become a common phenomenon. The rationale behind this phenomenon is that the host State restricts its sovereignty in exchange for increased foreign investment to stimulate its domestic economy and national development.

[121] Newcombe and Paradell (n 116) 101.
[122] Peter Malanczuk, *Akehurst's Modern Introduction to International Law* (Routledge 2007) 64; Newcombe and Paradell (n 116) 97.

2.1.2.1 National Jurisdiction as an Expression of Sovereignty

As an expression of territorial sovereignty, the State has the exclusive right to require foreign investors to settle their disputes according to domestic procedures. This has been well explained in following terms:

> At the basis of international law lies the notion that a state occupies a definite part of this surface of the earth, within which it normally exercises, subject to the limitations imposed by international law, jurisdiction over persons and things to the exclusion of the jurisdiction of other states. When a state exercises an authority of this kind over a certain territory it is popularly said to have 'sovereignty' over the territory.[123]

Jurisdiction is a 'vital and indeed central feature' of sovereignty and is 'an exercise of authority which may alter or create or terminate legal relationships and obligations'.[124] The State's jurisdiction over foreign investment disputes is essentially a power performed by the national judicial system and involves the national courts of a State trying foreign investment cases. Among the grounds upon which national courts can exercise their jurisdiction over foreign

[123] James L Brierly, *The Law of Nations: An Introduction to the International Law of Peace* (Clarendon Press 1963) 162.
[124] Malcolm N Shaw, *International Law* (6th edn, Cambridge University Press 2008) 645.

investment disputes, the mere presence of the defendant in the country, the nationality principle, and the domicile principle are all relevant.[125]

Among the international treaties, Resolution 1803 and CERDS have only addressed the jurisdiction of compensation regarding nationalization or expropriation, indicating a strong preference for national jurisdiction. CERDS takes an approach favoring national jurisdiction, stating that compensation disputes 'shall be settled under the domestic law of the nationalizing State and by its tribunals' unless other peaceful dispute resolution means have been chosen freely.[126] Resolution 1803, however, instead of giving its explicit favor to national jurisdiction, provides that national jurisdiction should be exhausted before going to international arbitration and adjudication.[127] In addition, as most current IIAs show, the dispute resolution framework can probably be formulated into four categories: amicable consultation and negotiation, national courts and administrative tribunals, previously agreed dispute settlement procedures, and international arbitration and adjudication; the only difference would be the arrangement of the hierarchy of jurisdictions among these treaties. However, national jurisdiction has always been respected.

[125] ibid 651.
[126] CERDS, art 2, para 2 (c).
[127] Resolution 1803 (n 91), art I, para 4.

2.1.2.1.1 The Territorial Principle of Jurisdiction is the Key

The territorial principle is the most important principle of jurisdiction, being regarded as representing full respect for the host State's sovereignty, and is accepted as the most fundamental principle of international law.[128] In both national and international legal systems, exclusive territorial jurisdiction is firmly recognized.[129] For instance, the Third Restatement of the Foreign Relations Law of the United States regulates the national jurisdiction with respect to 'conduct that, wholly or in substantial part, takes place within its territory' and to 'the status of persons, or interests in things, present within its territory'.[130]

The significance of this principle can be observed in a classic U.S. case, *American Banana Co. v United Fruit Co,*[131] judged by Justice Holmes, regarding the applicability of U.S. federal antitrust law to an American corporation that was alleged by a domestic corporation to have conducted monopolistic activities injuring its U.S. domestic market. In this case, Justice Holmes held as follows:

> [T]he general and almost universal rule is that the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done … For another jurisdiction, if it should happen to

[128] Mark Weston Janis, *International Law* (6th edn, Wolters Kluwer Law & Business 2012) 333.
[129] ibid.
[130] American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (1987) s 402 (1) (a) and (b).
[131] *American Banana Co. v United Fruit Co.* (1909) 213 U.S. 347.

> lay hold of the actor, to treat him according to its own notions rather than those of the place where he did the acts, not only would be unjust, but would be an interference with the authority of another sovereign, contrary to the comity of nations, which the other state concerned justly might resent.[132]

2.1.2.1.2 Nationality Principle of Jurisdiction Neutralized by State Immunity

The nationality principle of jurisdiction is used to extend a State's jurisdiction to extraterritorial areas. That is to say, an investor domiciled or managing its business in a foreign country may find itself being not only governed by the host State according to the territorial jurisdiction but also by the jurisdiction of its home country. In this regard, the Third Restatement of the Foreign Relations Law of the United States confirms a State's jurisdiction based on nationality with respect to 'the activities, interests, status, or relations of its nationals outside as well as within its territory'.[133]

However, an investor cannot rely upon this principle to bring a case to a tribunal of its home country to claim the wrongs of a State for exercising its sovereign power to regulate. In other words, the host State is immune from being sued in a national court of the foreign investor's home country for an alleged violation of

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[132] ibid 356.

[133] American Law Institute (n 130) s 402 (2).

national or international responsibility, except where there is consent from this host State which is based on another principle - sovereign immunity. As former U.S. Chief Justice Marshall, in rendering the first authoritative opinion regarding this principle, commented, though '[t]he jurisdiction of the nation within its own territory is necessarily exclusive and absolute',[134] this exclusive and absolute jurisdiction needs to be limited in the circumstance involving a foreign sovereign.[135]

2.1.2.1.3 Calvo Doctrine and Clause

The Calvo doctrine, proposed by Argentine jurist Carlos Calvo, was formulated as a response to the exercise of diplomatic protection and the emergence of minimum standard of treatment in the international community.[136] It is rooted on two important international law concepts, namely the equality of foreigners and nationals and the principle of noninterference from the outside.[137] As Carlos Calvo once explained, 'the responsibility of governments toward foreigners cannot be greater than the responsibility of governments toward their own

[134] *The Schooner Exchange v M'Faddon* (1812) 11 U.S. (7 Granch) 116, 136.
[135] ibid 137 ('One sovereign being in no respect amendable to another, and being bound by obligations of the highest character not to degrade the dignity of his nation, by placing himself or its sovereign rights within the jurisdiction of another, can be supposed to enter a foreign territory only under an express license, or in the confidence that the immunities belonging to his independent sovereign station, though not expressly stipulated, are reserved by implication, and will be extended to him.').
[136] Burns H Weston, 'The New International Economic Order and the Deprivation of Foreign Proprietary Wealth: Some Reflections upon the Contemporary International Law Debate' in Richard Lillich (ed), *International Law of State Responsibility for Injuries to Aliens* (University Press of Virginia 1983) 89-125.
[137] Alireza Falsafi, 'The International Minimum Standard of Treatment of Foreign Investors' Property: A Contingent Standard' (2006-2007) 30 Suffolk Transnatl L Rev 317, 327.

citizens'[138] and 'aliens who establish in a country are entitled to the same rights to protection enjoyed by nationals; they cannot expect to have a more extended protection'.[139] Three distinctive points generated from this doctrine deserve our attention:

1. Foreign investors enjoy no better treatment than the nationals of the host State.
2. The rights of foreign investors have to be governed by internal law.
3. Internal courts have exclusive jurisdiction over foreign investment disputes.[140]

Regarding the jurisdiction of a foreign investment dispute against a host State, the Calvo doctrine strongly maintains its standpoint that the national jurisdiction should be exclusive; if there should be possible grounds for an extraterritorial claim, it would most probably be a denial of justice.[141]

The belief that national jurisdiction has to be exclusive can also be observed in the national legislation of Latin American countries. For instance, a 1938 Ecuadorian law once stated the following:

[138] Montt (n 98) 39.
[139] ibid 40.
[140] Newcombe and Paradell (n 116) 13.
[141] Montt (n 98) 40.

> Foreigners, by the act of coming to the country, subject themselves to the Ecuadorian laws without any exception. They are consequently subject to the Constitution, laws, jurisdiction and police of the Republic, and may in no case, nor for any reason, avail themselves of their status as foreigners against the said conditions, jurisdiction, and police.[142]

A provision with the same effect can be found in the 1993 Constitution of Peru; the provision states that '[n]ational and foreign investments are subject to the same conditions' and that '[i]n all contracts of the State and public corporations with resident aliens, these [are] all subject to the national laws'.[143]

However, and as a matter of fact, although the Calvo doctrine was adopted in some States, it has never been regarded as part of customary international law;[144] in fact, it has even been criticized by some commentators for promoting irresponsibility in international law.[145]

[142] Kjos (n 99) 164.
[143] Art 63 of the 1993 Constitution of Peru, citing from Kjos (n 99) 164.
[144] Donald Richard Shea, *The Calvo Clause* (University of Minnesota Press 1955) 20.
[145] Samuel KB Asante, 'International Law and Foreign Investment: A Reappraisal' (1988) 37 Intl & Comp L Q 588, 591-92.

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

Injured investors seek to obtain redress from a reliable and trustworthy tribunal. Although, with due respect, my intention is not to question the authority or the legal profession of any country's legal system, it is indeed a problem for foreign investors to willingly hand over their destiny to local courts or administrative tribunals to determine whether or not these tribunals' own State is liable for its measures or not. In a country that lacks a system of checks and balances between the executive, the legislature, and the judiciary, the judicial process can easily be interfered with by the other two branches of the State. Whatever the form of the interference, its purpose is usually to interfere with the decision-making process or even with the person who gives the judgment. Investment arbitration, however, can 'depoliticize' this kind of investment dispute.[146]

It is generally accepted by most countries that in this situation, an international tribunal improves the foreign investor's confidence in obtaining a fair result in future possible disputes with the host State. The proliferation of treaty practice has contributed to the protection of foreign investment, not just in a substantive way but also, and even more importantly, procedurally, providing the stability and predictability needed to create an investment-friendly climate in the host

[146] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press 2012) 23.

State.[147] Therefore, it is a common and necessary compromise nowadays for a State to restrict its sovereignty in exchange for the willingness and confidence of foreign investors to make their investment decisions in a globalized international society.

International arbitration practice has stressed this point. As provided in an ICSID case, *Plama Consortium Limited v Bulgaria*, international arbitration has established its world-recognized role in dealing with the relationship between investors and host states:

> With the advent of bilateral and multilateral investment treaties since the 1980s (today estimated to be more than 1,500), the traditional diplomatic protection mechanism by home states for their nationals investing abroad has been largely replaced by direct access by investors to arbitration against host states. Nowadays, arbitration is the generally accepted avenue for resolving disputes between investors and states.[148]

2.1.2.2.1 Elevated Claims to International Investment Arbitration through 'Consent'

Sovereign States voluntarily conclude IIAs, accepting those international

[147] ibid 22.
[148] *Plama Consortium Limited v Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction, 8 February 2005, para 198.

standards as well as settling investor-State disputes through international arbitration or adjudication, which is based on the State's consent.[149] This 'consent' principle is often used to justify the legitimacy of the obligations and requirements of IIAs, including the admissibility of an investment dispute entering into international arbitration.[150]

The 'consent' of the host State is said to be the 'essence of the international law'.[151] According to this principle, IIAs actually represent a specifically negotiated legal framework in which a State voluntarily restricts its sovereignty in exchange for credibility and, especially, the expectation of more foreign investment. Once this consent has been given, the State needs to be limited and to be held responsible for applying the open-ended standards and for allowing foreign investors to seek redress through international arbitration and adjudication. That is to say, the foreign investor has the right to sue the host State directly at an international level as long as the consent given admits this right.

The value of the principle of consent is mostly determined by whether or not the foreigner is allowed to bring a claim to an international tribunal and at what time he/she is allowed to do so: that is, the conditions, if any, for the investor to bring a claim. It is notable that the consent to arbitration in IIAs is valid proof that

[149] Dolzer and Schreuer (n 146) 20-22.
[150] Judge Charles N Brower, 'Concurring and Dissenting Opinion' (2011) in *Impregilo S.p.A. v Argentine Republic* (ICSID Case No. ARB/07/17).
[151] ibid 16.

international arbitration has already been generally accepted as an 'avenue for resolving disputes between investors and states',[152] thus ensuring that foreign investors have the right to claim against a sovereign State at an international tribunal. However, as the tribunal in the *Plama Consortium Limited v Bulgaria* stated,

> that phenomenon does not take away the basic prerequisite for arbitration: an agreement of the parties to arbitrate. It is a well-established principle, both in domestic and international law, that such an agreement should be clear and unambiguous. In the framework of a BIT, the agreement to arbitrate is arrived at by the *consent* [emphasis added] to arbitration that a state gives in advance in respect of investment disputes falling under the BIT, and the acceptance thereof by an investor if the latter so desires.[153]

The necessity of consent and also its associated conditions have to be stressed. These conditions shape the consent to arbitration in a way that is seen as fitting by the State and thus are imposed according to the State's sovereign power in giving such consent. In the *Impregilo v Argentina* case, Judge Charles N. Brower objected to the incorporation of a most-favored-nation (MFN) clause to give investors access to international arbitration by bypassing the national jurisdiction. One of his theoretical grounds was that 'consent is expressed

[152] *Plama Consortium Limited v Bulgaria* (n 148) para 198.
[153] ibid.

broadly or restrictively, with conditions of exhaustion of local remedies or waiting periods, as allowing all claims or only certain claims: in other words, the consent is given under certain conditions'.[154] Arbitration practice also verifies this statement. For instance, in the case of *Armed Activities on the Territory of the Congo*, the International Court of Justice pointed out that

> [the Court's] jurisdiction is based on the consent of the parties and is confined to the extent accepted by them … When that consent is expressed in a compromissory clause in an international agreement, any conditions to which such consent is subject must be regarded as constituting the limits thereon.[155]

The nature of these well-negotiated conditions for investors to get consent to international arbitration has been described as a 'precondition', or a 'jurisdictional prerequisite', or a 'temporary bar' directed at the inadmissibility of the claim. This point was well criticized in *Telefónica S.A. v Argentine Republic*:[156]

[154] He also used the nationality requirement of the investor as an example to further explain this statement; that is to say, the investor, in order to be protected by a specific BIT, must fulfill the nationality requirement. See Brower (n 150) para 52.
[155] *Armed Activities on the Territory of the Congo (New Application: 2002)* (*Democratic Republic of the Congo v Rwanda*), *Jurisdiction and Admissibility*, I.C.J. Reports 2006, Judgment, 3 February 2006, para 88.
[156] *Telefónica S.A. v Argentine Republic*, ICSID Case No. ARB/03/20, Decision of the Tribunal on Objections to Jurisdiction, 25 May 2006.

> [T]he Tribunal notes that this requirement, or precondition, is best qualified as a temporary bar to the initiation of arbitration. The objection is therefore technically an exception of inadmissibility raised by Argentina against the claimant for not having complied with the requirement. The Tribunal notes that the inadmissibility of the claim would result in the Tribunal's temporary lack of jurisdiction…[157]

In *Burlington Resources Inc. v Republic of Ecuador*, the case concerned a determination of a waiting period requirement that could constitute a jurisdictional requirement. It was the tribunal's view that a six-month negotiation period was unavoidable because

> [b]y imposing upon investors an obligation to voice their disagreement at least six months prior to the submission of an investment dispute to arbitration, the Treaty effectively accords host States the right to be informed about the dispute at least six months before it is submitted to arbitration. The purpose of this right is to grant the host State an opportunity to redress the problem before the investor submits the dispute to arbitration.[158]

[157] ibid para 93.
[158] *Burlington Resources Inc. v Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Jurisdiction, 2 June 2010, para 315.

In summary, foreign investors have the right to bring their claim against a host State to international arbitration if the host State has in any way (IIAs or concession contract, etc.) given its consent to such arbitration. Although such consent may be accompanied with conditions, these conditions must also be observed in accordance with international law, in particular with the principles of good faith and fairness. In the following section, this 'temporary bar' is analyzed in terms of its content, rationale, and application.

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

Local remedies have to be exhausted by injured investors before they can seek access to an international tribunal for redress if this is explicitly required in IIAs. As a 'well-established rule of customary international law'[159] that must be considered by investors when choosing the forum in which to sue, the underlying principle of the exhaustion of local remedies rule is that a State who has committed an internationally wrongful act should be given the opportunity to redress the consequences in accordance with its own courts or administrative tribunals.

It is a principle mainly based on the concept of sovereignty and respect for the State's territorial jurisdiction, upholding the importance of national jurisdiction,

[159] *Interhandel* Case, ICJ Reports 1959, Judgment, 21 March 1959, para 27.

and 'this respect for the sovereignty of States is brought about by giving priority to the jurisdiction of the local courts of the State in cases of foreigners' claiming against an act of its executive or legislative authorities.[160] It is an international rule emphasizing the equality between foreign investors and domestic investors;[161] a lack of such a rule would create an unfair privilege for foreigners, allowing them to bypass a national jurisdiction and directly sue at international level without the host State's consent.

International treaties have generally accepted that this rule should be applied where appropriate. A provision in Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources, which concerns compensation for expropriation, states the following:

> In any case where the question of compensation gives rise to a controversy, *the national jurisdiction of the State taking such measures shall be exhausted* [emphasis added].[162]

This provision goes on to include an exception to this rule:

[160] Jiménez de Aréchaga (n 91) 292.
[161] ibid 291-95.
[162] Resolution 1803 (n 91), art I, para 4.

> However, *upon agreement by sovereign States and other parties concerned* [emphasis added], settlement of the dispute should be made through arbitration or international adjudication.[163]

In addition, the International Covenant on Civil and Political Rights proposed to establish a Human Rights Committee to deal with such disputes. One of the conditions for the Committee to have jurisdiction in the concerned matter is that 'all available domestic remedies [must] have been invoked and *exhausted* in the matter, in conformity with the generally recognized principles of international law'.[164] The matter under dispute can escape this condition only where 'the application of the remedies is unreasonably prolonged'.[165]

The ICSID Convention is another international treaty that gives recognition to the exhaustion of local remedies rule. In its Article 26, it stipulates that the '[c]onsent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy'.[166] This Article laid down the importance of consent and the significance of the arbitration used by ICSID to settle disputes. However, it goes on to say that '[a] Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration

[163] ibid.
[164] International Covenant on Civil and Political Rights, art 41, para (c).
[165] ibid.
[166] ICSID Convention, art 26.

under this Convention'.[167] Therefore, the exhaustion of local remedies rule is applied as a condition required by the host State for arbitration.

The jurisprudence of the ICSID is of particular relevance here. In a number of cases, the exhaustion of local remedies rule was debated and questioned with regard to its interpretation and application in the dispute resolution provisions of IIAs, especially when there are unclear and vague words regarding the waiting period requirement being applied with this rule.[168] Sometimes, this rule is required to be applied for a certain time limit (varying from 3 to 24 months), after which consent is granted to the foreign investors to seek redress through international arbitration regardless of the completeness of the proceedings and whether or not the final result is about to be provided by the local tribunals.[169]

In the case of *Wintershall*, the tribunal determined a requirement of 18 months' proceedings before a local court, which must be taken seriously by foreign investors, and made the following statement:

> In the present case, therefore, the BIT between Argentina and Germany is a treaty undoubtedly providing for a right of access to international

[167] ibid.
[168] Professor Brigitte Stern, 'Concurring and Dissenting Opinion' (2011) in *Impregilo S.p.A. v Argentine Republic* (ICSID Case No. ARB/07/17), para 88.
[169] *Impregilo S.p.A. v Argentine Republic*, ICSID Case No. ARB/07/17, Award, 21 June 2011, paras 90-94.

> arbitration (ICSID) for foreign investors, who are German nationals – but this right of access to ICSID arbitration is not provided for unreservedly, but upon condition of first approaching competent Courts in Argentina … a local-remedies rule may be lawfully provided for in the BIT – under the first part of Article 26; once so provided, as in Article 10(2), it becomes a condition of Argentina's 'consent' – which is, in effect, Argentina's 'offer' to arbitrate disputes under the BIT, but only upon acceptance and compliance by an investor of the provisions inter alia of Article 10(2); an investor (like the claimant) can accept the 'offer' only as so conditioned.[170]

The tribunal tried to define the nature of this local remedies rule:

> [T]he eighteen-month requirement of a proceeding before local courts (stipulated in Article 10(2)) is an essential preliminary step to the institution of ICSID Arbitration under the Argentina-Germany BIT; it constitutes an integral part of the 'standing offer' ('consent') of the Host State, which must be accepted on the same terms by every individual investor who seeks recourse (ultimately) to ICSID arbitration for resolving its dispute with the Host State under the concerned BIT.[171]

[170] *Wintershall Aktiengesellschaft v Argentine Republic*, ICSID Case No. ARB/04/14, Award, 8 December 2008, para 116.
[171] ibid para 160.

That is to say, for it to be able to gain access to an ICSID arbitral tribunal, an investor must try to settle its case in the local courts for 18 months. However, the issues of the effectiveness of this exhaustion of local remedies rule to settle disputes and whether justice can be afforded to foreign investors have been raised.

In summary, investors, in order to get access to international arbitration, must fulfill the exhaustion of local remedies requirement and its time limit requirement if they are explicitly required to do so by the IIAs concerned. However, the exhaustion of local remedies rule may be useless and thus not applicable if there is no remedy to exhaust or if there are available local remedies to exhaust but they are '"obviously futile" or "manifestly ineffective"'.[172] This situation most probably occurs in the course of the administration of justice, such as an unreasonable delay in administering the remedy that makes the remedy ineffective or the 'complete subservience of the judiciary to the government of the State',[173] which, if it can be proved by foreign investors, may constitute legitimate grounds for bypassing the local remedies rule even where it is so required.

[172] *Loewen Group, Inc. and Raymond L. Loewen v United States of America* (*Loewen v United States*), ICSID Case No. ARB (AF)/98/3, Opinion of Christopher Greenwood, QC (on the denial of justice under international law), 26 May 2001, paras 68, 71, 72.
[173] Jiménez de Aréchaga (n 91) 294.

2.2 The State's International Responsibilities in Regulating Foreign Investment

The following exploration of a State's international responsibilities in regulating foreign investment aims to clarify the difference between responsibility for non-compensable and general regulatory measures and responsibility for expropriation.

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

A State's responsibility for supervising and administrating foreign investment is based on the State's genuine intention to preserve and promote its general public welfare. In accordance with this principle, the State's supervisory and administrative measures are supposed to be fair and reasonable in nature, even from the perspective of protecting foreign investment. However, even if such State measures are managed with the greatest diligence, there could still be some influences that adversely affect foreign investment, but most probably, these influences will not trigger the State's international liability. This is the essential difference that distinguishes general regulatory measures from expropriatory measures (as will be introduced later). Bearing in mind this difference, this section aims to frame the boundaries of the State's regulatory power within which any claim of expropriation could not succeed.

2.2.1.1 Minimum Standard of Treatment in Customary International Law

> [W]hen a State admits into its territory foreign investment or foreign nationals it is ... bound to extend to them the protection of the law. However, it does not thereby become an insurer of that part of another State's wealth which these investments represent. ... The real question is whether a right has been violated, which right could only be the right of the State to have its nationals enjoy a certain treatment guaranteed by general international law, in the absence of a treaty applicable to the particular case.[174]

When an investment enters the territory of a host State, the State is bound by certain obligations towards this investment, even without a treaty explicitly stating these in writing.[175] By the early twentieth century, due to the increased attention given to the protection of foreign nationals investing abroad, it was commonly agreed in international society, and particularly in 'civilized states', that a general treatment should be established affording investors a 'minimum standard of treatment' in accordance with customary international law.[176] Even

[174] Alberto Alvarez-Jiménez, 'Minimum Standard of Treatment of Aliens, Fair and Equitable Treatment of Foreign Investors, Customary International Law and the *Diallo* Case before the International Court of Justice' (2008) 9 J World Invest & Trade 51, 56, citing from International Court of Justice, *Case Concerning the Barcelona Traction Light and Power Company Limited* (*Belgium v Spain*), *Second Phase*, Judgment, 5 February 1970, I.C.J. Rep. 3, para 87.
[175] Falsafi (n 137) 319.
[176] Newcombe and Paradell (n 116) 11-12.

though the content of this treatment has yet to be clearly determined, it has mostly been concerned with claims of denial of justice, expropriation, and so forth.

Elihu Root commented on the nature and scope of this treatment with specific emphasis on the equality between nationals and foreigners in the host State and the 'privilege' that foreigners can get in receiving justice. As he explained:

> Each country is bound to give to nationals of another country in its territory the benefit of the same laws, the same administration, the same protection, and the same redress for injury which it gives to its own citizen's, and neither more nor less: provided the protection which the country gives to its own citizens conforms to the established standard of civilization.
>
> There is a standard of justice, very simple, very fundamental, and of such general acceptance by all civilized countries as to form part of the international law of the world. A country is entitled to measure the standard of justice due from it to an alien by the justice it accords its own citizens only when its system of law and administration conforms to this general standard. If any country's system of law and administration does not conform to that standard of justice, although the people of the country

> may be content or compelled to live under it, no other country can be compelled to accept it as furnishing a satisfactory measure of treatment to its citizens.[177]

Under this analysis, whether or not the host State has committed a violation of international responsibility depends on its law and administration. The State's 'injustice', it has been asserted, would give rise to its international responsibility.

Brownlie illustrated the minimum standard of treatment, with expropriation and denial of justice as the primary concerns, and concluded that 'there is no single standard but different standards relating to different situations':[178] for instance, in Article 1105 of NAFTA concerning 'Minimum Standard of Treatment', fair and equitable treatment (FET) and full protection and security are two important components.[179] The consideration of this issue was well elaborated in the *ADF* Award:

> The 'international minimum standard' embraced by Article 1105(1) is, according to the Respondent, 'an umbrella concept incorporating a set of rules' which 'have crystallized into customary international law in

[177] Elihu Root, 'The Basis of Protection to Citizen's Residing Abroad' (1910) 4 Am J Intl L 517, 521-22.
[178] Ian Brownlie, *Principles of International Law* (6th edn, Oxford University Press 2003) 506.
[179] As Art 1105 ('Minimum Standard of Treatment'), para 1 states, '[e]ach Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security'.

specific concepts.' The term 'fair and equitable treatment' refers to 'the customary international law minimum standard of treatment' which encompasses rules such as 'those for denial of justice, expropriation and other acts subject to an absolute, minimum standard of treatment under customary international law.' On the other hand, the term 'full protection and security' refers to the 'minimum level of police protection against criminal conduct' required as a matter of customary international law. *The pertinent rules of the customary international law minimum standard of treatment of aliens, according to the Respondent, are 'specific ones that address particular contexts. There is no single standard applicable to all contexts.'*[180]

2.2.1.2 Modern Treaty-Based Treatments

Modern treaty-based treatments are more specific and independent and go beyond the mere expression of customary international law or a 'minimum standard of treatment'.[181] For instance, it has long been proposed that FET,[182] as previously discussed in relation to inclusion under the 'minimum standard treatment' in NAFTA, should 'go far beyond the minimum standard and afford

[180] *ADF Group Inc. v United States of America*, ICSID Case No. ARB (AF)/00/1, Award, 9 January 2003, para 110 (citations omitted).
[181] Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (Martinus Nijhoff Publishers 1995) 60.
[182] As the most frequently utilized treatment, FET is often established in IIAs with the following words: 'Investment shall at all times be accorded fair and equitable treatment', or '[e]ach Party shall at all times accord fair and equitable treatment' to the foreign investors and their investment. See, for example, Art II (2) (a) of the Argentina-United States BIT and Art I, s 1 of the Germany-United States Treaty (1954).

protection to a greater extent and according to a much more objective standard than any previously employed form of words'.[183]

The tribunal in the *Azurix* case held that FET and full protection and security should be interpreted 'as higher standards than required by international law',[184] and in the case of *Vivendi v Argentina*, the tribunal found there was no basis for FET to be read according to the minimum standard of treatment.[185] These treatments were believed to work independently and autonomously to manifest the situation concerned.[186] While there is an undeniable interaction and overlap between these treatments, it has, in fact, become modern practice for international arbitral tribunals to determine whether there has been a violation of respective treatments according to the treaty concerned and other precedents.

It is impossible, and it is not the major concern of this thesis, to exhaust all standards and contents of modern treaty-based treatments within one small

[183] FA Mann, 'British Treaties for the Protection and Protection of Investments' (1981) 52 Brit Y B Intl L 241, 244.
[184] *Azurix Corp. v The Argentine Republic* (*Azurix v Argentina*), ICSID Case No. ARB/01/12, Award, 14 July 2006, para 361.
[185] *Compañiá de Aguas del Aconquija S.A. and Vivendi Universal S.A. v Argentine Republic* (*Vivendi v Argentina*), ICSID Case No. ARB/97/3, English Award, 20 August 2007, paras 745-47.
[186] *Mondev International Ltd. v United States of America*, ICSID Case No. ARB (AF)/99/2, Award, 11 October 2002, para 118. It was concluded that the determination of fair and equitable treatment 'cannot be reached in the abstract; it must depend on the facts of the particular case'. In another award, *Waste Management, Inc. v United Mexican States* (*Waste Management v Mexico*), ICSID Case No. ARB (AF)/003, Award, 30 April 2004, at para 99, the tribunal pointed out that 'the standard is to some extent is a flexible one which must be adapted to the circumstances of each case'. For more discussion, see Dolzer and Schreuer (n 146) 137.

section, especially when most of them employ a contextual approach that is to be determined on a case-by-case basis. However, it is still possible for us to gain a general understanding of these treatments and how they work in practice and to build the theoretical foundation for distinguishing treatments for non-compensable regulatory measures from treatments for expropriation.

Therefore, the concrete treatments that oblige the host State to act with due diligence when exercising its supervisory and administrative power will be explained. In this respect, other available treatments accorded to foreign investors, including 'transfer of funds', the 'umbrella clause', 'State necessity', and the like, are not included in this discussion so as to maintain the consistency and clarity of the major concern in this chapter – distinguishing the host State's general regulatory power from its expropriatory regulatory power. Taking this as read, the given task here is to explore the underlying philosophy and content of FET, 'full protection and security', 'nonarbitrariness', 'nondiscrimination', 'national treatment', and 'MFN treatment' in order to frame the host State's obligations in regulating foreign investment in general.

A. Fair and Equitable Treatment (FET)

According to its plain meaning, FET should be understood as meaning 'where a foreign investor has an assurance of treatment under this standard, a straightforward assessment needs to be made as to whether a particular treatment

meted out to that investor is both "fair" and "equitable"'.[187]

In the *MTD* case, the tribunal tried to give FET a definition, stating that 'fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. Its terms are framed as a proactive statement – "to promote", "to create", "to stimulate" – rather than prescriptions for a passive behavior of the State or avoidance of prejudicial conduct to the investors'.[188]

Several considerations have been applied in arbitration practice to reinforce and develop the application of FET, including discrimination,[189] denial of justice,[190] due process,[191] transparency,[192] legitimate expectations,[193] the principles of good

[187] UNCTAD, *Fair and Equitable Treatment* (United Nations 1999) 10.
[188] *MTD* (n 117), Award, 25 May 2004, para 113.
[189] ibid para 109; *Waste Management v Mexico* (n 186), Final Award, 30 April 2004, para 98; *Loewen v United States* (n 172), Award, 26 June 2003, para 135.
[190] Art 5(2)(a) of the 2012 U.S. Model BIT states that '"fair and equitable treatment" includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal system of the world'. In addition, the arbitral cases have demonstrated that the consideration of denial of justice is relevant in determining a violation of FET. These cases are *Waguih Elie George Siag and Clorinda Vecchi v The Arab Republic of Egypt* (*Siag v Egypt*), ICSID Case No. ARB/05/15, Award, 1 June 2009, paras 451-55; *Loewen v United States* (n 172), Award, 26 June 2003, para 54; and *Grand River Enterprises Six Nations, Ltd., et al. v United States of America*, UNCITRAL Case, Award, 12 January 2011, paras 222-36.
[191] *Técnicas Medioambientales Tecmed, S.A. v The United Mexican States* (*Tecmed v Mexico*), ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, para 162; *Middle East Cement Shipping and Handling Co. S.A. v Arab Republic of Egypt* (*Middle East Cement v Egypt*), ICSID Case No. ARB/99/6, Award, 12 April 2002, para 143; *Loewen v United States* (n 172*)*, Award, 26 June 2003, paras 132-37.
[192] *Emilio Agustín Maffezini v The Kingdom of Spain* (*Maffezini v Spain*), ICSID Case No. ARB/97/7, Award on the Merits, 13 November 2000, para 83; *Tecmed v Mexico* (n 191) para 167.

faith[194] and reasonableness,[195] and others.[196]

In summary, the host State is obliged by this principle of FET to act in good faith and with due diligence (being reasonable and nondiscriminatory) to protect the foreign investment, to respect the investor's legitimate expectations (by creating a consistent, stable, and predictable investment climate in its country), to regulate in a transparent manner and in accordance with due process, and to prevent the 'denial of justice' in its local tribunals.

B. Full Protection and Security

As is generally accepted by arbitral and treaty practice, the 'full protection and security' standard is designed to encourage the host State to act with due diligence to prevent a foreign investment from physical and legal infringement.[197] This treatment 'will not be violated if a state exercises its right to legislate and regulate and thereby takes reasonable measures under the

[193] *Total S.A. v The Argentine Republic* (*Total v Argentina*), ICSID Case No. ARB/04/01, Decision on Liability, 27 December 2010, para 164; *EDF (Services) Limited v Romania* (*EDF v Romania*), ICSID Case No. ARB/99/6, Award, 8 October 2009, para 217; *S.D. Myers, Inc. v Government of Canada* (*S.D. Myers*), UNCITRAL Case, Second Partial Award, 21 October 2002, para 86; *Marvin Roy Feldman Karpa v United Mexican States* (*Feldman v Mexico*), ICSID Case No. ARB (AF)/99/1, Award, 16 December 2002, para 128.

[194] *Tecmed v Mexico* (n 191) 153; *Waste Management v Mexico* (n 186), Final Award, 30 April 2004, para 138; *Saluka Investments BV (The Netherlands) v The Czech Republic* (*Saluka v Czech Republic*), UNCITRAL Case, Partial Award, 17 March 2006, para 307; *Occidental Exploration and Production Company v The Republic of Ecuador* (*Occidental v Ecuador*), LCIA Case No. UN3467, Award, 1 July 2004, para 186.

[195] *Saluka v Czech Republic* (n 194), Partial Award, 17 March 2006, para 309.

[196] The considerations of 'stability', 'contractual obligations', and 'freedom from coercion and harassment' have been thoroughly assessed by R Dolzer and C Schreuer. See Dolzer and Schreuer (n 146) 130-60.

[197] Dolzer and Schreuer (n 146) 161.

circumstances'.[198] Therefore, whether this treatment is legally and reasonably protected can be justified on the basis of the circumstances of the case, but it should be noted that this liability is not strictly imposed on the host State. In the *ELSI* case, the court held that the existence of 'constant protection and security' cannot be 'construed as the giving of a warranty that property shall never in any circumstances be occupied or disturbed'.[199]

When this treatment is violated physically by the acts of governmental authorities, the host State can be held liable under this treatment. For instance, in *Wena Hotels v Egypt*,[200] Egypt was held liable because its police authorities were aware of the seizure of the claimant's hotel by a State entity but did not take necessary measures to protect the investor, and in *American Manufacturing & Trading, Inc. v Republic of Zaire*,[201] Zaire was held liable for its failure to prevent the claimant's commercial complex from being looted by members of the Zairian armed forces, an act which was found to have violated the full protection and security standard. However, this rule does not just apply to governmental authorities: if what is involved is a private party who infringes the rights of a foreign investor, the State may still be held liable under the full protection and security standard as long as certain criteria can be satisfied. A case in point is

[198] ibid 162.
[199] *Case Concerning Elettronica Sicula, SpA (ELSI)* case *(US v Italy)*, 1989 I.C.J. 15, Judgment, 20 July 1989, para 108.
[200] *Wena Hotels Limited v Arab Republic of Egypt* (*Wena Hotels v Egypt*), ICSID Case No. ARB/98/4, Award, 8 December 2000.
[201] *American Manufacturing & Trading, Inc. v Republic of Zaire*, ICSID Case No. ARB/93/1, Award, 21 February 1997.

Tecmed v Mexico: Although Mexico was not found liable for the 'social demonstrations' and disturbance at the claimant's landfill, the key reason for this ruling was that there was no proof that the Mexican authorities had in any way contributed to, and thus could be linked to, the chaos.[202]

Since this treatment is described as 'full', it has been argued that 'full protection and security' should extend beyond mere physical protection.[203] In the *Biwater* case,[204] this treatment was believed to imply 'a State's guarantee to stability in a secure environment, both physical, commercial and legal'.[205] The tribunal in *Siemens* further elaborated on this viewpoint through a comparison of adopting the full protection and security standard in tangible and intangible investments and concluded that 'the obligation to provide full protection and security is wider than "physical" protection and security. It is difficult to understand how the physical security of an intangible asset would be achieved'.[206] Therefore, it has been accepted in general that the full protection and security standard can be applied to legal infringements.

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[202] *Tecmed v Mexico* (n 191) para 176 ('[T]he Claimant has not furnished evidence to prove that the Mexican authorities, regardless of their level, have encouraged, fostered, or contributed their support to the people or groups that conducted the community and political movements against the Landfill, or that such authorities have participated in such movement. Also, there is not sufficient evidence to attribute the activity or behavior of such people or groups to the Respondent pursuant to international law.').
[203] *Azurix v Argentina* (n 184) para 408 ('However, when the terms "protection and security" are qualified by "full" and no other adjective or explanation, they extend, in their ordinary meaning, the content of this standard beyond physical security.').
[204] *Biwater Gauff (Tanzania) Ltd. v United Republic of Tanzania* (*Biwater*), ICSID Case No. ARB/05/22, Award, 24 July 2008.
[205] ibid para 729.
[206] *Siemens v Argentina* (n 104), Award, 17 January 2007, para 303.

C. Nonarbitrariness and Nondiscrimination

An investment should not be impaired by arbitrary or discriminatory measures: this reflects the fundamental principles of law. In international treaties, measures to protect foreign investment from arbitrary and discriminatory treatment are often established in one unified provision, each individual treaty provision having its own distinctive content and significance.

Professor Christoph Schreuer gave his legal opinion on the definition of 'arbitrariness' in the case of *EDF v Romania.*[207] According to Professor Schreuer, a measure would be arbitrary if it 'inflicts damage on the investor without serving any apparent legitimate purpose', or 'is not based on legal standards but on discretion, prejudice, or personal preference', or is 'taken for reasons that are different from those put forward by the decision maker', or is 'taken in willful disregard of due process and proper procedure'.[208]

There is confusion, though, regarding the relationship between the purpose of enacting such measures and its consequences. The tribunal in *Enron v Argentina* found there was no violation of the nonarbitrary treatment obligation since the measures taken 'were what the Government believed and understood was the

[207] *EDF v Romania* (n 193).
[208] ibid para 303.

best response to the unfolding crisis'.[209] This implied that there would be no liability for the State if it had obeyed the relevant obligations, such as good faith and due diligence, in taking regulatory measures. The *Occidental v Ecuador* tribunal, instead of focusing on the State's intention, held that the 'confusion and lack of clarity' had 'resulted in some form of arbitrariness, even if not intended'.[210]

The nondiscrimination standard, on the other hand, intends to deal with the issue of inequality between like persons or groups. This obligation to treat aliens equally, or more specifically, to treat foreign investors and nationals in an equal way, has been established in IIAs through the standards of national treatment, MFN treatment, and nondiscriminatory treatment. While the former two are based on nationality, nondiscriminatory treatment goes beyond that. In this respect, the tribunal in *Lauder v Czech Republic* has provided insightful views concerning domestic law which can be discriminatory. The tribunal stated:

> For a measure to be discriminatory, it does not need to violate domestic law, since domestic law can contain a provision that is discriminatory towards foreign investment, or can lack a provision prohibiting the

[209] *Enron Corporation and Ponderosa Assets, L.P. v Argentine Republic* (*Enron v Argentina*), ICSID Case No.ARB/01/3, Award, 22 May 2007, para 281.
[210] *Occidental v Ecuador* (n 194) para 163.

discrimination of foreign investment.[211]

With respect to the intention of the measure and its effect, the arbitral decisions have sparked controversy. Some tribunals have concentrated on the effect of the measure, like in the *Siemens* case, where the intent was held not decisive but rather 'the impact of the measure on the investment would be the determining factor to ascertain whether it had resulted in nondiscriminatory treatment'.[212] In contrast, the *LG&E* tribunal found both factors were equally important and thus stated that

> [i]n the context of investment treaties, and the obligation thereunder not to discriminate against foreign investors, a measure is considered discriminatory if the intent of the measure is to discriminate or if the measure has a discriminatory effect.[213]

D. National Treatment and Most-Favored-Nation (MFN) Treatment

National treatment and MFN treatment have emerged in international law, particularly in the field of international trade law, over time; the purpose of both kinds of treatment is to provide foreigners and nationals with equal rights.

[211] *Ronald S. Lauder v The Czech Republic* (*Lauder v Czech Republic*), UNCITRAL Case, Award, 3 September 2001, para 220.
[212] *Siemens v Argentina* (n 104), Award, 6 February 2007, para 321.
[213] *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v Argentine Republic* (*LG&E v Argentina*), ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, para 146 (citations omitted).

National treatment, in this context, focuses on the equality between the admitted, or even pre-entry,[214] foreign investors and the host State's domestic investors,[215] while MFN treatment intends to provide foreign investors from a contracting State with treatment as favorable as the treatment the contracting State gives to third parties.[216] Taken as a whole, they try to outline a legal framework enabling foreign investors to be treated as equal to other national or foreign investors when the host State exercises its regulatory power.

The determination of the host State's violation of national treatment involves three steps: first, the basis for foreign investors enjoying national treatment is that there are comparable situations between nationals and foreigners, namely 'like situations' or 'like circumstances'; second, there exist different treatments accorded to nationals and foreigners; and third, this differentiation, if any, cannot be justified according to relevant law.[217]

In certain circumstances, the State's regulatory measures could be justified even if such measures treat national and foreign investors differently, especially when these measures are conducted with the legitimate purpose of promoting or

[214] The United States, Canada, and Japan grant foreign investors access to their markets on the basis of this national treatment. For instance, in the 2012 U.S. Model BIT, Art 3 s 1 states that '[e]ach Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory'.
[215] UNCTAD, *Report on National Treatment* (United Nations 1999) 4.
[216] Dolzer and Schreuer (n 107) 186.
[217] Dolzer and Schreuer (n 146) 199.

preserving public interests. The tribunal in *S.D. Myers* pointed out this exception while considering the assessment of 'like circumstances' – 'circumstances that would justify governmental regulations that treat them differently in order to protect the public interest' should also be taken into account.[218] Further, the *GAMI v Mexico* case demonstrates that the State may take measures, even measures resulting in the insolvency of a local industry, 'in the interest of the national economy' but not measures directed at foreign investors.[219]

On the other hand, applying MFN treatment in international investment law is used in practice to invoke another investment treaty signed by the host State which provides better treatments to the investor and a better investment climate in the host State's territory compared with those provided in the basic treaty. It is generally accepted that the treatments to be transplanted should be substantive guarantees that exist in both treaties.[220] That is to say, the 'consent' of the host State should be respected and any treatment that has been carefully formulated should not be changed through the application of MFN treatment. This, however, is exactly the issue under debate nowadays concerning the incorporation of dispute resolution provisions from other treaties through an MFN clause into the basic well-negotiated treaty for the purpose of bypassing the host State's national

[218] *S.D. Myers* (n 193), Partial Award, 13 November 2000, para 250.
[219] *Gami Investments, Inc. v The Government of the United Mexican States* (*GAMI v Mexico*), UNCITRAL Case, Award, 15 November 2004, para 114.
[220] Yulia Andreeva, 'Interpreting Consent to Arbitration as a Unilateral Act of State: A Case Against Conventions' (2007) 2 Arbitration Intl 27, 135.

jurisdictions. Although the issue at point is far from clear, the following rule may be the foundation for generally understanding this treatment and for its future development: In *Hochtief v Argentina*, decided in 2011 by an ICSID tribunal, the assumption was laid down that the aim of MFN treatment is not to 'create wholly new rights where none otherwise existed' in the basic BIT.[221]

2.2.2 The Responsibility for Nationalization and Expropriation: Legality Requirement

The host State has to fulfill four conditions to lawfully expropriate or nationalize a foreign investment: 'public purpose', 'nondiscrimination', 'due process', and, most controversially, 'against compensation'. That is to say, to be internationally recognized as lawful, an expropriation must be (a) conducted with a public purpose, (b) in accordance with the due process of law, (c) nondiscriminatory in nature, and (d) accompanied with compensation. If, and only if, all four of these conditions are satisfied can a host State avoid triggering its international responsibilities. These conditions have been well recognized in almost all of the existing international investment treaties and have become part of customary international law.

[221] *Hochtief AG v The Argentine Republic* (*Hochtief v Argentina*), ICSID Case No. ARB/07/31, Decision on Jurisdiction, 24 October 2011, para 67.

2.2.2.1 Public Purpose

A State has a wide margin of discretion to take measures regulating foreign investment, but it also has a duty to prove that these measures are for public purposes as required by international law. This 'public purpose' requirement has been framed in various ways in IIAs, such as 'public interest' in the 2000 Austria-Azerbaijan BIT; 'public benefit' in the 1979 Netherlands-Sudan BIT; 'public utility' in the 1983 France-Pakistan BIT; and 'public use, public interest, or in the interest of national defense' in the 1980 Philippines-UK BIT.[222]

Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources requires an expropriation to 'be based on grounds or reasons of public utility, security or the national interest' which must override 'purely individual or private interests',[223] thus implying the requirement of a public purpose. Further evidence can be found in a range of treaties: for instance, the European Convention for the Protection of Human Rights and Fundamental Freedoms states that except for the purpose of 'public interest', no one shall be deprived of his/her possessions. Other treaties, such as the OECD Draft Convention on the Protection of Foreign Property,[224] the Inter-Arab Investment Agreement,[225] and the OIC Investment

[222] Newcombe and Paradell (n 116) 370.
[223] Resolution 1803 (n 91), art I, para 4.
[224] OECD, *Draft Convention on the Protection of Foreign Property* (1967) art 3, para (i).
[225] Unified Agreement for the Investment of Arab Capital in the Arab Countries (1980 Inter-Arab Investment Agreement), art 9.2.

Agreement,[226] have also stipulated the 'in the public interest' condition for States to expropriate foreign investment, and NAFTA and U.S. Model BITs have directly stipulated a 'public purpose' condition.

The general acceptance of public purpose is intended to respond to genuine public need and is primarily rooted on the principle of good faith.[227] For instance, some BITs, particularly (a) those where one of the contracting parties is the UK and (b) the 2001 Australia-Egypt BIT, explicitly narrow down the scope of public purpose to the 'internal needs' of the host State. Although internal and external affairs are unavoidably related to each other in structuring a State's economic and societal relations, limiting public purpose strictly to 'internal needs' underlies the consideration of avoiding using the threat of expropriation as a political tool in international relations.[228]

A case in point would be *ADC v Hungary*, where the respondent used 'the strategic interest of the State' to justify the legitimacy of measures which it argued had been conducted in the 'public interest'.[229] The tribunal found that

[226] Treaty on Promotion, Protection and Guarantee of Investments among Member States (1981 Organization of the Islamic Conference Investment Agreement), art 10.2.
[227] Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (Stevens 1953) 40.
[228] Dolzer and Stevens (n 181) 105; Newcombe and Paradell (n 116) 370.
[229] *ADC Affiliate Limited and ADC & ADMC Management Limited v The Republic of Hungary* (*ADC Affiliate Ltd. v Hungary*), ICSID Case No. ARB/03/16, Award, 2 October 2006, paras 431-32.

> [a] treaty requirement for '*public interest*' requires some genuine interest of the public. If mere reference to '*public interest*' can magically put such interest into existence and therefore satisfy this requirement, then this requirement would be rendered meaningless since the Tribunal can imagine no situation where this requirement would not have been met.[230]

2.2.2.2 Nondiscrimination

Nondiscrimination requires foreign investments to be expropriated equally. There are two facets to this issue. First, the reason for a governmental measure being directed at a specific investor must not be related to the substance of the matter;[231] thus, the investor's nationality is irrelevant to whether or not to implement the measure. Second, the host State is obliged to treat like persons equally.[232]

ADC Affiliate Ltd. v Hungary is a case in point. The claimant, who was the only foreign investor, was prohibited from operating an airport and claimed that this treatment was discriminatory. The respondent argued that all investors other than the 'statutorily appointed operator' were prohibited from operating the airport in question and thus its action was not discriminatory[233] and, in addition, 'since

[230] ibid para 432.
[231] AFM Maniruzzaman, 'Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview' (1998) 8 J Transnatl L & Pol 57, 59.
[232] ibid.
[233] *ADC Affiliate Ltd. v Hungary* (n 229) para 397.

discrimination can only be argued when a comparable party which was treated differently exists, it is not possible to refer to discrimination in the present case due to the fact no such comparable parties exist'.[234]

The tribunal, however, concluded the case by stating the following:

> It is correct for the Respondent to point out that in order for a discrimination to exist, particularly in an expropriation scenario, there must be different treatments to different parties. However and unfortunately, the Respondent misses the point because the comparison of different treatments is made here between that received by the Respondent-appointed operator and that received by foreign investors as a whole.[235]

The tribunal therefore concluded that the State's prohibition of operation in this case was indeed discriminatory in nature.[236]

In this regard, the Third Restatement of the Foreign Relations Law of the United States points out in its section 712 that '[a] state is responsible under international law for injury resulting from … a taking by the State of the property

[234] ibid para 420.
[235] ibid para 442.
[236] ibid para 443.

of a national of another state that … is discriminatory'. Furthermore, this standard has been unarguably established in almost all IIAs where an expropriation provision is presented.

2.2.2.3 Due Process

In the 2004 and 2012 U.S. Model BITs, there is a provision introducing the requirement of 'due process', the purpose of which is to determine lawful expropriation. Article 1110 (c) of NAFTA also sets forth this condition in elaborating the legitimate circumstances in which a host State can lawfully expropriate a foreign investment. An identical provision can also be found in a range of IIAs, although they are not formulated in the same language.[237]

With respect to the meaning of 'due process' in expropriation claims, the cases of *ADC Affiliate Ltd. v Hungary* and *Middle East Cement v Egypt* are of great significance. In the *Middle East* case, the tribunal found that the 'due process' standard had not been followed by the State in seizing and auctioning the investor's ship since there was an absence of direct notification of expropriation by the State to inform the investor of such measures.[238] In *ADC Affiliate Ltd. v Hungary,* the tribunal conducted a step-by-step analysis, including consideration of whether the measure concerned was discriminatory and whether it followed

[237] Newcombe and Paradell (n 116) 375. Some treaties may not adopt the 'due process' standard explicitly in their treaty languages but may alternatively use 'legal procedures' and the like.
[238] *Middle East Cement v Egypt* (n 191) para 143.

due process, in order to determine whether the government's prohibition of operation constituted proper expropriation. Making reference to the concept of 'due process' in the context of expropriation, the claimant demanded that the host State should have provided the investor with the opportunity to seek 'judicial review' and to receive 'reasonable notice and the right to a fair hearing and an impartial adjudicator'.[239] The tribunal agreed with the claimant. In the tribunal's opinion,

> …'due process of law', in the expropriation context, demands *an actual and substantive legal procedure for a foreign investor to raise its claims against the depriving actions already taken or about to be taken against it*. … In general, the legal procedure must be of a nature to grant an affected investor a reasonable chance within a reasonable time to claim its legitimate rights and have its claims heard.[240]

2.2.2.4 Against Compensation

Compensation is probably the most controversial issue in determining the legality of expropriation,[241] but what is not that controversial is the need of compensation for expropriation. Under international law, it is a compulsory

[239] *ADC Affiliate Ltd. v Hungary* (n 229) para 376.
[240] ibid para 435.
[241] PM Norton, 'A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation' (1991) 85 Am J Intl L 474; Newcombe and Paradell (n 116) 377; Dolzer and Schreuer (n 146) 100.

obligation for a host State to compensate an injured investor for its expropriatory measures.

The *Vivendi v Argentina* tribunal stressed the State's obligation to compensate in a case of expropriation:

> If we conclude that the challenged measures are expropriatory, there will be violation of Article 5 (2) of the Treaty [on expropriation], even if the measures might be for a public purpose and nondiscriminatory, because no compensation has been paid.[242]

Various valuation methods and standards have been argued to be the most 'appropriate' one. While the capital-exporting countries favor a full fair market value compensation formula, the capital-importing countries are inclined to choose a 'just' (normally less than 'full compensation') evaluation method as the compensation rule.

The 'Hull formula', in this respect, advocates a 'prompt, adequate and effective' compensation formula, which represents the views of the capital-exporting countries. In *Biloune v Ghana*, the opinion was that the Hull formula was part of customary international law:

[242] *Vivendi v Argentina* (n 185), Award, 20 August 2007, para 7.5.21.

> [U]nder the principles of customary international law, a claimant whose property has been expropriated by a foreign state is entitled to full – i.e., to prompt, adequate and effective – compensation. This generally means that such a claimant is to receive the fair market value or actual value of the property at the time of the expropriation, plus interest.[243]

In contrast to the Hull formula, 'appropriate compensation' represents a more flexible standard which might 'range from the payment of full compensation, the amount of profits lost, to the payment of no compensation at all',[244] 'taking into account the specific circumstances of each case'.[245] This standard has received general support (both from capital-importing and capital-exporting countries). This support can be seen in the well-accepted international treaty Resolution 1803 (XVII) Permanent Sovereignty over Natural Resources, which states that

> [t]he owner shall be paid *appropriate compensation*, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law.[246]

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[243] *Biloune and Marine Drive Complex Ltd v Ghana Investments Centre and the Government of Ghana* (*Biloune v Ghana*), UNCITRAL Case, Award, 27 October 1989, paras 210-11.
[244] M Sornarajah, *The International Law on Foreign Investment* (Cambridge University Press 2004) 480.
[245] Sergey Ripinsky and Kevin Williams, *Damages in International Investment Law* (British Institute of International and Comparative Law 2008) 76, citing from *Shahin Shaine Ebrahimi v Iran*, Award, 12 October 1994, 30 Iran-US CTR 170, 197.
[246] Resolution 1803 (n 91), art I, para 4.

CERDS reaffirms this approach, requiring that 'appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent'.[247]

Even if controversy still exists regarding the method of calculating compensation, the responsibility of the host State to compensate in cases of expropriation cannot in anyway be compromised as it is firmly established in international law.

In summary, a State's power to regulate foreign investment is accompanied with responsibilities and limitations. In this sense, general regulatory measures focus on the treatments and protections for foreign investment, while expropriation, on the contrary, is more concerned about the restrictions on the host State to enforce expropriatory measures. This unequal way of treating these two kinds of State measures indicates the fact that expropriation, as a measure having damaging effects on an investment, has to be carefully managed in State practice, in accordance with the requirements established in both national and international law.

[247] CERDS, art 2, para (c).

Therefore, to avoid the illegitimate use of sovereign power which could infringe on the property rights and interests of foreign investors, the State's right to expropriate is associated with certain limitations and responsibilities in form of some necessary 'legality' conditions, and foreign investors are allowed to seek remedies through international tribunals according to relevant laws and regulations (both national and international) and international standards. These restrictions, however, should not in any way be regarded as a denial of the host State's power to expropriate in international law, but they are used as criteria to ensure the lawful exercise of this power and to safeguard the fair rights and interests of the investor.

Chapter III Between Right and Wrong: Tension between the State's Power to Regulate and Expropriation (Indirect) Claims

States have the power, and are under the constitutional obligation, to regulate their domestic matters through the adoption of laws or through administrative measures, generally or specifically, which, by themselves or as part of the general economy, may to a certain extent bring adverse effects to investors.[248] Normally, these measures are accepted as the exercise of the 'police power' of the host State, which is an expression of State sovereignty. As stated in the American Law Institute's Third Restatement of the Foreign Relations Law of the United States,

> [a] state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of the states[249]

The 1961 Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens also safeguards the host State's general and non-compensable regulatory power. As stated in this document,

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[248] Rudolf Dolzer, 'Indirect Expropriations: New Developments?' (2002-2003) 11 NYU Envtl L J 64, 66.
[249] American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (American Law Institute Publishers 1987) v 2, s 712, Reporter's Note 1.

> [a]n uncompensated taking of an alien property or a deprivation of the use or enjoyment of property of an alien which results from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful.[250]

In this case, a State's regulatory measures, even those associated with negative consequences on foreign investments, are for a public purpose that is not a compensable 'taking'. However, such regulatory 'takings' can be too severe and excessive to be innocent general regulations. In the *AES v Argentina* case, the tribunal commented that the respondent (the Argentine Republic) 'as a sovereign State … had a right to adopt its economic policies; but this does not mean that the foreign investors under a system of guarantee and protection could be deprived of their respective rights under the instruments providing them with these guarantees and protection'.[251]

The truth, however, is sometimes ugly. Identifying today's State expropriation practice is no longer a job demanding only the examination of its legal conditions.

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[250] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (5).
[251] *AES Corporation v The Argentine Republic*, ICSID Case No. ARB/02/17, Decision on Jurisdiction, 26 April 2005, para 57.

This practice in its new generation may be exercised in a disguised and furtive way, making it look like general regulatory measures in order for the State to escape its obligations; alternatively, the State, with truly harmless intentions, may implement measures which in fact are harmful to foreign investments and may be expropriatory in nature. This shaped expropriation practice has been called indirect expropriation or regulatory expropriation, referring to those expropriations commonly found in today's State practice that, although involving no direct transfer of legal title to the State, have effects equivalent to outright takings.[252] In a word, due to the need of the host State to supervise and administer its domestic affairs and the complexity of reality, 'the single most important development in State practice has become the issue of indirect expropriation'.[253]

3.1 Simplified Provisions vs. Diversified Reality

In formulating current international law, much attention was paid to defining the conditions for a host State to exercise the power of expropriation, but the necessary efforts required to determine how expropriatory measures can be found in the first place were not made. That is to say, the question of whether an

[252] W Michael Reisman and Robert D Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation' (2004) Faculty Scholarship Series Paper 1002, 123.
[253] Dolzer (n 248) 65.

expropriation is lawful or unlawful has sort of been settled, but the way to find the occurrence of expropriation has yet to be identified.[254]

Applicable legal provisions in this respect have lagged far behind the needs of reality as they only provide general and vague definitions and thus cannot satisfy the challenge from real State practice.[255] However, if there is no explicit requirement for a State to promise not to issue illegitimate and unreasonable regulations that constitute expropriation, this protection regime could easily be compromised.

Most IIAs only point out that a State is prohibited from unlawfully nationalizing, expropriating, or taking foreign property.[256] Nevertheless, a legal principle has been established therein to find the loss of the foreign investor and the corresponding appropriation of the host State in order to determine whether direct expropriation has occurred. This is due to the fact that direct expropriation can only be found in cases where the foreign investment is nationalized or physically taken or legally transferred by the host State.[257] However, using this approach to determine the occurrence of indirect expropriation is neither

[254] Surya P Subedi, 'The Challenge of Reconciling the Competing Principles within the Law of Foreign Investment with Special Reference to the Recent Trend in the Interpretation of the Term "Expropriation"' (2006) 40 Intl L 121, 122.
[255] Uche Ewelukwa Ofodile, 'Africa-China Bilateral Investment Treaties: A Critique' (2013) 35 Mich J Intl L 131, 182.
[256] For more discussion, see Chapter 4.2.2.1 ('Various Expressions in IIAs' Definitions of Expropriation').
[257] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 92.

appropriate nor sufficient considering its unique nature. Also, many treaties only cover 'similar (or equivalent) measures' in addition to the traditional expropriation and nationalization or merely state that foreign investment should not be expropriated directly or indirectly. Unfortunately, the question of how an expropriation can be exercised in the absence of direct interference by the State has rarely been answered conclusively in the written sources.[258]

The fact that indirect expropriation has not been thoroughly and specifically identified in terms of its legal nature is the main issue confusing the determination of its occurrence as State practice can vary significantly from one State to another. In this respect, could a government's appointment of a temporary manager to control an investor's business be a severe enough measure to conclude that indirect expropriation had occurred and, if so, why?[259] How about government regulations concerning import and export that can influence an investor's business operations? [260] When and how can these kinds of administrative power be exercised in a way that constitutes indirect expropriation? What about the issuances of legal orders that are based on public concerns but in certain cases have been determined to be indirect expropriations? What are their rationales? For all of these confusing issues, there is a nonexclusive list of real

[258] For more discussion, see Chapter 4.2.2.1 ('Various Expressions in IIAs' Definitions of Expropriation').
[259] See the cases of *Starrett Housing Corp. v Iran* and *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran*.
[260] See the cases of *Pope & Talbot Inc. v Government of Canada* and *S.D. Myers. Inc. v Government of Canada.*

situations where State regulations could be challenged and indirect expropriation could be claimed.

Tribunals have to weigh up whether a case involves expropriation or regulation, and they have to do so in accordance with the very specific facts of each individual case.[261] In this process, it is hard for a tribunal to provide a cogent and convincing reason for concluding whether the State measures concerned constitute indirect expropriation since a slight difference between two similar measures may lead to contradicting decisions.

For instance, is the duration of interference a valid consideration in determining indirect expropriation? How can one measure whether the interference lasts for the requisite period of time so as to conclude that expropriation has occurred? International arbitration practice shows that there are varying opinions in regard to these questions. Generally, the interference of State regulations must be 'a persistent or irreparable obstacle',[262] as understood in *Generation Ukraine, Inc. v Ukraine*, to constitute indirect expropriation. In *S.D. Myers v Canada*, the tribunal concluded that interference 'usually amounts to a lasting removal' of the

[261] L Yves Fortier, CC, QC and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2005) 13 Asia Pac L Rev 79, 98.
[262] *Generation Ukraine, Inc. v Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, para 20.32.

ability of the investor to make use of the investment;[263] although the tribunal went on to conclude that there is the exception that 'partial or temporary' deprivation may in some contexts or circumstances constitute indirect expropriation,[264] where this exception can be found is another issue relying on further determination. A similar approach to determining this issue in the case of indirect expropriation can be found in *LG&E.*[265] As concluded in that case, indirect expropriation should have a permanent nature unless 'the investment's successful development depends on the realization of certain activities at specific moments that may not endure variations'.[266] Then, the question is whether or not it can be claimed that a temporary deprivation constitutes indirect expropriation and, if it can, under what circumstances exactly.

Current international arbitration practice suggests that each influencing factor for determining indirect expropriation has to be explained according to the facts of the case and on a case-by-case basis.[267] In this situation, merely sticking to the treaty provisions is not a feasible way of reasonably finding indirect expropriation. What is needed is a well-framed legal formulation pointing out the necessary considerations and procedures for determining this issue and, notably, the guidance of customary international law. Most of the current applicable

[263] *S.D. Myers, Inc. v Government of Canada* (*S.D. Myers*), UNCITRAL Case, Partial Award, 13 November 2000, para 283.
[264] ibid.
[265] *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v Argentine Republic* (*LG&E v Argentina*), ICSID Case No. ARB/02/1.
[266] *LG&E v Argentina* (n 265), Decision on Liability, 3 October 2006, para 193.
[267] UNCTAD, *Expropriation: A Sequel* (United Nations 2011) 57.

treaties, however, have not legally authorized this practice, and this has resulted in inconsistency between different tribunals in terms of finding indirect expropriation, even when the same investment treaty is being referred to.

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

The regulatory right of States is accepted as part of State sovereignty and is referred to as police power in current international law. As commonly recognized in State practice, the exercise of police power is not wrongful and cannot be compensated even if it is exercised adversely and affects the interests of foreign investment. The Third Restatement of the Foreign Relations Law of the United States reads as follows:

> A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that *is commonly accepted as within the police power of states* [emphasis added], if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price.[268]

[268] American Law Institute (n 249) v 2, s 712, Reporter's Note 1.

In *Sedco Inc. v National Iranian Oil Co*, the tribunal stated that it is 'an accepted principle of international law that a state is not liable for economic injury which is a consequence of bona fide "regulation" within the accepted police power of states'.[269] Furthermore, in *Saluka v Czech Republic*, the tribunal believed that an exercising of police power would not constitute expropriation and thus would be non-compensable and that this formed 'part of customary international law today'.[270]

However, it is still possible for State measures to be held compensable for unduly interfering with a foreign investment under certain conditions even if these measures are exercised in accordance with the State's police power. In this context, an attempt has been made in international arbitration practice to draw a line distinguishing between non-compensable regulatory measures and compensable measures, even those exercised in accordance with police power.

In both the *Pope & Talbot* case and the *S.D. Myers* case, the case concerned State regulatory measures affecting the investor's export business. In the former case, the Canadian Government issued policies to decrease the lumber export quotas from Canada to the United States. Consequently, the claimant experienced reduced access to the American market and heavier export duties as

[269] *Sedco Inc. v National Iranian Oil Co* (1985) 9 Iran-US CTR, 248, 275.
[270] *Saluka Investments BV (The Netherlands) v The Czech Republic* (*Saluka v Czech Republic*), UNCITRAL Case, Partial Award, 17 March 2006, para 262.

a result of this new Canadian policy and thereby substantially reduced profits. In the latter case, the Canadian Government issued an order forbidding the U.S. investor to export waste, which adversely affected the claimant's business operation and its economic benefits from the investment.

Although in both cases no occurrence of indirect expropriation was found, the reasoning of the tribunals was obviously controversial. The *Pope & Talbot* tribunal concluded that the interference of the Canadian Government's policies was not substantial enough to find that there had been indirect expropriation.[271] Furthermore, the tribunal held that '[m]ere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required'.[272] On the basis of the reasoning from *Pope & Talbot*, the interference in *S.D. Myers* was substantial enough since the investor's business was necessarily related to the export from Canada and the treatment in the United States. Canada's prohibition on the investor's export of waste had deprived its operation of business and thus could constitute indirect expropriation. The tribunal, however, found that there was no expropriation because a 'measure tantamount to expropriation' should be understood as a 'taking' which is conducted by a 'governmental-type authority' and transfers the ownership of

[271] *Pope & Talbot Inc. v The Government of Canada* (*Pope & Talbot*), UNCITRAL Case, Interim Merits Award, 26 June 2000, para 101.
[272] ibid para 88.

property to another person.[273] This interpretation was restated in the concluding remarks of the expropriation section of the tribunal's report, where the tribunal stated that it thought Canada had not profited from this event and that the evidence did not show that there had been a transfer of 'property or benefit directly to others'.[274] What is more confusing is that this tribunal stressed the need to consider 'the real interests involved and the *purpose and effect* [emphasis added] of the government measure'[275] in concluding that indirect expropriation has occurred.

So while the *Pope & Talbot* tribunal stressed the importance of substantial deprivation of investment in finding indirect expropriation, the tribunal in *S.D. Myers* emphasized the appropriation of expropriated property interests and the purpose and effect of the government measure. As developed in international investment law, the interference of a State's conduct can constitute expropriation if this interference has made the property right so useless that it cannot be reasonably exploited even though the State never intentionally expropriated the property or deprived the original owner of the legal title of the property.[276] This

[273] *S.D. Myers* (n 263), Partial Award, 13 November 2000, para 280. The tribunal stated that '[t]he term "expropriation" in Article 1110 must be interpreted in light of the whole body of state practice, treaties and judicial interpretations of that term in international law cases. In general, the term "expropriation" carries with it the connotation of a 'taking' by a governmental-type authority of a person's "property" with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the "taking"'.
[274] ibid para 287.
[275] ibid para 285.
[276] *Starrett Housing Corp. v Iran* (*Starrett Housing*), 4 Iran-U.S. Cl. Trib. Rep., 122 (1983), 154-55.

group of arbitral cases focuses exclusively on the extent or degree of interference imposed by State measures on foreign investment. Police power in this case cannot excuse the liability of the host State for unfairly interfering with foreign investors' assets under circumstances where substantial deprivation has been proved.

Moreover, there are other arbitral cases where the assessment of whether or not the State measures in question are severe enough to constitute indirect expropriation has to go beyond the legal basis and intention for adopting such measures or their consequences for foreign investment. For such cases, a purpose-effect test has been introduced to determine the proportionality of the measures in question in order to reasonably conclude an occurrence of indirect expropriation. In this approach, the purpose and the effect of a regulatory measure are weighed together in order to reach a final conclusion on its nature – whether it has been implemented within the ambit of non-compensable police power or whether the level of economic interference it involves is so severe that it exceeds the limits of a reasonable 'bona fide' regulation.

Interestingly, the importance of the investor's legitimate expectations in the process of determining indirect expropriation has also been witnessed in international treaty and arbitration practice. As Blades commented, 'the Tribunal's central focus upon an Investor's expectations - and whether a state has

done anything to foster those expectations - is a new, and perhaps welcome, development in NAFTA expropriation jurisprudence'.[277] At the core of this criterion is the investor's reasonable reliance on the host State to act in a consistent and transparent manner, which is at the heart of the host State's promise to guarantee a stable and predictable domestic investment environment.

Conversely, the host State will lose its attraction as a destination for continuous foreign investment and will be held liable for its frustration of investors' legitimate expectations if these expectations have been ignored.[278] Yet, what exactly is the State's obligation in regard to this criterion and how can it be established what expectations of investors have to be respected by the host State? The tribunal in the *Starrett Housing* case pointed out that foreign investors 'have to assume a risk that [a] country might experience strikes, lock-outs, disturbances, changes of the economic and political system and even revolution. That any of these risks materialized does not necessarily mean that property rights affected by such events can be deemed to have been taken'.[279] What this statement emphasizes is that the host State is not obliged to remain unchanged; rather, what really matters is that it should have justifiable grounds for changing.

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[277] Bryan W Blades, 'The Exhausting Question of Local Remedies: Expropriation under NAFTA Chapter 11' (2006) 8 Oregon Rev Intl L 33, 98.

[278] *CMS Gas Transmission Company v Argentine Republic* (*CMS v Argentina*), ICSID ARB/01/8, Decision on Jurisdiction, Award, 12 May 2005, para 274.

[279] *Starrett Housing* (n 276) 156.

Other considerations might play a pertinent role in finding the occurrence of indirect expropriation; these considerations include, but are not limited to, the standards of nondiscrimination, nonarbitrariness, due process, denial of justice, and transparency. In the context of expropriation jurisprudence, these considerations cannot operate alone in concluding indirect expropriation; rather, they serve as criteria incorporated into the whole process of assessing the character – nature, context and content - of a State measure. More often than not, their function is to testify whether the measure in question falls within the ambit of the State's police power and thus is bona fide in nature.

So, is State appropriation a compulsory requirement to find an occurrence of indirect expropriation? Will such State measures be exempt from liability to pay compensation as long as they have a legitimate purpose that falls within the ambit of police power? What if the interference caused by these measures is so serious that it is obviously unfair for investors to endure it? What if there is a prior promise made by the host State to foreign investors that is later violated by such measures? The answers to these questions are hard to conclude from the above-mentioned arbitration practice since it is impossible to reconcile the issues involved.

Although Jan Paulsson commented on this point that '[t]here is no magical formula'[280] to determine indirect expropriation and thus 'perfect predictability is an illusion',[281] this opinion cannot justify the chaos in current international investment law. International arbitral decisions have demonstrated that these varying and even contradicting formulations are not feasible for distinguishing reasonable State regulations from other measures, even those conducted with a legitimate purpose, which have unduly interfered with foreign investment and require, by international law, the payment of compensation. Accordingly, the bilateral investment treaties, international instruments, and customary international law should not be interpreted to fit the particular benefit and convenience of individual arbitral tribunals and States.[282]

Legal consistency, stability, and predictability in determining when, and in what circumstances, State measures constitute indirect expropriation are of great significance to foreign investors trying to calculate the risks of their investments and host States trying to be prudent about the consequences of their regulations. They are the essence of a trilateral legal regime, but in current expropriation jurisprudence, they have been undermined since the interpretations of these core concepts are so different and are even adopted on the basis of contradicting legal

[280] Jan Paulsson, 'Indirect Expropriation: Is the Right to Regulate at Risk?' (Paper presented at Symposium on Making the Most of International Investment Agreements: A Common Agenda, OECD Headquarters, Paris, 12 December 2005) 1, <http://www.oecd.org/dataoecd/5/52/36055332.pdf> accessed 31 January 2013.
[281] ibid 2.
[282] Subedi (n 254) 122.

principles.[283] This is not an acceptable solution to settling future disputes concerning the occurrence of indirect expropriation, nor is it a viable standard for both investors and States to be able to participate in cross-border investment activities without having doubts about potential expropriation events.

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

There are a number of reasons that explain why great tensions exist in current international investment law regarding the practice of distinguishing non-compensable State measures from indirect expropriation; these tensions have been identified as 'the single most important development in state practice'.[284] First, host States have been taking an increasingly active role in administrating and supervising foreign investments since the nineteenth century, and the legitimacy of this phenomenon has been questioned. Second, the development of IIAs has established more rigid obligations for host States to obey and for foreign investors to be protected from unfair State interference. Last but not least, the investor-State arbitration regime has allowed foreign investors to bring claims directly against host States instead of using diplomatic protection and seeking resolution from their home State.[285]

[283] ibid 122.
[284] Dolzer (n 248) 65.
[285] Ben Mostafa, 'The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law' (2008) 15 Austl Intl L J 267, 270.

Difficulties and confusions can be found in both international treaty law and arbitration practice in terms of distinguishing 'between a regulatory measure, which is an ordinary expression of the exercise of the State's police power that entails a decrease in assets or rights, and a de facto expropriation that deprives those assets and rights of any real substance'.[286] Therefore, the 'gap [that exists in current international expropriation jurisprudence] and the consequent uncertainty concerning the extent of States' obligations towards investors' are a cause of real concern in current international investment law, and thus one may ask whether there is 'a clear and principled approach to the determination of the limits of a State's responsibilities'.[287]

Without doubt, both international law and IIAs have demonstrated the legitimacy of the State's regulatory power over foreign investments, especially that States have 'the duty to prevent the worsening of [a] situation' and cannot 'simply leave events to follow their own course'.[288] Even in extreme cases, State measures have to 'be adopted to offset the unfolding crisis'.[289] However, as the tribunal in the *ADC v Hungary* case concluded on the basis of its understanding of the basic principles of international law, 'while a sovereign State possesses an inherent

[286] *Azurix Corp. v The Argentine Republic* (*Azurix v Argentina*), ICSID Case No. ARB/01/12, Award, 14 July 2006, para 115.
[287] Subedi (n 254) 127, citing from Vaughan Lowe, 'Regulation or Expropriation', Lecture Delivered at the University College of London (2003).
[288] *Enron Corporation and Ponderosa Assets, L.P. v Argentine Republic* (*Enron v Argentina*), ICSID Case No. ARB/01/3, Award, 22 May 2007, para 307.
[289] ibid para 308.

right to regulate its domestic affairs, the exercise is not unlimited and must have its boundaries'. [290]

Regarding the scope of these regulatory boundaries in cases of indirect expropriation, only a general view has been accepted by international expropriation jurisprudence, and this view is currently the most probable response to the chaos - that is, whether the State interference is so severe (or unfair or substantial) or the State measure 'goes too far' that it supports a finding of indirect expropriation;[291] otherwise, the State measure would just fall within the safe normal-regulation zone and thus could not be held liable since it is not severe enough. This line of understanding can be found in a number of cases, including *Pope & Talbot*, *Metalclad,* and *S.D. Myers*, but it has obviously failed to draw a fair line between 'so severe' and 'normal'.[292]

Some commentators may argue that the standard of indirect expropriation, as well as other treaty protections, was left intentionally vague and uncertain so as to 'give adjudicators a quasi-legislative authority to articulate a variety of rules

[290] *ADC Affiliate Limited and ADC & ADMC Management Limited v The Republic of Hungary* (*ADC Affiliate Ltd. v Hungary*), ICSID Case No. ARB/03/16, Award, 2 October 2006, para 423.
[291] *Pennsylvania Coal Co v Mahon et al.* (1922) 260 U.S. 393 (43 S.Ct. 158, 67 L.Ed. 322) 415.
[292] See, for example, *Pope & Talbot* (n 271) para 96; *S.D. Myers* (n 263), Partial Award, 13 November 2000, para 282.

necessary to achieve [a] treaty's object and purpose in particular disputes'.[293] However, this would surely undermine the functions and benefits of an expected legal system and might put too much discretionary power into the hands of an 'irrational' person.

So, it is more reasonable and fair for adjudicators to 'look behind the appearances and investigate the realities of the situation' of an alleged indirect expropriation.[294] To achieve this goal, an underlying principle has long been established for finding the boundary between these two kinds of measures, according to which the balance of rights and interests between the host State and its inbound investors should be measured carefully and fairly.[295] In this regard, the rules and principles on indirect expropriation should not diminish or alter to any degree the ability of host States to regulate in the public interest; at the same time, and even more importantly, State regulatory measures must not be used as a disguised mechanism for expropriating foreign property.[296] This process has to be backed up by the adoption of an international agreement between host and home States, within which there are carefully negotiated (although possibly not

[293] Rudolf Dolzer, 'Fair and Equitable Treatment: A Key Standard in Investment Treaties' (2005) 39 Invest Treaties Intl 87, 89； Susan Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions' (2005) 73 Fordham L Rev 1521, 1589.
[294] *Sporrong and Lönnroth v Sweden*, ECtHR judgment, 23 September 1982, Series A no. 52, para 63.
[295] Stephen Olynyk, 'A Balanced Approach to Distinguishing Between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration' (2012) 15 Intl Trade & Bus L Rev 254, 255.
[296] UNCTAD (n 267) 139.

comprehensive) provisions, and by the rules of international law. For instance, explicit requirements have been set out in U.S. and Canadian model BITs to determine when and whether regulatory measures can amount to indirect expropriation.[297]

In such situations, customary international law has played a significant role in easing the tensions created by the confusion surrounding the distinction between a State's normal administrative and supervisory measures and expropriatory measures; it focuses on the legal obligations of host States that result from consistent and well-recognized State practice.[298] This is why this thesis constantly refers to previous arbitral decisions in strengthening its analysis and arguments; to a great extent, these decisions have developed and contributed to the principles and rules of international investment law and have enhanced the old restricted legal framework that merely consisted of inflexible legal provisions. These decisions, however, should not be used at anyone's convenience; rather, they should be used to conclude some guiding principles to assist practitioners to figure out the confusion already in existence. As one scholar commented, 'while customary international law is constantly evolving and new examples of State practice are liable to change the existing rules, such new practices should, nevertheless, meet other criteria, including consistency, generality, and

[297] August Reinisch, 'Expropriations' in Peter Munchlinkski, Federico Ortino and Christoph H Schreuer (eds), *The Oxford Handbook of International Investment Law* (Oxford University Press 2008) 423-24.
[298] Subedi (n 254) 136.

uniformity, before they can alter existing rules'.[299] This thesis argues that we can learn from these arbitral decisions and that some, even if not all, of them can form part of expropriation jurisprudence under international investment law.

As evidenced in our aforesaid discussion, the issue of how to determine the occurrence of indirect expropriation is far from settled; its future is manifested in the language formulation of respective treaty provisions as well as in the contributions from international arbitral 'case law'. More research and detailed rules are needed to clarify the boundary between the normal exercise (non-compensable) of State regulatory power and indirect expropriation.

To sum up, the issue at point is whether the host State is exercising its non-compensable regulatory power that needs to be honored or its compensable expropriatory power that has to be restrained. To understand this issue, rules and methods are needed to distinguish expropriations from State general regulations.

However, there are rules and principles that attempt to define the legitimate circumstances where expropriation can be lawfully exercised; the rules for finding indirect expropriation have yet to be agreed upon. A number of reasons can explain the failure to produce a principled approach to determining indirect

[299] ibid 132.

expropriation, including, but not be limited to, the inconsistency between the legal provisions and the reality and between previous guiding international arbitral decisions.

There is the inconsistency because indirect expropriation is so furtive in nature - the State's direct interference with foreign investment is no longer a useful asset in this new type of expropriation. As a result, indirect expropriation shares great similarities with the State's general regulatory measures; the major difference between these two kinds of measures may only be that the outcome of indirect expropriation is so unfair and excessive for foreign investors. This finding is of great importance for proposing a scientific method to conclude indirect expropriation since it points out the necessity to classify and category the existing legal provisions together with previous arbitral decisions regarding indirect expropriation in order to examine the threshold at which the regulations may be seen as 'so unfair and excessive' and thus expropriatory.

Chapter IV Forms of Expropriation in Practice and Their Legal Definitions

As thoroughly discussed and commented above, the host State has certain responsibilities when exercising its power to expropriate. This chapter, bearing in mind these responsibilities, intends to elaborate on the content and character of expropriation, clarifying the factual circumstances that would constitute expropriation in its direct and indirect forms and identifying the key principles in them that would trigger a State's international legal liability in accordance with the applicable, whether domestically or internationally, legal requirements.

4.1 Recognizing Expropriation in its Distinctive Forms

Expropriation, a phenomenon that has existed for centuries, and indirect expropriation, a derivative form of traditional expropriation that has appeared in recent decades, were both created for their own specific purposes and in their exact historical environments. What they share in common, however, is that they both involve foreign investors having to bear the consequences, in terms of their legitimate rights and interests, of State measures designed to promote the welfare of society.

In an age of globalization, sovereign States need to attract foreign private capital and advanced technology for their own development and therefore need to avoid being labeled as States that frequently pose expropriation risks to foreign

investments.[300] That is why in recent decades, formal decrees by host States, which were common in the era of socialism and had the effect of directly depriving an investor of its property, have become relatively rare.[301] However, due to the needs associated with States' national development plans and environmental policies, the expropriatory measures of States have not been eliminated.[302]

Expropriation, as a dynamic concept and in this context, has experienced changes in response to the development of the worldwide investment climate. In seeking to maximally appreciate their own benefits, States and their foreign investors have in their own way contributed to the expansion of this concept to include various forms of a State's expropriatory acts when determining the occurrence of expropriation, such acts being termed 'indirect expropriation'.

The form of indirect expropriation is much more controversial and, to put it in an exaggerated way, difficult to determine, its nature being described as 'furtive'. Various descriptions, such as 'regulatory, constructive, consequential, disguised, de facto or creeping',[303] have been put forward to explain its unique nature. The

[300] W Michael Reisman and Robert D Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation' (2004) Faculty Scholarship Series Paper 1002, 118.
[301] ibid.
[302] *Methanex Corporation v United States of America* (*Methanex*), UNCITRAL Case, Final Award, 9 August 2005, Part IV, ch D, para 9.
[303] Burns H Weston, '"Constructive Takings" Under International Law: A Modest Foray into the Problem of "Creeping Expropriation"' (1975) Va J Intl L 103, 106.

following sections will be instructive in terms of understanding the difference between direct and indirect expropriation and their quintessence and researching the relevant legislative documents, the aim being to identify the problems in the current international investment legal regime, particularly those regarding how to distinguish between a State's legitimate regulatory power and compensable indirect expropriation.

4.1.1 Direct (or Formal) Expropriation

Direct (or formal) expropriation is an event in which a foreign investment is openly and deliberately seized by the host State and/or the title of this investment is transferred to the State or its mandated third party.[304] The tribunal in *Amco Asia Corporation v Indonesia* agreed on this point, stating that direct expropriation can be found 'not only when a state takes over private property but also when the expropriating state transfers ownership to another legal or natural person'.[305]

Thus it is obvious that governmental acts such as nationalization and physical seizure of assets by the State definitely fall into the category of direct

[304] R Doak Bishop, James Crawford and W Michael Reisman, *Foreign Investment Disputes: Cases, Materials, and Commentary* (Kluwer Law International 2005) 845, quoting from Errol P Mendes, 'The Canadian National Energy Program: An Example of Assertion of Economic Sovereignty or Creeping Expropriation in International Law' (1981) 14 Vand J Transnatl L 475, 498-501.

[305] Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Wolters Kluwer Law & Business, Kluwer Law International 2009) 323, citing from *Amco Asia Corporation v Indonesia*, Award, 20 November 1984, 1 ICISD Rep 413, 455.

expropriation. Besides these acts, a legislated transfer of assets exercised by the State has the same effect of transferring property from the foreign investor to the State or its mandated beneficiary and is therefore direct expropriation.[306]

In this context, in direct expropriation events, the key consideration is actual 'appropriation' – whether the investor is deprived of its property (e.g. forced transfer of title) and correspondingly whether the State or its mandated third party has appropriated this property. A case in point is *Mr. Franz Sedelmayer v Russia,* in which a Presidential Decree was issued by the Russian Government to transfer the claimant's property to its governmental authorities, thus constituting direct expropriation because of the Russian Government's appropriation.[307]

4.1.2 Indirect Expropriation: Expansionary Trend of Traditional Expropriation

In contrast, indirect expropriation's core value does not concentrate on the 'appropriation'. It is generally concluded that it occurs 'when there is an interference by the State in the use, enjoyment, or benefits derived from a property even when the property is not seized and the legal title of the property is

[306] ibid 338.
[307] *Mr. Franz Sedelmayer v The Russian Federation*, Ad hoc Arbitral Award, IIC 106 (1998), Arbitration Institute of the Stockholm Chamber of Commerce.

not affected'.[308] Such interference, instead of directly affecting the property, might occur gradually and be disguised in steps and by separate acts.[309]

G.C. Christie established the principles of indirect expropriation in 1962: 'a State may expropriate property, where it interferes with it, even though the State expressly disclaims any such intention', and 'even though a State may not purport to interfere with rights to property, it may, by its actions, render those rights so useless that it will be deemed to have expropriated'.[310] It was therefore evidenced that the distinction between direct and indirect expropriation is whether there is an actual appropriation or transfer of ownership. These principles have gained general acceptance and have subsequently been followed in arbitration practice.

The case of *Starrett Housing* concerned the Iranian Government's appointment of a 'temporary' manager to an American housing project. As asserted by Starrett, the majority shareholder of the company, the appointment had deprived the company of its right to manage and thus constituted indirect expropriation. The

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[308] Catherine Yannaca-Small, 'Indirect Expropriation and the Right to Regulate in International Investment Law' (2004) Organisation for Economic Co-operation and Development, Working Papers on International Investment Number 2004/4, 4.

[309] Courtenay Barklem and Enrique Alberto Prieto-Ríos, 'The Concept of "Indirect Expropriation", Its Appearance in the International System and Its Effects in the Regulatory Activity of Governments' (2011) 11(21) Civilizar Ciencias Sociales y Humanas 77, 77.

[310] GC Christie, 'What Constitutes a Taking under International Law' (1962) 38 Brit Y B Intl L 307, 311.

case is significant because it began to recognize that the interference of a State's conduct must constitute expropriation if this interference makes a property right useless even though the State never intentionally expropriated the property or deprived the original owner of the legal titles of the property.[311] As stated in the award,

> …[it] is recognized in international law that measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been taken, even though the state does not purport to have expropriated them and the legal title to the property formally remains with the original owner.[312]

In *Tippetts*, also decided by the Iran-United States Claims Tribunal, the tribunal found that the actions of the manager appointed by the Iranian Government constituted indirect expropriation and that

> [a] deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected. While assumption of control over property by a government

[311] *Starrett Housing Corp. v Iran* (*Starrett Housing*), 4 Iran-U.S. Cl. Trib. Rep., 122 (1983), 154-55.
[312] ibid.

> does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral. The intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.[313]

The tribunal in the case of *CDSE v Costa Rica*,[314] which concerned a governmental expropriation decree, furthered the analysis, concluding that

> [a] decree which heralds a process of administrative and judicial consideration of the issue in a manner that effectively freezes or blights the possibility for the owner reasonably to exploit the economic potential of the property, can, if the process thus triggered is not carried out within a reasonable time, properly be identified as the actual act of taking.[315]

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[313] *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran* (*Tippetts*), 6 Iran-U.S. Cl. Trib. Rep., 219 (1984), 255-56.
[314] *Compañía del Desarrollo de Santa Elena, S.A. v The Republic of Costa Rica* (*CDSE v Costa Rica*), ICSID Case No. ARB/96/1, Award, 17 February 2000.
[315] ibid para 76.

In *Metalclad v United Mexican States*, the claimant was prohibited from opening and operating a hazardous waste disposal facility even though it had met all of the legal and other relevant requirements. The claimant argued that this prohibition was issued after the initial stage of its operation. Since the Mexican Government had created a preserve in this area, it would be impossible for the facility to continue to operate. Due to these facts, the tribunal found that this denial of a permit with no legitimate grounds constituted indirect expropriation. Regarding the forms of expropriation, the tribunal concluded:

> Expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.[316]

Thus, the doctrine of indirect expropriation can be viewed as an expansion of traditional expropriation, but this expansionary doctrine, unlike direct expropriation, does not demand actual appropriation by the State or the transfer

[316] *Metalclad Corporation v The United Mexican States* (*Metalclad*), ICSID Case No. ARB (AF)/97/1, Award, 30 August 2000, para 103.

of the legal title of the property to the State.[317] In situations where an indirect expropriation occurs, the State may obstruct the foreign investor from benefiting from or utilizing their investment interests by using its sovereign legislative or regulatory power.[318]

4.1.2.1 De Facto Expropriation

De facto expropriation is a type of indirect expropriation, but it shares a key characteristic with direct expropriation, that is, *de facto* expropriation 'transfers property'.[319]

Sporrong and Lönnroth v Sweden, which was decided by the European Court of Human Rights, is a case in point. Although no expropriation was found in this case, its significance lies in the Court's attempt to find the definition of *de facto* expropriation. The tribunal held that

> [in] the absence of formal expropriation, that is to say a transfer of ownership, the Court considers that it must look behind the appearances and investigate the realities of the situation complained of … Since the Convention is intended to guarantee rights that are 'practical and effective'

[317] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 92.
[318] Jeswald Salacuse, *The Law of Investment Treaties* (Oxford University Press 2010) 297.
[319] Laurent Sermet, *The European Convention on Human Rights and Property Rights* (rev edn, Council of Europe 1998) 24.

> […], it has to be ascertained whether that situation amounted to a *de facto* expropriation, as was argued by the applicants.[320]

Dames and Moore v The Islamic Republic of Iran[321] can be illustrative in terms of understanding the nature of *de facto* expropriation. The tribunal in this case held that the 'unilateral taking of possession of property and the denial of its use to the rightful owners may amount to an expropriation even without a formal decree regarding title to the property'.[322] The rule developed from this case is that for *de facto* expropriation to be found, two conditions have to be met: (i) taking possession of the property and (ii) denial of its use to the rightful owners.[323] Therefore, *de facto* expropriation is linked to its use by the host State or by the beneficiaries appointed by it.[324]

Similarly, the tribunal in *Amco*[325] held that in addition to the outright seizure of property or transfer of title,[326] '[e]xpropriation in international law also exists merely by the state withdrawing the protection of its courts from the owner

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[320] *Sporrong and Lönnroth v Sweden*, ECtHR judgment, 23 September 1982, Series A no. 52, para 63.
[321] Charles N Brower and Jason D Brueschke, *The Iran-United States Claims Tribunal* (Martinus Nijhoff Publishers, Kluwer Law International 1998) 384, citing from *Dames and Moore v The Islamic Republic of Iran*, Award No. 97-54-3, 20 December 1983, reprinted in 4 Iran-U.S. Cl. Trib. Rep. 212.
[322] ibid.
[323] Allahyar Mouri, *The International Law of Expropriation as Reflected in the Work of the Iran-U.S. Claims Tribunal* (Martinus Nijhoff 1994) 89.
[324] ibid 69.
[325] *Amco Asia Corporation and Others v Republic of Indonesia,* ICSID Case No. ARB/81/1, Award, 20 November 1984.
[326] ibid para 158.

expropriated and tacitly allowing a *de facto* possessor to remain in possession of the thing seized',[327] implying that expropriation may exist if the State intentionally prevents the investment from being returned to the owner and thereby benefits the *de facto* possessor. Instead of indirectly benefiting a specific group (e.g. consumers or society in general), this possessor is specifically given the property as a result of the exercise of the State's power.[328] In cases like this, *de facto* expropriation could be found.

The Supreme Court of Canada took the same approach and decided the case of *Canadian Pacific Railway Co. v Vancouver* on the basis of the said criteria of *de facto* expropriation. The case concerned a bylaw issued by the City of Vancouver to prohibit the Canadian Pacific Railway from using an abandoned railway, which could not be sold, in other ways. The bylaw required that this land should be a public thoroughfare.[329] The Court, however, declined the claim of *de facto* expropriation. One important reason for the decision was that the requirement of acquisition of the beneficial interest in that land was not satisfied: that is to say, the City of Vancouver did not gain any benefits from this bylaw.[330] Thus, *de facto* expropriation could not be found.

[327] ibid.
[328] ibid.
[329] *Canadian Pacific Railway Co. v Vancouver (City)*, [2006] 1 S.C.R. 227, 2006 SCC 5, 22-23.
[330] ibid 31-37.

4.1.2.2 Creeping Expropriation

Article 15 (1) of the ILC's Articles on State Responsibility introduces the concept of a composite act: '[t]he breach of an international obligation by a State through a series of actions or omissions defined in aggregate as wrongful occurs when the action or omission occurs which, taken with the other actions or omissions, is sufficient to constitute the wrongful act'.[331]

The feature of creeping expropriation is reflected in this provision since, as concluded by the *Telenor* tribunal, this form of expropriation involves 'a series of acts over a period of time none of which is itself of sufficient gravity to constitute an expropriatory act but all of which taken together produce the effects of expropriation'.[332] Keith Highet also noted this feature in his dissenting opinion on *Waste Management Inc. v Mexico* and pointed out that this kind of expropriation 'is comprised of a number of elements, none of which can – separately – constitute the international wrong'[333] and that it 'must logically be more than the mere sum of its parts'.[334] In the case of *Tradex v Albania*, the tribunal also found that while 'none of the single decisions and events' could be

[331] ILC's Articles on State Responsibility, art 15 (1).
[332] *Telenor Mobile Communications A.S. v The Republic of Hungary,* ICSID Case No. ARB/04/15, Award, 13 September 2006, para 63.
[333] *Waste Management, Inc. v United Mexican States* (*Waste Management v Mexico*), ICSID Case No. ARB (AF)/98/2, Dissenting Opinion (of Keith Highet), 8 May 2000, para 17.
[334] ibid para 18.

said to be expropriatory, it was still possible that 'the combination of the decisions and events' could qualify as expropriation.[335]

In other words, creeping expropriation 'occurs as a result of a series of measures taken over time that cumulatively have an expropriatory effect',[336] thus distinguishing it from general indirect expropriation. In *Starrett Housing*, the tribunal correctly held that the appointment of the 'temporary' manager constituted expropriation. This appointment, however, was not 'the first or only act of expropriation; in fact, it was the last of a series of such measures' and thus the 'final measure cannot logically serve to obscure the earlier acts of expropriation'.[337] Accordingly, the significance of creeping expropriation is better understood.

UNCTAD defined the concept of 'creeping expropriation' in the following words:

> [T]he slow and incremental encroachment on one or more of the ownership rights of a foreign investor that diminishes the value of its investment. The legal title to the property remains vested in the foreign

[335] *Tradex Hellas S.A. v Republic of Albania* (*Tradex v Albania*), ICSID Case No. ARB/94/2, Award, 29 April 1999, para 191.
[336] Newcombe and Paradell (n 305) 343.
[337] Reisman and Sloane (n 300) 127, citing from *Starrett Hous. Corp. v Iran*, 4 Iran-US CTR 123, (1984) 23 ILM 1090, 1125 (Holtzmann, J, concurring).

> investor but the investor's rights of use of the property are diminished as a result of the interference by the State.[338]

The tribunal in *Generation Ukraine v Ukraine* tried to define this unique type of expropriation and described it as

> a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the State over a period of time culminate in the expropriatory taking of such property.[339]

In the case of *Tecmed v Mexico*,[340] the claimant wanted to seek remedies for its investment by alleging Mexico's violations of treaty protection. In this case, the claimant had invested in a hazardous industrial waste landfill in 1996 but had been unable to renew its license to operate from the Mexican Government two years later. It thus claimed for its investment loss due to the arbitrary and non-substantiated decision of the Mexican Government and sued Mexico for expropriation. The tribunal held that this nonrenewal of the license amounted to

[338] UNCTAD, *Taking of Property* (United Nations 2000) 11.
[339] *Generation Ukraine, Inc. v Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, para 20.22.
[340] *Técnicas Medioambientales Tecmed, S.A. v The United Mexican States* (*Tecmed v Mexico*), ICSID Case No. ARB (AF)/00/2.

indirect expropriation and reached the following conclusion on the scope of creeping expropriation:

> This type of expropriation does not necessarily take place gradually or stealthily - the term 'creeping' refers only to a type of indirect expropriation - and may be carried out through a single action, through a series of actions in a short period of time or through simultaneous actions.[341]

In *Biloune et al. v Ghana Investment Centre et al.*, the investor had been prohibited by a government affiliated entity from continuing its construction on the basis of the absence of a building permit after it had completed a substantial amount of the work. The investor had submitted an application but never received a response. The tribunal in this case paid due attention to the investor's justifiable reliance on the representations of the government about the permit application. The facts were that the government had known about the construction for more than a year before issuing the stop work order, that building permits had not been required for other projects, and that there was no procedure for dealing with building permit applications. On the basis of the details of the facts of the case, the tribunal stated:

[341] ibid para 114.

> What is clear is that the conjunction of the stop work order, the demolition, the summons, the arrest, the detention, the requirement of filing assets declaration forms, and the deportation of Mr Biloune without possibility of re-entry had the effect of causing the irreparable cessation of work on the project.
>
> …
>
> The tribunal therefore holds that the Government of Ghana, by its acts and omissions culminating with Mr Biloune's deportation, constructively expropriated MDCL's assets, and Mr Biloune's interest therein.[342]

In another relevant case, *Santa Elena v Costa Rica*, the tribunal expressed the same opinion in defining creeping expropriation:

> [T]he period of time involved in the process may vary – from an immediate and comprehensive taking to one that only gradually and by small steps reaches a condition in which it can be said that the owner has truly lost all the attributes of ownership. It is clear, however, that a measure or series of measures can still eventually amount to a taking, though the individual steps in the process do not formally purport to amount to a taking or to a transfer of title.[343]

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[342] *Biloune and Marine Drive Complex Ltd. v Ghana Investments Centre and the Government of Ghana* (*Biloune v Ghana*), UNCITRAL Case, Award on Jurisdiction and Liability, 27 October 1989, paras 209-10.
[343] *CDSE v Costa Rica* (n 314) para 76.

4.1.2.3 Consequential Expropriation

Another type of indirect expropriation that is significant to this research is consequential expropriation, which, as proposed by Professor W. Michael Reisman and Professor Robert D. Sloane, concerns the 'the host state's failures to create, maintain, and properly manage the legal, administrative, and regulatory normative framework contemplated by the relevant BIT, an indispensable feature of the "favourable conditions" for investment'.[344] By definition, we can tell that this type of expropriation focuses only on the presented consequences resulting from the failure of the State to exercise its constitutional, judicial, administrative, and regulatory obligations.

State sovereignty empowers the host State to exercise these obligations in the best interests of the public but also imposes liability upon it when it unlawfully exercises its power or fails to fulfill its obligations. Failure to regulate may, in this context, amount to expropriatory measures;[345] this liability, however, does not intend to limit the State's regulatory power by threatening that every potential or possible uneconomical consequence would constitute expropriation. In *Feldman*, the tribunal explained the relationship between regulatory measures and their consequences, denying that a finding of expropriation can be reached merely by relying on the severity of the economic consequences. As the tribunal stated:

[344] Reisman and Sloane (n 300) 128.
[345] ibid 129.

> [N]ot all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue. […] [G]overnments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.[346]

It is important, and equally hard, to prove the casual link connecting the deprivation of the foreign investment and the State's failure to maintain, create,

[346] *Marvin Roy Feldman Karpa v United Mexican States* (*Feldman v Mexico*), ICSID Case No. ARB (AF)/99/1, Award, 16 December 2002, paras 103 and 112 (citations omitted).

and properly manage an appropriate legal, administrative, and regulatory framework for foreign investment which thus results in the occurrence of consequential expropriation.[347] Some illustrative scenarios may provide great guidance for the purpose of understanding the rationale of consequential expropriation in this context. For instance, consequential expropriation may exist if the State promises to establish an apparatus for improving the foreign investment climate but eventually fails to do so or if the established apparatus or the functioning of the administrative and judicial departments is not reasonably efficient and is thereby harmful to a foreign investment.[348]

A relevant case here would be *Metalclad v United Mexican States*.[349] In this case, the claimant had been prohibited from opening and operating a hazardous waste disposal facility even though it had met all of the legal and other relevant requirements. It was further argued that this prohibition had been issued after the initial operation stage. Furthermore, since the Mexican Government had created a preserve in this area, it would be impossible for the facility to continue to operate. In this case, the Mexican Government had failed to maintain and properly manage its administrative plan and, by ignoring the initial policy, issuing the prohibition, and creating a preserve, had deprived the claimant of its investment. The tribunal held that 'the complete frustration of the operation of

[347] Reisman and Sloane (n 300) 130.
[348] ibid 131.
[349] *Metalclad* (n 316), Award, 2 September 2000.

the landfill [eliminated] the possibility of any meaningful return on Metalclad's investment'[350] and thus constituted expropriation.

4.2 Recognizing Expropriation by its Legal Definitions

Having classified the distinctive forms of expropriation according their practical effects, it is the right time for us to have a close look at the laws, both national and international, which define these expropriations. The hope of eliminating the chaos in the international investment environment depends on whether or not these regulations are thorough and comprehensive enough to overcome the variety of situations that involve a determination of expropriatory acts. Typically, a 'good' regulation has to balance the interests of the host State and the foreign investors, creating confidence among foreign investors and thus attracting inbound capital, advanced technology, and so forth, but, more importantly, not limiting the State's legitimate power to regulate them. The reality, however, is not that inspiring, as can be observed from the inconsistent and incomplete definitions of expropriation in existing laws.

In addition to the treaties concluded by States, their national laws and the international laws are equally significant for identifying the most appropriate definition of expropriation. Treaty practice has accepted this viewpoint and

[350] ibid para113.

continuously demands our attention to this issue. For instance, Article 42 (1) of the ICSID Convention provides the following:

> The Tribunal shall decide a dispute in accordance with *such rules of law as may be agreed by the parties*. In the absence of such agreement, the Tribunal shall apply *the law of the Contracting State party to the dispute* (including its rules on the conflict of law) and *such rules of international law* as may be applicable.[351]

4.2.1 State Practice in Recognizing Indirect Expropriation

Is there any general and consistent State practice in terms of recognizing expropriation? Is there any difference between capital-importing and capital-exporting countries in terms of recognizing expropriation? Additionally, is there any difference in recognizing expropriation in accordance with various national laws, BITs, FTAs, or other international treaties? Finally, how will the answers to these questions help us to find which method of determining expropriation is the most reasonable? The following sections will examine the positions some States have taken on the issue of expropriation.

[351] ICSID Convention, art 42 (1).

4.2.1.1 China and India

China and India are two leading capital-importing, and also developing, countries that can be used as examples in this case by elaborating on their stands on expropriation.

As pointed out by Premier Li in his 2014 Working Report, one notable thing upsetting social harmony in China is the 'expropriation' of land by the Chinese Government.[352] Although such expropriation is not precisely directed at the foreign investment being indirectly expropriated, the rationale behind this upsetting truth is the same as that in the case of indirect expropriation: it is the lack of laws in the existing Chinese legal framework for determining and limiting expropriatory acts.

Chinese legislation has lagged far behind international practice in providing a legal definition of expropriation. It is also the case that for decades the Chinese Government did not consider this issue in its legal thinking or make it a provision for confirming the State's responsibility in relation to the expropriation of citizens' property (foreign investments in particular).

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[352] Li Keqiang, *2014 Report on the Work of the Government* (Delivered at the Second Session of the Twelfth National People's Congress on 5 March 2014) <http://www.china.org.cn/chinese/2014-03/17/content_31806665_3.htm> accessed 6 June 2014.

For instance, the 1982 Chinese Constitution only gave general recognition to the need to protect the ownership of private property such as 'lawfully earned income, savings, houses and other lawful property'.[353] As for the State's power and responsibility with regard to expropriation, it only stated that the State could take over land for public interest purposes,[354] with no other corresponding limitations. Although it was argued at the time that this 'public interest' requirement extended beyond mere land expropriation and also applied to other forms of property (e.g. foreign investment),[355] there are still no clear rules conferring legitimate power on the State to expropriate private property and no limitations (except the public interest requirement) on exercising such power.

Where it related to the expropriation of private property, the Constitutional Law of China was silent on the subject when was enacted and for decades thereafter. In 2004, the revised Constitution was promulgated and was viewed as a giant step forward in China's legislative process. It contains an article explicitly on the State's expropriation of private property. This article states that the lawful property rights of citizens cannot be encroached upon and that their ownership of private property is protected by the State.[356] The State can only expropriate or

[353] 1982 Constitution of the People's Republic of China, art 13.

[354] ibid art 10.

[355] Lianlian Lin and John R Alison, 'An Analysis of Expropriation and Nationalization Risk in China' (1994) 19 Yale J Intl L 135, 173.

[356] 2004 Constitution of the People's Republic of China, art 22.

nationalize the property of its citizens for public use and in the public interest, and it has to pay compensation as legally required;[357] the same conditions also apply to land expropriations.[358]

In this respect, there are other laws and regulations touching upon the issue of the expropriation of foreign investments. The PRC Law on Chinese-Foreign Equity Joint Ventures kept silent on the issue of expropriation in 1979 and only assured foreign investors that their investments were under protection.[359] Eleven years later, an expropriation provision was introduced into this law which clearly provided that the State could expropriate or nationalize a joint venture under special circumstances.[360] The provision stated that the exercise of this right depended on 'the needs of social public interest' and should be exercised in accordance with legal procedures and accompanied with compensation.[361]

The same approach to identifying the State's power to expropriate can be found as early as in both the 1986 and 2000 versions of the PRC Law on Foreign-

[357] ibid.

[358] ibid art 20.

[359] 1979 Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, art 2.

[360] 1990 and 2001 Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, art 2.

[361] ibid.

Capital Enterprises;[362] for instance, Article 5 of the 1986 PRC Law on Foreign-Capital Enterprises states:

> The state shall not nationalize or requisition any enterprise with foreign capital. Under special circumstances, when public interest requires, enterprises with foreign capital may be requisitioned by legal procedures and appropriate compensation shall be made.

In addition, the 1982 PRC Regulation on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises stipulates that the State has the right to expropriate a foreign investor's property in the event of 'war, threat of war or other state of emergency'.[363] In the 2001 revised version of this regulation, however, the State is obliged not to expropriate in general but has the right to expropriate 'under special circumstances' according to 'the needs of public interests'.[364] Additionally, an expropriation should be performed in accordance with 'legal procedures' and with the 'appropriate compensation'.[365]

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[362] 1986 and 2000 Law of the People's Republic of China on Foreign-Capital Enterprises, art 5.

[363] 1982 Regulation of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises, art 26.

[364] 2001 and 2011 Regulation of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises, art 4.

[365] ibid.

Another important law that should involve the consideration of expropriation is a State's property law. In China's case, the PRC Property Law was not promulgated until 2007. This law should have contained provisions on the issue of expropriation that provide a comprehensive set of rules for resolving conflicts between the State's sovereign power and the protection of private property. Unfortunately, it does not grasp the nature and essence of expropriation, especially its disguised and indirect form. The provision concerning expropriation is Article 42, which states that '[t]o meet the needs of public interests, collectively-owned lands, premises owned by entities and individuals or other real properties may be expropriated in accordance with the power scope and procedures provided by laws'; this article is followed by provisions on compensation for such expropriatory activities.[366]

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[366] Property Law of the People's Republic of China, art 42. This article goes on to provide the following:

> As for the expropriation of collectively-owned land, it is necessary to, according to law and in full amount, pay such fees as land compensation fees, placement subsidies, compensations for the above-ground fixtures of the lands and seedlings, arrange for social security fees for the farmers whose land is expropriated, secure their livelihood and safeguard their legitimate rights and interests.
>
> As for the expropriation of the premises owned by entities and individuals or other real properties, it is necessary to make compensation for demolishment and relocation according to law and safeguard the legitimate rights and interests of the owners of the real properties expropriated; as for the expropriation of the individuals' residential houses, it is necessary to safeguard the housing conditions of the owners of the houses expropriated.

Therefore, the only provision in the PRC Property Law regarding expropriation concentrates on land expropriation and is not explicitly concerned with regulating the expropriation of private property, although the legislative interpretation of this article implies its underlying intention to include other forms of property, including private property, in this expropriation provision.

From these expropriation provisions, it can be concluded that China's approach to the expropriation of foreign investments, as legally required, is that it has to be conducted in accordance with legal procedures and with compensation, and, most importantly, under special circumstances and in the public interest. These requirements have been criticized for their ambiguity.[367] What might be a sufficient and reasonable interpretation of 'public interest' to qualify the State's expropriatory measures as legitimate so as to distinguish lawful expropriation from unlawful expropriation? How can the State's expropriations be distinguished from its normal administrative measures if they should both be enforced in the 'public interest' but one needs to be accompanied with compensation and the other does not? Needless to say, none of aforementioned Chinese laws has legislatively extended the traditional direct expropriation

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No entity or individual may embezzle, misappropriate, privately share, detain or delay in the payment of the compensation fees for expropriation.

[367] See, for example, Lei Chen, 'The New Chinese Property Code: A Giant Step Forward?' (2007) 11(2) Electronic J Comp L 1, 12.

doctrine to its indirect forms or mentioned the applicable method for determining the occurrence of indirect expropriation.[368]

One thing that is particularly notable in Chinese law is the legal status of international treaties in China's law hierarchy. For instance, the PRC Civil Procedure Law requires that the provisions of an international treaty (to which China is a Contracting Party and does not make reservations) should prevail if there is a conflict between treaty law and domestic law.[369] The effect of this kind of provision is more significant when found in substantive laws. In China's 'Civil Code', Article 142 of the General Principles of Civil Law, which was created to deal with foreign interests, provides that

> [i]f any international treaty concluded or acceded to by the People's Republic of China contains provisions differing from those in the civil laws of the People's Republic of China, the provisions of *the international treaty shall apply*, unless the provisions are ones on which the People's Republic of China has announced reservations.[370]

[368] Wallace Wen-Yeu Wang and Jian-Lin Chen, 'Bargaining for Compensation in the Shadow of Regulatory Giving: The Case of Stock Trading Rights Reform in China' (2006) 20 Colum J Asian L 298, 323 ('Currently, there is certainly no equivalent Chinese doctrine of regulatory takings.'); Li Ping, 'The Impact of Regulatory Takings by the Chinese State on Rural Land Tenure and Property Rights' (2007) Rights and Resources Initiative, 9 ('Currently, China does not have a regulatory takings law.').

[369] 2012 Civil Procedure Law of the People's Republic of China, art 260.

[370] General Principles of the Civil Law of the People's Republic of China, art 142.

There are more stipulations that emphasize the situations where there is no law to apply and/or where there are no detailed rules to regulate, which is exactly the case with regards to indirect expropriation in China. Article 42 provides that

> *[i]nternational practice may be applied* on matters for which neither the law of the People's Republic of China nor any international treaty concluded or acceded to by the People's Republic of China has any provisions.[371]

Thus, theoretically and legally speaking, the provisions of China's IIAs regarding expropriation and indirect expropriation can be applied where these treaties have different rules for determining expropriatory measures compared with Chinese legislative provisions, and it is possible to integrate accepted international practice into the process of determining such measures since a detailed determination method cannot be found in either Chinese laws or China's treaty stipulations.

Indirect expropriation risks, therefore, exist not only for foreign investors because of China's lack of relevant legislative requirements for defining and regulating expropriatory measures (particularly regarding indirect expropriation), which could undermine their legitimate property protection, but also for the

[371] ibid.

Chinese Government, as by relying on the legal rule that treaty law prevails over domestic law, foreign investors could claim expropriation by the Chinese Government and demand expropriation protection by citing the rules in treaty law (to be examined in later sections) and even a body of international arbitral decisions. Although a Chinese court may not choose to decide a case on the basis of Article 142, these risks, whether to China or to its foreign investors, are undesirable and are mainly caused by the deficiencies of the Chinese legal framework. The rule of law system, as constitutionally promoted in China and by its Government,[372] is thus undermined.

India provides even less legal protection to foreign investment, although its constitution implies the inclusion of indirect expropriation but only states that 'no person shall be deprived of his property save by authority of law' and '[n]o property shall be compulsorily acquired or requisitioned save for a public purpose and save by authority of a law which provides for acquisition of the property for an amount which shall be fixed by such law'.[373] Thus, the right to property in India can only amount to a statutory right rather than a constitutional right.

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[372] Article 5 of the PRC Constitution (since the 1999 version) states that '[t]he People's Republic of China practices ruling the country in accordance with the law and building a socialist country of law'.

[373] Matthew C Porterfield, 'State Practice and the (Purported) Obligation under Customary International Law to Provide Compensation for Regulatory Expropriations' (2011-2012) 37 NCJ Intl L & Com Reg 159, 173.

In summary, it can be deduced that many capital-importing countries 'have yet to extend private property rights protection to regulatory takings'.[374]

4.2.1.2 U.S. Jurisprudence

American practice has had great influences on the development of how indirect expropriation is determined in international law.[375] Its takings clause under the Fifth Amendment, which has evolved from covering mere direct takings to including direct and regulatory takings, requires that private property shall not 'be taken for public use without just compensation'.[376] It was in *Pennsylvania Coal v Mahon* that the Supreme Court expressed the opinion that governmental regulations could constitute expropriation. Specifically, Justice Holmes held that 'while property may be regulated to a certain extent, if a regulation goes too far it will be recognized as a taking'.[377] The definition of 'too far' is actually a determination of the 'degree'[378] of interference in a specific case and thus cannot

[374] Wang and Chen (n 368) 332.
[375] M Sornarajah, *The International Law on Foreign Investment* (2nd edn, Cambridge University Press 2004) 353-55.
[376] *Lucas v South Carolina Coastal Council* (1902) 505 US 1003, 1014, 1028; *Lingle, Governor of Hawaii, et al. v Chevron USA Inc.* (*Lingle*) (2005) 544 US 528, 537.
[377] *Pennsylvania Coal Co v Mahon et al*. (1922) 260 U.S. 393 (43 S.Ct. 158, 67 L.Ed. 322), 415.
[378] Justice Holmes discussed whether or not the point at which the exercise of police power can be said to have become a taking that needs compensation is a question of degree both in this case and also in *Bent v Emery*. See *Bent v Emery*, 173 Mass., 496.

be summarized into a general conclusion.[379] The *Pennsylvania Coal v Mahon* case has its merits because it was regarded as the foundation of American 'regulatory takings' jurisprudence.[380]

The case of *Lingle, Governor of Hawaii, et al. v Chevron USA Inc.*, which was decided in 2005, confirmed the criteria established in a previous case for determining the occurrence of indirect expropriation by explicitly pointing out that 'regulatory takings challenges are governed by the standards set forth in *Penn Central*'.[381] Such a confirmation strengthened the weight of *Penn Central* in U.S. jurisprudence in determining indirect expropriation. The analysis in *Penn Central* concentrated on the following:

> 'Taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated. In deciding whether a particular governmental action has effected a taking, this Court focuses rather both

[379] *Pennsylvania Coal Co v Mahon et al*. (1922) 260 U.S. 393 (43 S.Ct. 158, 67 L.Ed. 322), 416. In the current case, Justice Holmes gave his opinion that the Kohler Act violated the Just Compensation Clause by prohibiting *all economic use* of the support right of the owner. Therefore, this prohibition constituted a 'taking'. Another example to illustrate the 'degree' would be *McCarter* case, according to which the measure would constitute a 'taking' if a regulation renders the property 'wholly useless'. See *Hudson County Water Co. v McCarter* (1908) 209 U.S. 349, 355.
[380] D Benjamin Barros, 'The Police Power and the Takings Clause' (2003-2004) 58 U Miami L Rev 471, 499.
[381] *Lingle* (n 376) 538.

on the character of the action and on the nature and extent of the interference with rights in the parcel as a whole.[382]

4.2.1.3 Canadian Approach

Canada's view on the matter of expropriation in its domestic jurisprudence most probably represents the position of a capital-exporting country – that is, to reject the theory of indirect expropriation.[383] In this respect, Canada's constitution maintains absolute silence on the doctrine of expropriation. Only the 1960 Canadian Bill of Rights provides some limited protection for foreign investment, stating that individuals have 'the right … to … [the] enjoyment of property, and the right not to be deprived thereof except by due process of law'.[384] Hence, the criticism was made that in Canada, private property rights lacked a constitutional foundation for not being unjustifiably expropriated.[385] In this situation, the provincial and federal statutory provisions take on the duty of giving expropriation its legal definition and its conditions.[386] According to these statutory provisions, the occurrence of indirect expropriation depends on whether the rightful owner's use of the investment is essentially denied and whether there

[382] *Penn Central Transportation Co v New York City* (1978) 438 U.S. 104, 130-31.
[383] Porterfield (n 373) 178.
[384] Canadian Bill of Rights, S.C. 1960, c. 44, s 1(a).
[385] Bryan P Schwartz and Melanie R Bueckert, 'Canada' in Rachelle Alterman (ed), *Takings International: A Comparative Perspective on Land Use Regulations and Compensation Rights* (American Bar Association 2010) 93 ('Canada's constitutional framework lacks safeguards to protect property owners from governments that unjustifiably expropriate private property.'); L Kinvin Wroth, 'Lingle and Kelo: The Accidental Tourist in Canada and NAFTA-Land' (2005-2006) 7 Vt J Envtl L 62, 77 ('In Canada … the law of expropriation lack[s] a constitutional basis.').
[386] Porterfield (n 373) 179.

is a State appropriation or acquisition.[387] Therefore, in Canadian jurisprudence, compulsory acquisition is a precondition for indirect or regulatory expropriation, which is totally different from U.S. takings jurisprudence.[388]

4.2.1.4 European Jurisprudence

Europe is indispensable to a discussion on expropriation regulations since it is one of the largest recipients, as well as exporters, of capital around the world. The attitudes of European countries toward this issue, however, are not consistent or unified. Below, some of the main countries' legislative situations will be briefly introduced and then the experience of the European Court of Human Rights will be used to serve as the indicator showing the most likely future development of the jurisprudence on indirect expropriation in Europe. In general, the European countries have not given much attention to defining indirect expropriation in their detailed regulations in their domestic jurisprudence; even if there are some definitions available, they are most probably for land use regulations.[389]

In the United Kingdom, the government's actual seizures are recognized, but the common law system 'has systematically avoided the concept of a regulatory

[387] *Mariner Real Estate v Nova Scotia*, 177 D.L.R. 4th, 732; Mouri (n 323) 89.
[388] Elmarie van der Schyff, 'Constructive Appropriation – The Key to Constructive Expropriation? Guidelines from Canada' (2007) 40 Comp & Intl L J S Afr 306, 311.
[389] Harvey M Jacobs, 'The Future of the Regulatory Takings Issue in the United States and Europe: Divergence or Convergence?' (2008) 40 Urb L 51, 59-60.

taking'; for English courts, 'a mere negative prohibition, though it involves interference with an owner's enjoyment of property, does not … carry with it at common law any right to compensation'.[390]

In France, the 1789 Declaration of the Rights of Man and Citizen states the following: '[p]roperty being an inviolable and sacred right, no one may be deprived of it except when public necessity, certified by law, obviously requires it, and on the condition of a just compensation in advance'.[391] In addition, Article 545 of the French Civil Code provides that '[n]o one may be compelled to yield his ownership, unless for public purposes and for a fair and previous indemnity'.[392] However, the reality is that the right to claim a regulatory taking is seriously limited. A commentator once pointed out this situation in land use regulations, namely that '[u]nder French law, public authorities have both a broad and a strong set of authorities to manage privately owned land. Owners have no basis to claim a regulatory taking, and the public may preempt proposed private land sales'.[393]

In Germany, Article 14 of its Basic Law requires that '[e]xpropriation shall only be permissible for the public good',[394] thus extending this law beyond mere

[390] Philip A Joseph, 'The Environment, Property Rights, and Public Choice Theory' (2003) 20 NZ Univ L Rev 408, 425.
[391] Jacobs (n 389) 58.
[392] French Civil Code, art 545.
[393] Jacobs (n 389) 68.
[394] German Basic Law, art 14.

direct seizure and acquisition by the State. German law acknowledges the possibility of the State's unintentional measures adversely affecting the rightful owner's property rights[395] as well as its unlawful actions or omissions producing similar consequences.[396] German law jurisprudence recognizes expropriation in accordance with its forms, including expropriatory infringement (*enteignende Eingriff*), where the State lawfully exercises its regulatory rights but produces unwelcome side effects, and quasi-expropriatory infringement (*enteignungsgleiche Eingriff*), where the State unlawfully exercises its power to regulate. However, there is no legislative provision to compensate for damages due to regulations with an expropriatory effect.[397]

Perhaps Harvey M. Jacobs's comment is more useful in concluding the current situation in Europe:

> [I]n much of Europe, government has had and continues to have the right to regulate property, … And some European constitutions further reinforce this tension by expressly noting the social obligations or social rights inherent in property (and thus the need for individuals to curb their

[395] Hanri Mostert, 'Does German Law Still Matter? A Few Remarks about the Relevance of Foreign Law in General and German Law in Particular in South African Legal Development with Regard to the Issue of Constructive Expropriation' (2002) 3 German L J 1, 15 <http://www.germanlawjournal.com/index.php?pageID=11&artID=183> accessed 9 July 2013.

[396] ibid note 61, citing from F Schoch, '*Die Haftung aus enteignungsgleichem und enteignendem Eingriff*' (1990) Juristische Ausbildung (Jura) 140-41.

[397] This situation was well known according to a German famous case - *Naßauskiesungsbeschluß*. For more information, see Mostert (n 395) 16.

> individualistic expectations). What has not happened in Europe is something parallel to the 1922 *Pennsylvania Coal* decision. Neither on a country nor European basis has a legal, legislative, or policy decision been forthcoming that articulates a concept of regulatory takings. At least in Europe today, there is still a hard line between the concept of taking—an action of physical expropriation—and the concept of regulation.[398]

More importantly, it is noteworthy that in Europe, the European Court of Human Rights has a great influence on formulating the way to determine expropriation. According to Article 1 ('Protection of Property') of the European Convention on the Protection of Human Rights and Fundamental Freedoms:

> Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

[398] Jacobs (n 389) 60.

This provision, as the judgment in *Sporrong and Lönnroth v Sweden* further explained, comprises three distinct rules:

> The first rule, which is of a general nature, enounces the principle of peaceful enjoyment of property … The second rule covers deprivation of possessions and subjects it to certain conditions … The third rule recognises that the States are entitled, amongst other things, to control the use of property in accordance with the general interest, by enforcing such laws as they deem necessary for the purpose.[399]

In addition to these three distinct rules, interference, deprivation, and control of use, one more important consideration in determining the occurrence of indirect expropriation in ECtHR jurisprudence is to 'achieve a "fair balance" between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights'.[400]

4.2.2 Finding Indirect Expropriation in International Treaties and Legal Documents

[399] *Sporrong and Lönnroth v Sweden* (n 320) para 61.
[400] *Mellacher v Austria*, App no 10522/83; 11011/84; 11070/84 (1990), 12 EHRR 391, para 48.

Continuing with our exploration of the legal requirements on expropriation, the international legal documents have more detailed and comprehensive formulations than ordinary national legislation. The aim of this section is to classify these international documents into different categories in order to show the stages of their evolution as well as their various legislative focuses.

4.2.2.1 Various Expressions in IIAs' Definitions of Indirect Expropriation

There are some IIAs that define expropriation by simply stating that 'investments … shall not be expropriated'[401] or by referring to expropriation and nationalization and other 'similar measures'.[402]

Other IIAs, instead of explicitly using the terms expropriation or nationalization, choose the expressions 'deprivation',[403] 'restriction',[404] or 'interference'[405], or use phrases such as 'effect similar to dispossession'[406] and 'effect of which

[401] 2001 Austria-Egypt BIT, art 4.
[402] 1994 China-Chile BIT, art 4.
[403] 1991 Czechoslovakia-Netherlands BIT, art 5 ('Neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments.').
[404] 1989 Belgo-Luxembourg Economic Union (BLEU) – Burudi, art 4 ('deprivative or restrictive measure or any other measure having a similar effect').
[405] 1989 Germany-USSR BIT, art 4. The Protocol to this BIT provides that '[a]n Investor shall also be entitled to compensation if the other Contracting Party interferes with the economic activities of an enterprise in which he is participating, if his investment is significantly reduced by such interference'. See *Mr. Franz Sedelmayer v The Russian Federation* (n 307), Arbitration Award, 7 July 1998, 11.
[406] 1991 Argentina-France BIT, art 5 (2) ('The Contracting Parties shall not adopt, directly or indirectly, measures of expropriation or nationalization or any other equivalent measure having an effect similar to dispossession, except for public purpose and provided that such measures are not discriminatory or contrary to a specific commitment.').

would be direct or indirect dispossession',[407] or even list potential types of measures that can be expropriatory.[408]

Nevertheless, in IIA practice, the most common way of defining expropriation is to refer to expropriation or nationalization through direct or indirect means ('directly or indirectly') or to identify the consequence of this expropriation or nationalization with the adjectives 'similar', 'same', 'equivalent', or 'tantamount', showing that the determination of expropriation depends on its expropriatory effect rather than its form.[409]

4.2.2.2 New Trend of Expression in IIAs

The new trend in defining expropriation is reflected in series of BITs and FTAs, particularly in Canadian and U.S. Model BITs and their latterly enforced IIAs, which are equipped with detailed rules and depend on case-by-case and fact-based inquiry. This new trend has been mirrored in a number of BITs and FTAs.[410] As examples, the United States-Singapore FTA, the United States-

[407] Yannaca-Small (n 308) 6.

[408] For instance, in the 1984 Congo-US BIT, Article 6 states that 'the levying of taxes equivalent to indirect expropriation, the compulsory sale of all or part of an investment, or the impairment or deprivation of the management, control, or economic value of an investment' can be expropriatory.

[409] Newcombe and Paradell (n 305) 332.

[410] In this case, the 2007 Colombian Model BIT also has detailed rules (Art VI (2)) after providing its general provision on expropriation (Art VI (1)):

(a) Indirect expropriation results from a measure or series of measures of a Contracting Party having an equivalent effect to direct expropriation without formal transfer of title or outright seizure;

Australia FTA, the United States-Morocco FTA, and the United States-Uruguay BIT all take the same approach to determining indirect expropriation that requires, but is not limited to, a full consideration of the government regulatory measure's purpose and its economic effect and the investor's legitimate expectations.

For instance, Article 6 in the 2012 U.S. Model BIT states:

> Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization…

(b) Indirect expropriation results from a measure or series of measures of a Contracting Party having an equivalent effect to direct expropriation without formal transfer of title or outright seizure;

1) The economic impact of the measure or series of measures; however, the sole fact of a measure or series of measures having adverse effects on the economic value of an investment does not imply that an indirect expropriation has occurred;

2) The scope of the measure or series of measures and their interference on the reasonable and … distinguishable expectations concerning the investment;

(c) Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures of a Party that are designed and applied for public purposes or social interest or with objectives such as public health, safety and environment protection, do not constitute indirect expropriation.

There is no significant difference between the main body of this provision and other IIAs in terms of defining expropriation, except that an annex is attached to this provision furthering the determination process in depth. As the Treaty declares, there is a shared understanding that:

1. Article 6 [Expropriation and Compensation](1) is intended to reflect customary international law concerning the obligation of States with respect to expropriation.
2. An action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.
3. Article 6 [Expropriation and Compensation](1) addresses two situations. The first is direct expropriation, where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure.
4. The second situation addressed by Article 6 [Expropriation and Compensation](1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.

    (a) The second situation addressed by Article 6 [Expropriation and Compensation](1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation

without formal transfer of title or outright seizure.

(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

(iii) the character of the government action.

(b) Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.

The approach taken by the United States is to provide a comprehensive and flexible framework that only offers arbitral tribunals possible considerations and guidance to take into account when thinking about and deducing the most reasonable decision in each specific case. It is thus a balanced approach, not giving preference to either the host State or the foreign investor, even though, as stated in the annex, it 'is intended to reflect customary international law concerning *the obligation of States* [emphasis added] with respect to expropriation'.

The 2007 Norwegian Model BIT, on the other hand, is based on the perspective of protecting the State's regulatory power. Therefore, in addition to a general provision on expropriation, the Treaty states the following:

> The preceding provision shall not, however, in any way impair the right of a Party to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

This Norwegian approach is concerned more with the preservation of the State's regulatory freedom and right to issue regulations without worrying about its liability for compensation.[411]

Taking China as an example to elaborate on the evolving trend in State treaty practice to accept a balanced approach to defining indirect expropriation: As of 1 June 2013, China had signed 128 bilateral investment treaties, 103 of which had entered into force.[412] In addition, China has signed FTAs with ASEAN, Chile, New Zealand, Singapore, and other five other countries and has concluded closer economic and partnership arrangements with Hong Kong and Macau. All of

[411] Please refer to the English translation of '*Comments on the Model for Future Investment Agreements*' (2007) 21 <http://www.uio.no/studier/emner/jus/jus/JUR5850/tekster/norway_draft_model_bit_comments.pdf> accessed 6 October 2013.

[412] For more details, please see the list of China's BITs provided on the UNCTAD website <http://unctad.org/Sections/dite_pcbb/docs/bits_china.pdf> accessed 6 October 2013.

these treaties constitute the Chinese treaty law basis for us to examine the approach China has adopted in identifying indirect expropriation.

The doctrine of indirect expropriation has been formulated by various legal expressions in Chinese treaty practice; for instance, it is 'other similar measures [to expropriation or nationalization], directly or indirectly'[413] in the 2007 China-Korea BIT; 'any other measures that have the same effect'[414] of expropriation or nationalization in the 1984 China-France BIT; 'any other similar measure in regard to' expropriation or nationalization in the 1982 China-Sweden BIT; and 'any other measure the effects of which would be tantamount to expropriation or nationalization'[415] in the 2003 China-Germany BIT.

The China-ASEAN FTA and the ASEAN Comprehensive Investment Agreement were both promulgated in 2009 but took different approaches in dealing with indirect expropriation issues. Whereas the ASEAN Comprehensive Investment Agreement applied a formulation specifically defining and determining indirect expropriation in its Annex, the China-ASEAN FTA adopted a general exception clause, namely 'exclud[ing] from the scope of the treaty as a whole government measures necessary for, or relating to, certain public policy objectives'.[416] Such public policy objectives include the protection of public

[413] 2007 China-Korea BIT, art 4.1.
[414] 1984 China-France BIT, art 4.2.
[415] 2003 China-Germany BIT, art 4.2.
[416] UNCTAD, *Expropriation: A Sequel* (United Nations 2011) 89.

morals, protection of life and health and safety, maintenance of public order, and others,[417] but they are not specified as exceptions in relation to indirect expropriation.

In contrast to the simplified version of the definition of indirect expropriation, some other Chinese IIAs have shaped their formulations to adapt to the evolution of traditional expropriation. In particular, the China-New Zealand FTA, the China-India BIT, and the China-Colombia BIT serve as great references for future treaty formulation considerations.

In the Protocol to the China-India BIT, there is a 'shared understanding' between China and India on the interpretation of expropriation. It starts with the definition of expropriation and points out the difference between direct and indirect expropriation. The Protocol states that indirect expropriation occurs where an action or series of actions is 'taken intentionally by a Party to create a situation whereby the investment of an investor may be rendered substantially unproductive and incapable of yielding a return without a formal transfer of title or outright seizure'.[418] To closely determine its occurrence, a case-by-case and fact-based analysis has to be adopted, thoroughly considering the 'economic impact'[419] and 'character and intent'[420] of the concerned measure or measures

[417] 2009 China-ASEAN FTA, art 16 ('General Exceptions').
[418] 2006 China-India BIT, Art III (1) of the Protocol.
[419] ibid. Art III (2) (i) further states that the adverse economic effect on investment cannot, on its own, guarantee the occurrence of indirect expropriation.

and whether there is any discrimination[421] and/or frustration of the investor's 'distinct, reasonable, investment-backed expectations'.[422] Finally, there is also a 'rare circumstances' exception: Indirect expropriation cannot be found if the measure or measures are of a nondiscriminatory regulatory nature and in pursuit of the public interest (including 'measures pursuant to awards of general application rendered by judicial bodies'[423]).[424]

In the China-Zealand FTA, a five-step examination formulation was established in its Annex 13 ('Expropriation'). First, expropriation can only be found in situations where the interferences of the concerned measure or measures have infringed 'a tangible or intangible property right or property interest' of the investment.[425] Second, Article 2 of the Annex provides definitions of direct expropriation and indirect expropriation. While direct expropriation refers to an outright taking, including 'nationalisation, compulsion of law or seizure', indirect expropriation refers to a taking that although carried out 'in a manner equivalent to direct expropriation, in that it deprives the investor in substance of the use of the investor's property', uses means that fall short of those used in an

[420] ibid. Art III (2) (iv) adds that to examine the character and intent of the measure or measures, it is necessary to determine 'whether they are for bona fide public interest purposes or not and whether there is a reasonable nexus between them and the intention on to expropriate'.
[421] ibid art III (2) (ii) of the Protocol.
[422] ibid.
[423] ibid art III (3) of the Protocol.
[424] ibid.
[425] 2008 China-New Zealand FTA, Annex 13 ('Expropriation'), art 1.

outright taking.[426] Third, Article 3 focuses on the effect of the interference and whether this interference can satisfy the proportionality test. In this context, the deprivation of the investment must be 'severe' or for 'an indefinite period' or 'disproportionate to the public purpose' for indirect expropriation to be found.[427] Fourth, whether there has been any discrimination and/or whether there has been any breach of the State's previous written commitment constitute additional criteria for identifying the occurrence of indirect expropriation.[428] Last but not least, there is the 'rare circumstances' exception, according to which 'measures taken in the exercise of a State's regulatory powers as may be reasonably justified in the protection of the public welfare, including public health, safety and the environment' cannot constitute indirect expropriation.[429]

The China-Peru FTA incorporates all of the criteria established in the China-New Zealand FTA and adds one more article into its expropriation provision. This article follows step three of the China-New Zealand FTA, where a determination is made as to whether the measure or measures were severe or for an indefinite period or disproportionate to the public interest. It further demands a case-by-case and fact-based inquiry to examine the specific facts of a situation: 'the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an

[426] ibid art 2.
[427] ibid art 3.
[428] ibid art 4.
[429] ibid art 5.

investment, standing alone, does not establish that an indirect expropriation has occurred'.[430]

Another bilateral investment treaty that incorporates a detailed provision for determining the occurrence of indirect expropriation is the treaty between China and Colombia. This treaty concludes that indirect expropriation occurs through an action or a series of actions 'having an equivalent effect to direct expropriation without formal transfer of title or outright seizure'.[431] A case-by-case and fact-based inquiry is required for determining indirect expropriation, considering its economic impact rather than its sole effect and the scope of the measures as well as the 'reasonable and distinguishable expectations' therefrom.[432] Except in rare circumstances where the measures concerned are too severe in light of their purpose to be reasonably regarded as having been introduced in good faith, nondiscriminatory measures enacted with a public purpose or social interest do not constitute indirect expropriation.[433]

More recently, the treaty between China and Uzbekistan, which was concluded in 2011, has demonstrated its significance to discovering the Chinese Government's attitude in formulating indirect expropriation provisions. An important feature of this treaty is its clear definition of indirect expropriation:

[430] 2009 China-Peru FTA, Annex 9 ('Expropriation'), art 4.
[431] ibid art 4.2(a).
[432] ibid art 4.2(b).
[433] ibid art 4.2(c).

'"[m]easures the effects of which would be equivalent to expropriation or nationalization" means indirect expropriation'.[434] As for the factors necessary to determining indirect expropriation, these include, but are not limited to, the 'economic influence' of the State measures,[435] any 'discrimination in scope or application' toward investors or investments,[436] any damage caused to the 'reasonable investment expectation of investors',[437] and/or 'the character and purpose' of State measures.[438] Furthermore, except in exceptional circumstances (e.g. 'the measures adopted severely surpassing the necessity of maintaining corresponding reasonable public welfare'), nondiscriminatory regulatory measures having legitimate purposes do not constitute indirect expropriation.[439]

However, the inconsistency in China's treaty practice cannot be ignored. The language in Chinese IIAs has been formulated in various ways to define and determine indirect expropriation; in many of these IIAs, even those effected very recently, the parties have consented to a general definition of indirect expropriation without further clarifications regarding its determination and exceptions. Treaties like the five discussed above are rare and are not constantly

[434] 2011 China-Uzbekistan BIT, art 6.1.
[435] ibid art 6.2(a).
[436] ibid art 6.2(b).
[437] ibid art 6.2(c). This provision further clarifies that 'such expectation arises from the specific commitments made by one Contracting Party to the investors of the other Contracting Party'.
[438] ibid art 6.2(d). According to this provision, to examine the character or purpose of a State measure, some questions must be answered – 'whether it is adopted for the purpose of public interest in good faith, and whether it is in appropriation to the purpose of expropriation'.
[439] ibid art 6.3.

adopted in China's international treaty framework. They can, however, serve as references for concluding new treaties and as possible guidance for interpreting those vague provisions through the adoption of the MFN clause,[440] especially as China has already fully accepted the jurisdiction of international investment arbitrations in several treaties.[441]

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[440] Even for those Chinese treaties in which the ICSID's jurisdiction is limited to compensation for expropriation, their dispute resolution clause can be incorporated with the ICSID's full jurisdiction from other treaties through a most-favored-nation (MFN) clause. As Jane Y Willems commented: '[w]hereas China had thought prior to Tza that the jurisdictional remit of its earlier BITs was restrictive, its later BITs executed since 2003 have openly broad language on jurisdiction. If the previous generations BITs are read by future tribunals to contain MFN clauses allowing broadened jurisdiction, then all prior China BITs would benefit from the broader jurisdictional language of its new BITs'. The *Tza Yap Shum v Peru* case provides another line of analysis to broaden the interpretation of 'a dispute involving the amount of compensation for expropriation' with the purpose of extending the jurisdiction of international investor-State arbitration. According the tribunal's decision, this sentence was intended to include 'the determination of the amount of a compensation' but did not mean that 'the dispute must be restricted thereto'. That is to say, what an ICSID tribunal can decide is 'not only the mere determination of the amount but also any other issues normally inherent to an expropriation, … including whether the property was actually expropriated in accordance with the BIT provisions and requirements, as well as the determination of the amount of compensation due, if any'.

[441] There is a new development that shows China has changed its attitude toward investor-State arbitration in its new generation of treaties involving contracting states that have good diplomatic relations with China, including Germany, North Korea, Russia, India, and the Czech Republic, and has fully accepted the jurisdiction of the ICSID over all disputes resulting from an investment. This change is reflected in two generations of bilateral investment treaties concluded between China and Germany. In the first China-Germany BIT, which was concluded in 1983, a dispute could be submitted to arbitration at the consent of both contracting parties. In the new China-Germany BIT, which was signed in 2003, ICSID arbitration can be sought for a dispute if it cannot be settled within six months through amicable means. Thus, Article 9.1 of the 2004 China-Germany BIT states that '[a]ny dispute concerning investments [emphasis added] between a Contracting Party and an investor of the other Contracting Party should as far as possible be settled amicably between the parties in dispute' and '[i]f the dispute cannot be settled within six months of the date …, [t]he dispute shall be submitted for arbitration under the Convention of 18 March 1965 on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID)'. Article 9 of the 2005 China-Czech Republic BIT states that '[i]f any dispute [emphasis added] between an investor of one Contracting Party and the other Contracting Party cannot be thus settled within six months of the date when the request for the settlement has been submitted, the investor shall be entitled to submit the case, at his choice, for settlement to … (b) the International Centre for Settlement of Investment Disputes (ICSID) having regard to the applicable provisions of the Convention on the Settlement of Investment Disputes between States and Nationals of other States opened for signature at

4.2.2.3 International Legal Documents Defining Indirect Expropriation

Many international legal documents have contributed to the development of the expropriation doctrine, some of which have had even greater influence since they were created to set the standards for international practice and to involve more participants. These documents cannot be ignored, especially when we are trying to summarize a generally accepted formulation for determining expropriatory measures, as through the addition of their features, this formulation is more likely to embrace the customary international law.[442]

The 1961 Draft Convention on the International Responsibility of States for Injuries to Aliens is of great significance to the expropriation doctrine. It states that

> [a] 'taking of property' includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after inception of such interference.[443]

Washington D.C. on 18 March 1965'.

[442] In this context, it is not possible to consider all international documents, especially those that are not significant or special; for instance, Article III of the 1959 Draft Convention on Investment Abroad is not new as it only refers to 'measures … to deprive … directly or indirectly of the property', and thus it will not be mentioned in the main body of the thesis.

[443] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (3)(a).

Furthermore, in its elaboration, the Convention touches upon the theory of police power, which can excuse the State's uncompensated takings from international legal liability:

> An uncompensated taking of property of an alien or a deprivation of the use or enjoyment of property of an alien which results from the execution of the tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health, or morality; or from the valid exercise of belligerent rights; or is otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful, provided:
>
> (a) it is not a clear and discriminatory violation of the law of the State concerned;
>
> (b) it is not the result of a violation of any provisions of Articles 6 to 8 of this Convention;[444]
>
> (c) it is not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world; and
>
> (d) it is not an abuse of the powers specified in this paragraph for the purpose of depriving an alien of his property.[445]

[444] ibid. Arts 6 to 8 mainly provide procedural rights.
[445] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (5).

The American Law Institute has promulgated a Restatement of the Foreign Relations Law of the United States series which takes another approach to understanding the term expropriation. In its Second Restatement, it defines 'taking' as follows: 'conduct attributable to a state that is intended to, and does, effectively deprive an alien of substantially all benefit of his interest in property, constitutes a taking of the property … even though the state does not deprive him of his entire legal interest in the property'.[446] This definition, however, has been replaced by a new one established in the Third Restatement;[447] this Restatement also established a provision with the same effect, according to which a lawful exercise of police power would not be classed as expropriation. Specifically, the Third Restatement states:

> A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that *is commonly accepted as within the police power of states* [emphasis added], if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price.[448]

[446] American Law Institute, *Restatement (Second) of the Foreign Relations Law of the United States* (American Law Institute Publishers 1965) s 192.
[447] American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (American Law Institute Publishers 1987).
[448] ibid vol 2, s 712, Reporter's Note 1.

The draft Multilateral Agreement on Investment (MAI) encountered criticism in promoting its definition of expropriation, which, the same as in other general provisions, is too vague.[449] An interpretive note was therefore introduced to clarify the content of expropriation and to distinguish expropriation from non-compensable regulations. The interpretive note states:

> 'Measures tantamount to expropriation or nationalisation' reflects the fact that international law requires compensation for an expropriatory taking without regard to the label applied to it, even if title to the property is not taken. It does not establish a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments.[450]

In line with this note, another interpretive note on taxation explores when and how the imposition of taxation may constitute expropriation. As was concluded in this taxation note, '[t]axation measures may constitute an outright expropriation, or while not directly expropriatory they may have the equivalent

[449] Art IV.2.1 of the draft Multilateral Agreement on Investment (MAI) states that '[a] Contracting Party shall not expropriate or nationalise [directly or indirectly] an investment in its territory of an investor of another Contracting Party or take any measure or measures having equivalent effect'.
[450] Organisation for Economic Co-operation and Development, 'The Multilateral Agreement on Investment: Draft Consolidated Text' (1998) DAFFE/MAI(98)7/REV1, 143.

effect of an expropriation (so-called 'creeping expropriation')' but 'will not be considered to constitute expropriation where it is generally within the bounds of internationally recognised tax policies and practices'.[451]

4.2.2.4 Identifying Exceptions in Defining Indirect Expropriation in IIAs

The U.S. Model BIT has applied one standard to its expropriation provision, namely that '[e]xcept in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations'.[452]

The Third Restatement of the Foreign Relations Law of the United States also explains the regulations that are non-compensable:

> A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that *is commonly accepted as within the police power of states*, if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price.[453]

[451] ibid 86.
[452] See Annex B of the 2012 U.S. Model Bilateral Investment Treaty (can also be found in the 2004 Version).
[453] American Law Institute (n 447) vol 2, s 712, Reporter's Note 1 (emphasis added).

Nevertheless, despite general descriptions confirming the State's regulatory freedom, there are some cases in which the treaty explicitly provides the scenarios where the host State cannot be held liable for enforcing expropriatory measures. For instance, in the 2004 Canadian Model BIT, an exception provision is provided in response to the general definition of expropriation:

> The [expropriation provisions] shall not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, or to the revocation, limitation or creation of intellectual property rights, to the extent that such issuance, revocation, limitation or creation is consistent with the WTO Agreement.[454]

Identical provisions can also be found in a range of treaties, including NAFTA,[455] the 2003 US-Singapore FTA,[456] the 2004 U.S. Model BIT,[457] and the IISD Model BIT,[458] showing a common, or at least common in several jurisdictions, recognition of these exceptions to the definition of expropriation.

[454] 2004 Canadian Model BIT, art 13.5.
[455] North American Free Trade Agreement (NAFTA), art 1110.7.
[456] 2003 US-Singapore FTA, art 15.6.5.
[457] 2004 U.S. Model Bilateral Investment Treaty, art 6.5.
[458] IISD ('International Institute for Sustainable Development') Model BIT, art 8 (G).

To conclude, identifying indirect expropriation needs clear and detailed rules due to the complexity of its factual situations but current legal rules have failed in this task. In practice, indirect expropriation may be exercised in a disguised and furtive way, making it look like general regulatory measures; or, the State, with truly harmless intentions, may implement measures which in fact are harmful to foreign investments and may be expropriatory in nature. This kind of expropriation involves no physical takings, but substantially destroys the economic value of the investment, or makes the owner impossible to manage, use or control its property in a meaningful way.

Current laws and rules have failed to produce a scientific and comprehensive formulation to determine indirect expropriation. At this point, most IIAs only point out that a State is prohibited from unlawfully nationalizing, expropriating, or taking foreign property; and many other treaties only cover 'similar (or equivalent) measures' in addition to the traditional expropriation and nationalization, or merely state that foreign investment should not be expropriated indirectly. Therefore, most investment treaties and free trade agreements state this issue implicitly, and those legal documents generally provide no more than vague and open-ended provisions on the subject. In this case, the scope of the term has largely been left to international courts and tribunals to determine, based on general rules of international law. The question

of how an expropriation can be exercised in the absence of direct interference by the State has rarely been answered conclusively in the written sources.

Chapter V Competing Doctrines in Determining Indirect Expropriation: Legal Definition Demands Practical Guidance

The applicable treaty provisions are the first choice for seeking guidance in determining the issue of indirect expropriation, but these provisions have constantly disappointed our wish to establish a consistent, predicable, and stable formulation by offering only vague and open-ended wordings. Customary international law, in this respect, has played a significant role in assisting arbitral tribunals to find the most appropriate way to identify indirect expropriation by not only referring to the exact treaty provisions but also to other well-recognized considerations.

5.1 Police Power Doctrine: Protecting the Host State's Power to Regulate

The police power doctrine has its roots in American constitutional law and is used to describe the State's power to regulate.[459] It suggests that disadvantaged foreign investors would not have grounds for claiming compensation if the governmental conduct which caused their property loss was enacted for a public purpose and with no discrimination toward them.[460] The essence of the police

[459] Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 109.
[460] JL Gudofsky, 'Shedding Light on Article 1110 of the North American Free Trade Agreement (NAFTA) Concerning Expropriations: An Environmental Case Study' (2000) 21 Northwest J Intl L & Bus 243, 287.

power doctrine is its 'legitimate public purpose' test.[461] Once this test is satisfied, there is no need for a further step to determine the effect on the property owner. The nature and functions of government make this test generally accepted as the most appropriate one for deciding what purpose is in the public interest and what measure is suitable to protect it.[462]

5.1.1 Recognized by International Practice

International law has given its recognition to the application of police power by host States to regulate foreign investment. The Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens proposes that the characteristics of non-compensable takings 'result[ing] from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful'.[463]

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[461] L Yves Fortier, CC, QC and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2005) 13 Asia Pac L Rev 79, 85. The authors categorized the tests determining non-compensable regulatory measures and compensable indirect expropriation into three approaches: effect, purpose, and the approach that gives weight to both. When defining the purpose approach, they took 'legitimate public purpose' as the main and even exclusive concern that may 'in and of itself suffice to cast a measure as being in the nature of the normal exercise of police powers, and hence non-compensable, regardless of the magnitude of its effect on an investment'.

[462] Ben Mostafa, 'The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law' (2008) 15 Austl Intl L J 267, 275.

[463] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (5).

A provision with the same effect is also established in the Third Restatement of the Foreign Relations Law of the United States, according to which a lawful exercise of police power would not be classed as expropriation; specifically, it states that '[a] state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that *is commonly accepted as within the police power of states* [emphasis added], if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price'.[464]

The development of recent investment treaties also shows us the trend in expropriation jurisprudence to protect the exercise of police power in indirect expropriation claims. A direct reflection of this trend can be found in AUSFTA, which clearly states that '[e]xcept in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to achieve legitimate public welfare objectives, such as the protection of public health, safety, and the environment, do not constitute indirect expropriation'.[465]

[464] American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (American Law Institute Publishers 1987) v 2, s 712, Reporter's Note 1.
[465] Australia-US Free Trade Agreement (AUSFTA), annex 11-B (4)(b). This provision has been incorporated into several investment treaties, for instance the United States-Chile Free Trade Agreement (Annex 10-D(4)) and the United States-Morocco Free Trade Agreement (Annex 10-B(4)).

International tribunals have extensively used the doctrine of police power in the context of international investment to examine State regulatory measures. This doctrine can be applied to decide whether or not these regulatory measures should, or could, be regarded as compensable indirect expropriation or as non-compensable government regulatory measures. Some tribunals have even expressed the view that the written documents, investment treaties, and case decisions have made the police power doctrine part of customary international law. The expropriation jurisprudence of the Iran-United States Claims Tribunal, which has used several cases concerning the application of police power to illustrate the State's power to regulate, is of great significance in this regard.

In *Sedco Inc. v National Iranian Oil Co*, the tribunal wrote on this doctrine, stating that 'an accepted principle of international law [is] that a State is not liable for economic injury which is a consequence of bona fide 'regulation' within the accepted police power of states'.[466] In another case that concerned the seizure of the claimant's liquor license, the tribunal rejected the claimant's compensation claim and explained the rationale behind this decision as follows:

> A State is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation or any other action that is commonly accepted as within the police power of States, provided

[466] *Sedco Inc. v National Iranian Oil Co* (1985) 9 Iran-US CTR 248, 275.

> it is not discriminatory and is not designed to cause the alien to abandon the property to the State or to sell it at a distress price…[467]

So why were these tribunals willing to recognize police power as 'an accepted principle of international law' and to take it as 'commonly accepted'? A UNCITRAL case, *Saluka,* might provide us the answer. In *Saluka v Czech Republic*, the tribunal believed that an exercise of police power would not constitute expropriation and thus would be non-compensable, arguing that this 'forms part of customary international law today'.[468]

Also, a famous NAFTA case, *Methanex Corp. v United States of America*, concerning the distinction between a State's regulatory power and indirect expropriation established the criteria that a successful claim of indirect expropriation would require the government measure to have been enacted with discrimination, or not in the interests of the public, or with a specific commitment to foreign investors.[469] Specifically, the tribunal wrote that 'as a matter of general international law, a non-discriminatory regulation for a public purpose which is enacted in accordance with due process and which affects, *inter alios*, a foreign investor or investment is not deemed expropriatory and

[467] *Too v Greater Modesto Insurance Associates* (1989) 23 Iran-US CTR 378.
[468] *Saluka Investments BV (The Netherlands) v The Czech Republic* (*Saluka v Czech Republic*), UNCITRAL Case, Partial Award, 17 March 2006, paras 262 and 289.
[469] Stephen Olynyk, 'A Balanced Approach to Distinguishing Between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration' (2012) 15 Intl Trade & Bus L Rev 254, 277.

compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation'.[470]

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

The police power doctrine as a general rule in international law has received support from written documents, bilateral and multilateral treaties, and actual cases and arbitral awards. However, it has been criticized in past years for its definition, scope, and deficiency. Here, I would like to explore its problematic situation in international investment law nowadays, pointing out the confusions in the academic literature and in practice.

5.1.2.1 Undefined Scope of Police Power

It has been repeatedly stated in international arbitral cases that the application of police power is 'commonly accepted'.[471] But the confusion - how 'commonly accepted' its scope actually is – is clear when we look through the relevant literature and case decisions.

5.1.2.1.1 Broad Scope of Police Power

[470] *Methanex Corporation v United States of America* (*Methanex*), UNCITRAL Case, Final Award of the Tribunal on Jurisdiction and Merits, 3 August 2005, IV D 7.
[471] In the discussion in this chapter, I cite the cases of *Sedco Inc. v National Iranian Oil Co* (n 466) and *Too v Greater Modesto Insurance Associates* (n 467).

The police power doctrine has been recognized as an approach to protecting foreign investors' rights and interests.[472] Generally, we understand that the exercise of police power is used to promote 'public welfare'[473] and maintain 'public order'[474] and to protect health, morality, safety, and the environment, all of which are contained in the concept of 'public welfare'.[475] This line of interpretation, however, is debatable since its attempts to limit the exercise of police power are actually enlarging its application. Under this interpretation, any State regulatory measure can seek a legitimate purpose to disguise its true intention and, actually, such measures can usually find themselves such a purpose. So the police power doctrine will excuse any measures, including indirect expropriation, from compensation if, and only if, the 'purposes' of these measures are in the interests of public welfare. This undesirable situation is in conflict with the internationally accepted definition of 'expropriation'.

Expropriation, as we discussed in Chapter 4, is well recognized in international law, especially in the context of bilateral investment treaties, and should be

[472] Mostafa (n 462) 267.

[473] See, for example, *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v The Argentine Republic*, ICSID Case No. ARB/03/17, Decision on Liability, 30 July 2010, para 128. The tribunal held that 'in evaluating a claim of expropriation it is important to recognize a State's legitimate right to regulate and to exercise its police power in the interests of *public welfare* and not to confuse measures of that nature with expropriation'.

[474] As was concluded by some scholars, one of the main functions of police power is 'the maintenance of public order'. See Simon Baughen, 'Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven' (2006) 18 J Envl L 207, 211.

[475] David Schneiderman, 'NAFTA's Takings Rule: American Constitutionalism Comes to Canada' (1996) 46 U Toronto L J 499, 530; Lucien Dhooge, 'The Revenge of The Trail Smelter: Environmental Regulation as Expropriation Pursuant to The North American Free Trade Agreement' (2001) 38 Am Bus L J 475, 525.

conducted in accordance with its legal restrictions. In almost every BIT now in force, the criterion that a lawful expropriation must be in the public interest occupies first position among the four criteria used in determining whether or not an expropriation is lawful.[476] Therefore, if the police power doctrine is intended to cover all State measures with the purpose of promoting public welfare, it will become useless since the purpose of lawful expropriation is also to promote public welfare.[477] In *Vivendi Universal SA v Argentine Republic*, the tribunal clearly stated that '[i]f public purpose automatically immunises the measure from being found to be expropriatory, then there would never be a compensable taking for a public purpose'.[478]

5.1.2.1.2 Limited Scope of Police Power

In its definition, the application of police power is limited, and thus the mere fact that the purpose of a government measure is to promote public welfare cannot guarantee that it will be regarded as police power.[479]

In contrast to the 'public welfare' purpose discussed above, the purposes of police power under this approach have been limited to 'health, safety or even

[476] Dolzer and Schreuer (n 459) 91.
[477] Mostafa (n 462) 274.
[478] *Compañia de Aguas del Aconquija S.A. and Vivendi Universal S.A. v Argentine Republic*, ICSID Case No. ARB/97/3, Award, 20 August 2007, para 7.5.21.
[479] Jack Coe and Noah Rubins, 'Regulatory Expropriation and the *Tecmed* Case: Context and Contributions' in Todd Weiler (ed), *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May 2005) 597, 642.

morality'[480] and even to measures concerning 'tax, crime, and "the maintenance of public order"'.[481] We can see that the application of police power has been narrowed and redefined according to the very specific ends that particular government measures are trying to pursue. Ian Brownlie has commented on this, and he listed several areas of regulation in his *Principles of Public International Law*:

> [S]tate measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licences and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.[482]

There are also other criteria supporting a limited scope of police power instead of a comprehensive one. Sornarajah has contributed to this doctrine by proposing that police power is essential to the efficient functioning of the State; therefore, any nondiscriminatory measures, including antitrust, antidumping, consumer protection, national security, environmental protection and the like, affecting the

[480] Gudofsky (n 460) 290-92; Mostafa (n 462) 290.
[481] Baughen (n 474) 221.
[482] Ian Brownlie, *Principles of Public International Law* (7th edn, Oxford University Press 2008) 531.

State's efficient functioning can be regarded as a legitimate use of police power and thus as non-compensable.[483]

5.1.2.2 Unreasonable Responsibility for Foreign Investor

Should foreign investors pay for the costs of promoting public welfare? Is it reasonable for foreign investors to swallow the loss resulting from government regulatory measures without exception? What if the government measure concerned is unnecessary when taking into account its purpose in association with its damages? And what if the purpose itself is just a mask used to disguise the government's true intention of taking?

Allen S. Weiner raised these issues in his article *Indirect Expropriations: The Need for a Taxonomy of "Legitimate" Regulatory Purposes*, asking questions about 'which regulatory measures require the economic consequences to be borne by affected property owners, and which require the burden to be shared by a society as a whole'.[484] To determine the boundaries of these two categories of measures, a tribunal will need to conduct a thorough examination of the legitimacy of the stated public welfare objectives or, at least, as proposed by Weiner, 'the legitimacy of requiring property owners to bear the costs of

[483] M Sornarajah, *The International Law on Foreign Investment* (2nd edn, Cambridge University Press 2004) 283.
[484] Allen S Weiner, 'Indirect Expropriations: The Need for a Taxonomy of "Legitimate" Regulatory Purposes' (2003) 5 Intl L Forum 166, 172.

measures taken in furtherance of those objectives'.[485] Among the considerations that may be relevant, whether or not a government regulatory measure is implemented in good faith is of great importance. This issue will be further analyzed in the next chapter.

5.1.3 Tracking the Roots of the Police Power Doctrine in U.S. Law: Definition and Application

Since this doctrine came from U.S. law, I would like to explore its development process in its place of origin in order to provide us with a better understanding of this doctrine and to enable us to consider its merits and deficiencies.

5.1.3.1 The Definition of Police Power in U.S. Law

The term 'police power' sparked a hot debate inside the United States over its proper application, especially concerning its scope and nature and its relationship with the Just Compensation Clause.[486] One scholar even commented that '[b]y all accounts, takings law is a mess [in United States]. Numerous commentators have noted that the U.S. Supreme Court's takings jurisprudence is contradictory and confusing'.[487] Although a number of decisions have been offered to address the issue of 'takings', there is still no a clear standard for drawing a conclusion of

[485] ibid 173.
[486] Kevin P. Arlyck, 'What *Commonwealth v. Alger* Cannot Tell Us about Regulatory Takings' (2007) 82 NYU L Rev 1746, 1756; David A Thomas, 'Finding More Pieces for the Takings Puzzle: How Correcting History Can Clarify Doctrine' (2004) 75 U Colo L Rev 497.
[487] Arlyck (n 486) 1746 (citations omitted).

its occurrence.[488] As a matter of fact, 'the vagueness in takings doctrine may well reflect a deeply ingrained societal disagreement about the nature of private property and the role of government'.[489]

One thing that is clear is that this doctrine, together with the physical invasion test, the diminution in value test, and the noxious use test,[490] is generally understood to clarify and explain State regulatory power in order to ensure the successful operation of the government and protect the private property rights.[491] Marshall gave his opinion on police power, paying specific attention to the use of the term 'police', in *Gibbons v Ogden (1824)*; he understood this power as the State's power to regulate 'its police, its domestic trade, and to govern its own citizens'.[492] The definition of this term remained unclear until the *License* and *Passenger* cases: A conclusion was reached on the point that police power was a product of State sovereignty. Chief Justice Taney expressed his viewpoint on this issue:

> [W]hat are the police powers of a State? They are nothing more or less than the powers of government inherent in every sovereignty to the extent

[488] Andrea L. Peterson, 'The Takings Clause: In Search of Underlying Principles Part I-A Critique of Current Takings Clause Doctrine' (1989) 77 Cal L Rev 1299, 1303.
[489] Marc R. Poirier, 'The Virtue of Vagueness in Takings Doctrine' (2002) 24 Cardozo L Rev 93, 100.
[490] Frank I Michelman, 'Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law' (1967) 80 Harv L Rev 1165.
[491] *Pennsylvania Coal Co v Mahon et al.* (1922) 260 U.S. 393 (43 S.Ct. 158, 67 L.Ed. 322), 413.
[492] *Gibbons v Ogden* (1824) 22 U.S. (9 Wheat.) 1, 208.

> of its dominions. And whether a State passes a quarantine law, or a law to punish offences, or to establish courts of justice, or requiring certain instruments to be recorded, or to regulate commerce within its own limits, in every case it exercises the same powers; that is to say, the power of sovereignty, the power to govern men and things within the limits of its dominion.[493]

Justice McLean argued that as police power is vested in State sovereignty, '[n]o legislature can bargain away the public health or the public morals'.[494] He went on to strengthen this statement by pointing out that

> [t]he States, resting upon their original basis of sovereignty, subject only to the exceptions stated, exercise their powers over everything connected with their social and internal condition.[495]

As one of the most influential cases in this regard, *Alger*[496] contributed a lot to the development of the police power doctrine and has often been cited in American constitutional law.[497] The rationale of this doctrine, as established by Chief Justice Lemuel Shaw of the Massachusetts Supreme Court in this case, is

[493] The *License Cases* (1847) 46 U.S. (5 How.) 504, 583.
[494] *Stone v Mississippi* (1880) 101 U.S. 814, 819.
[495] D Benjamin Barros, 'The Police Power and the Takings Clause' (2003-2004) 58 U Miami L Rev 471, 588.
[496] *Commonwealth v Alger*, 61 Mass (1851) (7 Cush) 53.
[497] Arlyck (n 486) 1747; Barros (n 495) 479.

significant. The rationale can be summarized as follows: first, the purpose of police power is to promote public welfare; second, its intent is to establish clear and certain regulations to achieve that purpose.[498] As Shaw considered this issue, he believed that the State should have broad power to decide how a trade should be deemed a dangerous or noxious trade, in what circumstances it should not be set up, and how to regulate it.[499] He went on to state:

> Things done may or may not be wrong in themselves, or necessarily injurious and punishable as such at common law; but laws are passed declaring them offences, and making them punishable, because they tend to injurious consequences; but more especially for the sake of having a definite, known and authoritative rule which all can understand and obey.[500]

This decision was followed in subsequent cases such as *Mugler v Kansas.*[501] The decision in *Mugler v Kansas* was delivered by the U.S. Supreme Court, and as a famous American legal scholar once commented, '[i]f something was so harmful

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[498] Arlyck (n 486) 1770-75.
[499] *Commonwealth v Alger* (n 496) 96.
[500] ibid.
[501] See, for example, *Mugler v Kansas* (1887) 123 U.S. 623, 624 and 669. In this case, the court held that '[t]he manufacture and sale of intoxicating liquors shall be forever prohibited in this State, except for medical, scientific, and mechanical purposes'. Therefore, '[t]he exercise of the police power by the destruction of property which is itself a public nuisance, or the prohibition of its use in a particular way, whereby its value becomes depreciated, is very different from taking property for public use. [...] In the one case, a nuisance only is abated; in the other, unoffending property is taken away from an innocent owner'.

as to justify regulation under the police power, it could be regulated without compensation, regardless of the effect of the regulation on value'.[502]

The boundary between compensable taking and the non-compensable exercise of police power concluded in the *Alger* and *Mugler* cases depends on the specific intention of the government measure: A government measure must be compensable if it is conducted to take or use the property and non-compensable if its goal is to prevent noxious use and it is therefore done in the interests of public welfare.

But the approach taken in *Alger* and *Mugler* was questioned, and it was in another leading case concerning the definition and scope of police power that the decision in the *Alger* case was overruled. In *Pennsylvania Coal Co v Mahon*, Justice Holmes stated that he believed that '[t]he general rule at least is that while property may be regulated to a certain extent, if a regulation goes too far it will be recognized as a taking'.[503] The definition of 'too far' is actually a determination of the 'degree' of State interference [504] in a specific case and thus

[502] William Treanor, 'The Original Understanding of the Takings Clause and the Political Process' (1995) 95 Colum L Rev 782, 800-801.
[503] *Pennsylvania Coal Co v Mahon* (n 491) 415.
[504] Justice Holmes discussed whether or not the point at which the exercise of police power can be said to have become a taking that needs compensation is a question of degree in this case and also in *Bent v Emery*. See *Bent v Emery*, 173 Mass. 496.

cannot be summarized into a specific conclusion.[505] This case has its merits because it is regarded as the foundation of American 'regulatory takings' jurisprudence.[506] The tribunal in the case of *Quilici v Village of Morton Grove* reached a similar conclusion to that of Justice Holmes:

> It is well established that a Fifth Amendment taking can occur through the exercise of the police power regulating property rights. In order for a regulatory taking to require compensation, however, the exercise of the police power must result in the destruction of the use and enjoyment of a legitimate private property right.[507]

5.1.3.2 Limitations on the Application of Police Power in U.S. Law

Attempts have been made to limit the use of police power. There are scholars who believe that the ends pursued by a government measure are likely to be important in determining the application of police power.[508] The phrase 'public welfare' is so broad that it may probably lead to a 'yes' decision for every measure claiming to promote public welfare.

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[505] *Pennsylvania Coal Co v Mahon* (n 491) 416. In the current case, Justice Holmes gave his opinion that the Kohler Act violated the Just Compensation Clause by prohibiting *all economic use* of the support right of the owner. Therefore, this prohibition constituted a 'taking'. Another example to illustrate the 'degree' would be the *McCarter* case, according to which a measure would constitute a 'taking' if a regulation renders the property 'wholly useless'. See *Hudson County Water Co. v McCarter* (*McCarter*) (1908) 209 U.S. 349, 355.
[506] Barros (n 495) 499.
[507] *Quilici v Village of Morton Grove* (1981) 532 F. Supp. 1169, 1183-84.
[508] Joseph L Sax, 'Takings and the Police Power' (1964) 74 Yale L J 36, 48-50; Frank I Michelman (n 490) 1196-1201.

Various courts and commenters have tried to limit the scope of police power by limiting its 'acknowledged legitimate ends'.[509] For instance, in the case of *Thorpe v Rutland & Burlington R.R.*, Chief Justice Redfield from the Vermont Supreme Court discussed this issue and defined the scope of police power as being to protect the 'general comfort, health, and prosperity of the State'.[510] In *Mugler v Kansas*, it was argued that the police power of a State was 'exerted for the protection of the health, morals, and safety of the people'.[511] In *Barbier v Connolly,* Justice Field concluded that police power should promote 'the health, peace, morals, education, and good order of the people' and also 'increase the industries of the state, develop its resources, and add to its wealth and prosperity'.[512] Therefore, '[p]ublic safety, public health, morality, peace and quiet, law and order … are some of the more conspicuous examples of the traditional application of the police power'; however, these examples 'merely illustrate the scope of the power and do not delimit it'.[513] As the sad truth that 'any power granted to the state can be abused, and the police power is no exception to the general rule' has been confirmed,[514] it has been argued that '[s]tatutes that defined legal obligations with "certainty and precision" had the

[509] Barros (n 495) 471 and 487.
[510] *Thorpe v Rutland and Burlington Railroad Co.* (1954) 27 Vt. 140, 150.
[511] *Mugler v Kansas* (1887) 123 U.S. 623, 668.
[512] *Barbier v Connolly* (1885) 113 U.S. 27, 31.
[513] *Berman v Parker* (1954) 348 U.S. 26, 32; *Noble State Bank v Haskell* (1911) 219 U.S. 104, 111.
[514] Richard A Epstein, '*Pennsylvania Coal v. Mahon*: The Erratic Takings Jurisprudence of Justice Holmes' (1997-1998) 86 Geo L J 875, 881.

advantage of preempting disputes over the boundary between noxious and innocent uses and gave owners increased security in their property by making them "sure of the protection of the law"'.[515]

As evidenced in *Pennsylvania Coal Co v Mahon*, another trend is to examine whether the exercise of police power has reached the threshold that causes the degree of economic loss to the property owner required to conclude that the act concerned cannot be forgiven and must be accompanied with due compensation.[516] As Justice Holmes put it, if a 'regulation goes too far', it may become a taking. What really matters then is when to find that this threshold has been reached. This matter was of concern in *Pennsylvania Coal Co v Mahon* and in even earlier cases[517] decided by Justice Holmes, but no definite answer emerged since Holmes considered that this issue should be analyzed on a case-by-case basis.[518] In *Penn Central Transportation Co v New York City*, Justice Brennan also expressed his opinion that the takings jurisprudence was

[515] Arlyck (n 486) 1763 (citations omitted).
[516] *Pennsylvania Coal Co v Mahon* (n 491) 413 ('Government hardly could go on if to some extent values incident to property could not be diminished without paying for every such change in the general law. As long recognized, some values are enjoyed under an implied limitation and must yield to the police power. But obviously the implied limitation must have its limits, or the contract and due process clauses are gone. One fact for consideration in determining such limits is the extent of the diminution. When it reaches a certain magnitude, in most if not in all cases there must be an exercise of eminent domain and compensation to sustain the act. So the question depends upon the particular facts. The greatest weight is given to the judgment of the legislature, but it always is open to interested parties to contend that the legislature has gone beyond its constitutional power.').
[517] These cases are *Rideout v Knox*, *Bent v Emery,* and *Hudson County Water Co. v McCarter.* For more discussion, please see Barros (n 495) 505.
[518] Robert Brauneis, '"The Foundation of Our 'Regulatory Takings' Jurisprudence": The Myth and Meaning of Justice Holmes's Opinion in *Pennsylvania Coal Co. v. Mahon*' (1996-1997) 106 Yale L J 613, 891.

'essentially ad hoc' and 'factual'.[519] Consequently, it is difficult to find a one-size-fits-all solution to determine whether a taking has occurred. As Justice Clark held in *Goldblatt v Hempstead*:

> This is not to say, however, that government action in the form of regulation cannot be so onerous as to constitute a taking which constitutionally requires compensation. [. . .] There is no set formula to determine where regulation ends and taking begins. Although a comparison of values before and after is relevant, it is by no means conclusive, see *Hadacheck v. Sebastian*, where a diminution in value from $800,000 to $60,000 was upheld. How far a regulation may go before it becomes a taking we need not now decide [in current case].[520]

Yet these cases share one significant conclusion that explicitly disagrees with the decision rendered in *Mugler* that the exercise of police power will never lead to a taking claim even if it deprives the concerned property of all its economic value. In *Hudson County Water Co. v McCarter* and *Mahon*, Holmes gave his opinion on the threshold at which the exercise of police power could become a taking. In this case, Holmes stated:

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[519] *Penn Central Transportation Co v New York City* (1978) 438 US 104, 124.
[520] *Goldblatt v Hempstead* (1962) 369 U.S. 590, 594 (citations omitted).

> [T]he police power may limit the height of buildings in a city, without compensation. To that extent it cuts down what otherwise would be the rights of property. But if it should attempt to limit the height so far as to make an ordinary building lot *wholly useless* [emphasis added], the rights of property would prevail over the other public interest, and the police power would fail. To set such a limit would need compensation and the power of eminent domain.[521]

A similar understanding was reached in the *Mahon* case: The point at which the exercise of police power could be classed as a taking was judged to be when it results in the prohibition of all economic use of the owner's rights.[522] *Mahon* was characterized as the foundation of American 'regulatory taking' jurisprudence for a reason: It established a general principle that even if government measures can satisfy the 'public welfare' test, that is to say, they fall within the scope of police

[521] *McCarter* (n 505) 349, 355.
[522] Brauneis (n 518) 691; Epstein (n 514) 875.

power, they may constitute 'taking' if they render a property useless or valueless.[523]

However, it is quite simply not possible 'to develop any "set formula" for determining when "justice and fairness" require that economic injuries caused by public action be compensated by the government'.[524] Nevertheless, under certain circumstances, such measures may not constitute a 'taking' even if they render a property useless or valueless. The rationale for this statement is based on the aforementioned cases of *Alger* and *Mulger*: If the nature of such measures is, for instance, to prevent property owners using their property for dangerous or noxious trade, when a property is being used for these purposes, the exercise of police power will not require compensation because the property owner has no right to engage in such activities. Therefore, no 'taking' occurs due to the

[523] Justice Brennan expressed the same opinion, namely that '[p]olice power regulations such as zoning ordinances and other land-use restrictions can destroy the use and enjoyment of property in order to promote the public good just as effectively as formal condemnation or physical invasion of property. From the property owner's point of view, it may matter little whether his land is condemned or flooded, or whether it is restricted by regulation to use in its natural state, if the effect in both cases is to deprive him of all beneficial use of it. From the government's point of view, the benefits flowing to the public from preservation of open space through regulation may be equally great as from creating a wildlife refuge through formal condemnation or increasing electricity production through a dam project that floods private property. Appellees implicitly posit the distinction that the government intends to take property through condemnation or physical invasion whereas it does not through police power regulations. But "the Constitution measures a taking of property not by what a State says, or by what it intends, but by what it does." It is only logical, then, that government action other than acquisition of title, occupancy, or physical invasion can be a "taking," and therefore a *de facto* exercise of the power of eminent domain, where the effects completely deprive the owner of all or most of his interest in the property'; see *San Diego Gas & Elec. Co. v City of San Diego* (1981) 450 U.S. 621, 652-53.

[524] *Penn Central* (n 519) 124.

exercise of police power regardless of the severity of the impact on the property.[525]

5.2 Sole Effect Test: Safeguarding the Foreign Investment from Economic Interference

As early as 1962, G. C. Christie, by analyzing two early international decisions on expropriation,[526] reached the following conclusions: 'a State may expropriate property, where it interferes with it, even though the State expressly disclaims any such intention'; 'even though a State may not purport to interfere with rights to property, it may, by its actions, render those rights so useless that it will be deemed to have expropriated them'.[527] These conclusions have been closely followed in subsequent international arbitral decisions and commentary.[528]

Since then, it has been widely accepted by both academics and practitioners that the existence of expropriation should be determined in 'consequential rather than formal terms'.[529] This acceptance was evidenced in a series of cases, one of which, taken as an example here, is *Phelps Dodge*. The tribunal in this case stated that it fully understood 'the reasons why the Respondent felt compelled to protect its interests' and 'the financial, economic and social concerns that

[525] Sax (n 508) 46-50.
[526] W Michael Reisman and Robert D Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation' (2004). Faculty Scholarship Series, Paper 1002, 119.
[527] GC Christie, 'What Constitutes a Taking of Property under International Law' (1962) 38 Brit Y B Intl L 307, 311.
[528] Reisman and Sloane (n 526) 120.
[529] ibid 121.

inspired the law pursuant to which it acted' but that those reasons and concerns could not 'relieve the Respondent of the obligation to compensate Phelps Dodge for its loss'.[530] In the *Patrick Mitchell Annulment* case, it was stated that reference should be made 'only to the effect of the measure for the investor, without taking into account the purpose sought by the expropriating authority'.[531] Therefore, the effect on the expropriated victim is the key criterion in determining whether expropriation has occurred.[532]

The sole effect test, according to which the existence of indirect expropriation is unavoidable if the effect of a government measure has reached a certain threshold,[533] is based on the belief that 'a sufficiently restrictive effect' would not appear if the government measure concerned is properly implemented through the use of police power; if there is such an effect, then the said government measure constitutes indirect expropriation.[534] This doctrine rules out the character and the intention of the government in its analysis and puts all its weight on a determination of whether the government's conduct unduly

[530] *Phelps Dodge Corp. v Iran* (*Phelps Dodge*), 10 Iran-U.S. Cl. Trib. Rep., 121 (1986), 130.
[531] *Patrick Mitchell v The Democratic Republic of Congo*, ICSID Case No ARB/99/7, Annulment Proceedings, 1 November 2006, para 53.
[532] Rudolf Dolzer, 'Indirect Expropriations: New Developments?' (2002-2003) 11 NYU Envtl L J 64, 79.
[533] Olynyk (n 469) 271.
[534] An Chen, *The New Development of International Investment Law and the New Practice of China's Bilateral Investment Treaties* (Fudan University Press 2007) 144 (Chinese version).

interferes with the investment itself or deprives a foreign investor of its economic interest in the investment.[535]

At what point does a government's conduct amount to indirect expropriation? Gudofsky would say when it 'removes all benefits of ownership';[536] Wagner believes that it is when its effect 'renders property "virtually valueless"';[537] and in Wortley's opinion, it is when it is 'equivalent to the [direct] expropriation of a property right'.[538] There is no common agreement on the level at which State interference can appropriately be deemed to constitute indirect expropriation. As concluded in recent arbitral decisions, this interference can amount to a 'severe economic impact' on, or to a 'substantial loss of control or value' of, the foreign investment.

There are no definite guidelines for determining this damaging *effect*. As illustrated in the *Tokios* case, this uncertain situation is a 'critical factor' in the sole effect test. In *Tokios Tokee v Ukraine*, the standard of 'substantial' loss was used, but it was opined that no relevant treaty text or any existing jurisprudence has clarified the 'precise degree' of deprivation that would meet the standard of

[535] Fortier and Drymer (n 461) 93.
[536] Gudofsky (n 460) 291.
[537] J Martin Wagner, 'International Investment, Expropriation and Environmental Protection' (1999) 29 Golden Gate U L Rev 465, 536.
[538] Ben Wortley, *Expropriation in Public International Law* (Cambridge University Press 1959) 110.

substantiality.[539] The tribunal raised an example illustrating at what level a diminution would amount to a substantial deprivation of foreign property: 'one can reasonably infer that a diminution of 5% of the investment's value will not be enough for a finding of expropriation, while a diminution of 95% would likely be sufficient'. [540] Nevertheless, the tribunal stressed that this method of determining the level of deprivation would be better applied on a case-by-case basis on the basis of the individual facts of each case.[541]

5.2.1 Recognized by International Practice

International law has recognized that the interference caused by the conduct of a State must constitute expropriation if this interference has made the property right completely useless even though the State never intentionally expropriated the property from its original owner or deprived the original owner of the legal titles to the property.[542] This understanding of expropriation originally comes from the *Starrett Housing* case, in which the tribunal stated that indirect expropriation can be proved in a situation where the property rights of a foreign investor have been 'rendered so useless that they must be deemed to have been expropriated'.[543]

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[539] *Tokios Tokelés v Ukraine*, ICSID Case No. ARB/02/18, Award, 26 July 2007, para 120.
[540] ibid.
[541] ibid.
[542] *Starrett Housing Corp. v Iran* (*Starrett Housing*), 4 Iran-U.S. Cl. Trib. Rep., 122 (1983), 154-55.
[543] ibid 155.

Another case of great importance is *Tippetts*, which was decided by the Iran-US Claims Tribunal. In this case, the tribunal accepted the claimant's argument that the actions of the Iranian Government's appointed manager constituted an indirect expropriation. The tribunal explained its position in the Award: '[t]he Claimant is entitled under international law and general principles of law to compensation for the full value of the property of which it was deprived. The Tribunal prefers the term "deprivation" to the term "taking", although they are largely synonymous, because the latter may be understood to imply that the Government has acquired something of value, which is not required'.[544] The tribunal further agreed with the *Starrett Housing* tribunal, stating that '[a] deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected'.[545] After pointing out the essentials of their determination related to the 'use of the property' and the 'enjoyment of its benefits', the tribunal continued its analysis and explicitly put forward another key consideration. This consideration further reinforced the tribunal's viewpoint on indirect expropriation, namely that '[t]he intent of the government is less important than the effects of the measures on the owner, and

[544] *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran* (*Tippetts*), 6 Iran-U.S. Cl. Trib. Rep. 219 (1984), 225-26.
[545] ibid.

the form of the measures of control or interference is less important than the reality of their impact'.[546]

Due attention should be paid to two key phrases, namely the 'effects of the measures' and 'the reality of their impact', that summarize the attitude of the *Tippetts* tribunal toward indirect expropriation. On this point, *Biloune* and *Metalclad*, although decided respectively in 1989 and 2000, adopted the same approach that takes the intention of the State out of the equation when determining the existence of indirect expropriation. The tribunal in *Biloune* thought that the *motivations* of the government measures concerned were not clear, nor were they necessary for the tribunal to reach a conclusion on whether these measures constituted indirect expropriation.[547] Similarly, in *Metalclad*, the tribunal declared that it 'need[s] not decide or consider the motivation or intent of the adoption of the Ecological Decree'.[548] Expropriation under NAFTA Article 1110 includes not only direct expropriation but also 'covert and incidental interference with the use of property'.[549]

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[546] ibid.

[547] *Biloune and Marine Drive Complex Ltd v Ghana Investments Centre and the Government of Ghana* (*Biloune v Ghana*), UNCITRAL Case, Award on Jurisdiction and Liability, 27 October 1989, 95 ILR 184, 209. The tribunal further explained its position by saying '[w]hat is clear is that the conjunction of the stop work order, the demolition, the summons, the arrest, the detention, the requirement of filing assets declaration forms, and the deportation of Mr [sic] Biloune without possibility of re-entry had the *effect* [emphasis added] of causing the irreparable cessation of work on the project'.

[548] *Metalclad Corporation v The United Mexican States* (*Metalclad*), ICSID Case No. ARB (AF)/97/1, Award, 30 August 2000, para 111.

[549] ibid para103.

There are other recent cases supporting the sole effect test, including *Biwater*[550] and *Siemens v Argentina*[551]. These cases have formed a coherent body of jurisprudence that represents one of the typical approaches in international law to determining the existence of indirect expropriation.[552]

5.2.2 The Problematic Situation of the Sole Effect Test in International Investment Law

The sole effect test has always been seen as a method for determining indirect expropriation that favors protecting the interests of foreign investors.[553] According to the sole effect test, the *effect* of a government's conduct is the sole and exclusive criterion for determining whether there is indirect expropriation as long as this *effect* reaches a certain threshold. Other considerations, for instance the intention or the motivation, are all excluded from the determination. However, is it reasonable for tribunals to make decisions that are based solely upon the economic effect of a government measure, not fully considering its nature or its *reasonableness*?

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[550] *Biwater Gauff (Tanzania) Ltd. v United Republic of Tanzania* (*Biwater*), ICSID Case No. ARB/05/22, Award, 24 July 2008, para 463. Although not explicitly accepting the sole effect test, the tribunal made references to other tribunals that took this approach and paid due attention to 'the effect of relevant acts, rather than the intention behind them'.

[551] *Siemens A.G. v The Argentine Republic* (*Siemens v Argentina*), ICSID Case No. ARB/02/8, Award, 17 January 2007, para 270. The tribunal interpreted the treaty on the basis of the sole effect test and found that expropriation means 'measures that have the effect of an expropriation; it does not refer to the intent of the State to expropriate'.

[552] Mostafa (n 462) 281.

[553] ibid 267.

In 1961, Professors Sohn and Baxter proposed the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, in which it was provided that a taking would be considered as having occurred if there was 'unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after the inception of such interference'.[554]

In practice, the 'unreasonable interference' standard first appeared in the Iran-US Claims Tribunal but with no clear clarification of what this standard really is.[555] The question is whether this standard should be interpreted only as the degree of interference reflected by the sole effect on the property or as an interference requiring a 'weighing and balancing' between its outcome and its purpose.[556]

Rudolf Dolzer once worried that the 'weighing and balancing' approach would provide the opposite answer to the conclusion drawn from sole effect test as to whether or not the conduct concerned should be seen as indirect expropriation.[557]

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[554] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10, para 3 (a).
[555] These representative cases are *Hazra Engineering Co v Islamic Republic of Iran* (1982) 1 Iran-US CTR 499, *Ataollab Golptra v Iran* (1983) 2 Iran-IS CTR 171, and *International Technical Products Corp v Iran* (1985) 9 Iran-US CTR 206. For more information, see Mostafa (n 462) 282.
[556] Mostafa (n 462) 282.
[557] Rudolf Dolzer and Felix Bloch, 'Indirect Expropriation: Conceptual Realignments?' (2003) 5 Intl L F D Intl 155, 164.

Furthermore, it would impair the legitimate interests of foreign investors if this 'weighing and balancing' approach could not be properly applied.

However, it has been seen in many arbitral cases and pieces of legislation that the purpose of the government measure concerned and its context can play a part in the legal assessment of the existence of indirect expropriation.

The Iran-United States Claims Tribunal in the *Sea-Land Service, Inc. v Iran* case did not decide the case following the approach used in the *Starrett Housing* case but rather explicitly stated that '[a] finding of expropriation would require, at the very least, that the Tribunal be satisfied that there was deliberate governmental interference with the conduct of Sea-Land's operation, the effect of which was to deprive Sea-Land of the use and benefit of its investment'.[558]

Prior to the promulgation of the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, the First Protocol of the European Convention on Human Rights stated that

> [e]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by

[558] *Sea-Land Serv., Inc. v Iran*, 6 Iran-U.S. Cl. Trib. Rep. 149 (1984), 166.

> the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

How then should we understand the State's power to 'control the use of property' if it deems this necessary and the proper criteria for this purpose under the Protocol? The European Court of Human Rights has interpreted this clause through cases. The leading case of *Sporrong and Lönnroth v Sweden* laid down the basic understanding of this clause: 'States are entitled, amongst other things, to control the use of property in accordance with the general interest by enforcing such laws as they deem necessary for the purpose';[559] the Court 'must determine whether a fair balance was struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights'.[560]

The cases that inherited the 'weighing and balancing' analogy to determine indirect expropriation have had an influence on international investment arbitration practice. The representative cases under the ICSID regime are *Tecmed*

[559] *Sporrong and Lönnroth v Sweden*, ECtHR Judgment, 23 September 1982, para 18.
[560] ibid para 19.

v Mexico,[561] *Azurix v Argentina*,[562] and *LG&E v Argentina*.[563] Instead of using the phrase 'weighing and balancing', these tribunals adopted the *proportionality* test in their analysis.

The *Tecmed* tribunal believed that it should consider 'whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality'.[564] The *LG&E* tribunal, after considering the *Tecmed* tribunal's position, said that '[w]ith respect to the power of the State to adopt its policies, it can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed'.[565]

This 'weighing and balancing' or 'proportionality' approach contravenes the sole effect test and takes the purpose and context of the government conduct concerned into account when determining the occurrence of indirect

[561] *Técnicas Medioambientales Tecmed, S.A.v The United Mexican States* (*Tecmed v Mexico*), ICSID Case No. ARB (AF)/00/2.
[562] *Azurix Corp. v The Argentine Republic* (*Azurix v Argentina*), ICSID Case No. ARB/01/12.
[563] *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v Argentine Republic* (*LG&E v Argentina*), ICSID Case No. ARB/02/1.
[564] *Tecmed v Mexico* (n 561), Award, 29 May 2003, para 122.
[565] *LG&E v Argentina* (n 563), Decision on Liability, 3 October 2006, para 122.

expropriation. This approach is not designed to question the dominant role of the effect in the determination, but it gives a broader framework that takes all relevant factors into account and balances the interests involved.

5.3 Purpose and Effect Test: A Weighing and Balancing Approach

As already discussed in this chapter, the police power doctrine mainly puts weight on examining the purpose of a government regulatory measure, while the sole effect test's concern is the effect of such a measure. Both tests have received support from commentators and arbitrators. However, with the development of the concept of 'indirect expropriation', both academics and practitioners have been working to find the most scientific way of determining the occurrence of indirect expropriation instead of just seeking guidance from the test examining the pure purpose of the measure or the economic effect on the foreign investor and its investment. Thus, the phenomenon of applying both the police power doctrine and the sole effect doctrine emerged.

Professor G. C. Christie commented on the relationship between a measure's purpose and its effect in his article *What Constitutes a Taking of Property Under International Law?*, putting forward the argument that a legitimate purpose for enacting a government measure could justify the measure's severe damages, the effect of which may support a finding of expropriation. Specifically, he wrote that

> [t]he conclusion that a particular interference is an expropriation might also be avoided if the State whose actions are the subject of complaint had a purpose in mind which is recognized in international law as justifying even severe, although by no means complete, restrictions on the use of property.[566]

This statement is consistent with the rationale behind the police power doctrine, confirming the importance of the government's purpose and intention as a decisive consideration when determining indirect expropriation. In other words, a legitimate purpose could and should exempt the government from the liability of compensation; there is only one condition: as proposed by GC Christie, there would be a warranted finding of expropriation if the interference to the property was 'complete'.

L. Yves Fortier and Stephen L. Drymer reviewed the cases concerning indirect expropriation and concluded that a trend of examining the occurrence of indirect expropriation by taking into account both the purpose and the effect of a government measure had appeared, although in this famous article, they still used the phrase 'purpose (character) of the measure' and took the effect as only one

[566] Christie (n 527) 331-32.

consideration in concluding the occurrence of indirect expropriation.[567] Similarly, in his article *A Balanced Approach to Distinguishing between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration*, Stephen Olynyk incorporated the regulatory measure's 'purpose, context and nature' with the police power doctrine to determine indirect expropriation. He also pointed out that some commentators view the police power doctrine as 'a controlling element that exempts the measure automatically from any duty to compensate the foreign investors',[568] while others, like the writer himself, consider that the purpose of a government measure should be 'weighed against other factors such as the effect'.[569]

The significance of the purpose and the effect and their connection to the evaluation of indirect expropriation and non-compensable regulatory power is evidenced in the literature.

5.3.1 Recognized by International Practice: Some Illustrative Cases

The approach that favors using both the purpose and the effect of a government measure to distinguish between indirect expropriation and government regulatory power has been widely recognized in international investment law. Here, I would like to illustrate its application by introducing three representative arbitral cases.

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[567] Fortier and Drymer (n 461) 97.
[568] Olynyk (n 469) 277.
[569] ibid.

5.3.1.1 S.D. Myers, Inc. v Government of Canada

In this case, an American company had invested in Canada and obtained a business license to take a specific type of environmentally hazardous chemical waste back to its facility in the United States for treatment. From 1980, the U.S. government prohibited the movement of this waste to its territory, but it granted the claimant permission to import in 1995. However, the Canadian Government issued an order forbidding the claimant to export the waste, which adversely affected the claimant's business operation and its economic benefits from its investment. The prohibition lasted for almost 16 months. The claimant brought a claim under NAFTA Chapter 11 alleging that Canada had violated several obligations and claiming the compensation thereof. In respect of the expropriation claim, the claimant's request was dismissed.

The tribunal dismissed the claim of expropriation on the basis of its own understanding of the expropriation provision in NAFTA. They considered that the interpretation of 'measure tantamount to expropriation' should be understood as 'taking' which is conducted by a 'governmental-type authority' and which transfers the ownership of the property to another person.[570] In the concluding

[570] *S.D. Myers, Inc. v Government of Canada* (*S.D. Myers*), UNCITRAL Case, Partial Award, 13 November 2000, para 280. The tribunal stated that '[t]he term "expropriation" in Article 1110 must be interpreted in light of the whole body of state practice, treaties and judicial interpretations of that term in international law cases. In general, the term "expropriation" carries with it the connotation of a "taking" by a governmental-type authority of a person's "property" with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the "taking"'.

remarks of the expropriation section, the tribunal stated that it thought that Canada did not profit from this event and that there was no transfer of 'property or benefit directly to others';[571] therefore, no expropriation occurred due to the order issued by the Canadian Government.

Although this tribunal did not provide an appropriate understanding of the expropriation provision in NAFTA, they stressed the need to consider both the effect and the purpose of a government measure when determining indirect expropriation.

The tribunal did not deny that in legal theory, rights other than property rights could be expropriated by government measures.[572] In such cases, the tribunal thought that 'international law makes it appropriate for tribunals to examine the purpose and effect of governmental measures'[573] and that to prove the occurrence of indirect expropriation, '[a] tribunal should not be deterred by technical or facial considerations from reaching a conclusion that an expropriation or conduct tantamount to an expropriation has occurred'.[574] In the tribunal's view, what should be paid due attention to is 'the real interests involved and the *purpose and effect* [emphasis added] of the government measure'.[575]

[571] ibid para 287.
[572] ibid para 281.
[573] ibid.
[574] ibid para 285.
[575] ibid.

5.3.1.2 Técnicas Medioambientales Tecmed, S.A. v The United Mexican States

This ICSID case demonstrates to a great extent the relationship between the purpose of government measures and their effect in determining the occurrence of indirect expropriation. A 'weighing and balancing' between them can justify the reasonableness of the measures and, furthermore, distinguish compensable indirect expropriation from the legitimate exercise of the State's non-compensable regulatory power.

On the basis of the Spain-Mexico BIT, the claimant, a Spanish company with two subsidiaries in Mexico, wanted to seek remedies for its investment by alleging Mexico's violations of treaty protection. The claimant in this case had invested in a hazardous industrial waste landfill in 1996 but was unable to obtain a renewal of its license to operate from the Mexican Government two years later. It thus claimed for its investment loss due to the arbitrary and non-substantiated decision of the Mexican Government and sued Mexico for expropriation. Other claims based on fair and equitable treatment (FET) and full protection and security were also brought. The tribunal ruled in favor of the claimant and supported its claims on expropriation and FET.

The tribunal carefully examined the facts and pointed out the essentials of the case as follows: first, the Mexican Government's decision indicated that the landfill would be closed permanently and irrevocably, and thus the landfill would

become useless and have no economic value; second, the tribunal found that the consequence (the damages to the investors' rights and interests) of the government measure concerned was disproportionate with its aims (e.g. the protection of the environment) for it deprived the claimant of its right to operate the landfill and thereby it lost its investment.

The tribunal examined whether or not the measures were reasonable in relation to the Mexican Government's purposes. Clearly, there were things that the Government could have done but did not.

If we consider the facts of the case, the true reason for Mexico's nonrenewal of the license was not because the claimant had breached several environmental regulations (as the respondent claimed); rather, the established evidence proved that social and political concerns and the pressures associated with them played the key roles in forcing the closure of the landfill. If we closely observe the details of the facts, we can see that the claimant was ready to relocate the landfill and was awaiting further instructions from the Mexican Government.

From these considerations, the tribunal concluded that there was an indirect expropriation due to the nonrenewal of the claimant's license to operate. Although there was no transfer of ownership, the investor had been deprived of the economic value of its investment and the investment could not be exploited.

Therefore, the Mexican Government had violated Article 5 of the Spain-Mexico BIT.

Notably, this case exploited the relationship between the effect and the purpose and established the connection, reasonably linking these two factors as a whole for the determination of indirect expropriation.

A. The Purpose

Specifically, the Mexican Government's nonrenewal of the claimant's license to operate the landfill put an end to the latter's on-going business, and this was alleged to constitute indirect expropriation.[576] However, the tribunal summarized the Mexican Government's attitude toward the allegation: The Government argued that the Order 'was a regulatory measure issued in compliance with the State's police power within the highly regulated and extremely sensitive framework of environmental protection and public health' and alleged that '[i]n those circumstances … the Resolution is a legitimate action of the State that does not amount to an expropriation under international law'.[577]

The Mexican Government's intention seems to have been to secure the safety of the environment and guarantee the long-term development of the city center.[578]

[576] *Tecmed v Mexico* (n 561), Award, 29 May 2003, para 96.
[577] ibid para 97.
[578] ibid para 110.

In addition, it also stressed its concern over 'the need to provide a response to the community pressure'.[579] It was subsequently questioned by the tribunal why the Government had not provided a new place for the claimant even after the claimant, at the very beginning of the negotiations, had agreed with the Government's relocation plan[580] and had promised to assume its costs[581] on one condition only, namely that 'a new site be identified before closing the operation … and that the continuity of the operation at the new site and premises be guaranteed with the necessary permits'.[582]

B. The Effect

After taking a close look at the facts that helped to determine the purpose of the Mexican Government, the tribunal explicitly expressed its opinion that it should determine 'if due to the actions of the Respondent, the assets involved have lost their value or economic use for their holder and the extent of the loss'.[583] In this regard, the tribunal held that

[579] ibid para 125(2). However, the tribunal, after examining the evidence submitted to it, had the confidence to conclude that there were other factors influencing the government's final decision, not just whether or not the claimant had complied with relevant laws and regulations. These 'other' factors had 'a decisive effect in the decision to deny the Permit's renewal'. 'Political circumstances' are included in these factors; see para 127.
[580] ibid para 110.
[581] ibid paras 112 and 142.
[582] ibid para 110.
[583] ibid para 115.

> [t]his determination is important because it is one of the main elements to distinguish, from the point of view of an international tribunal, between a regulatory measure, which is an ordinary expression of the exercise of the state's police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives those assets and rights of any real substance. Upon determining the degree to which the investor is deprived of its goods or rights, whether such deprivation should be compensated and whether it amounts or not to a *de facto* expropriation is also determined. Thus, the effects of the actions or behavior under analysis are not irrelevant to determine whether the action or behavior is an expropriation.[584]

The cases and references the tribunal used reinforced its understanding of the role of the effect in the determination of indirect expropriation. The tribunal considered that '[t]he government's intention is less important than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects'.[585] It then strengthened its position by quoting the judgment in *Baruch Ivcher Bronstein v Peru*, arguing that it should not 'restrict itself to evaluating whether a formal dispossession or expropriation took

[584] ibid.
[585] ibid para 116.

place, but should look beyond mere appearances and establish the real situation behind the situation that was denounced'.[586]

C. Proportionality Test

The proportionality test links the purpose test and the effect test as a whole and introduces 'weighing and balancing' into the determination. It was important for the tribunal to answer the question of *whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such an impact plays a key role in deciding the proportionality*.[587]

The tribunal was seeking to find the 'reasonable relationship' between the government measure's purpose and its effect on the investment and the investor, which is the basis for determining whether or not the investor could be compensated. In the tribunal's words,

[586] ibid, citing from *Ivcher Bronstein* Case (*Baruch Ivcher Bronstein v Peru*), Interamerican Court of Human Rights, Judgment, 6 February 2001, 56.
[587] ibid para 122.

> [t]here must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure. To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the state and whether such deprivation was compensated or not.[588]

D. Purpose – Effect – Proportionality Analysis

The tribunal, in reaching its conclusion, could not find enough evidence to support that there was 'a real or potential threat to the environment or to the public health' because of the landfill, nor could it prove that the claimant's wrongful doings had constituted 'a real crisis or disaster of great proportions' that brought with it 'massive opposition'.[589]

In addition, the Order concerned not only terminated the permission but also had the effect of permanently closing down the landfill, which made 'the economic or commercial value directly or indirectly associated with those operations and activities and with the assets earmarked for such operations and activities irremediably destroyed'.[590]

[588] ibid.
[589] ibid para 144.
[590] ibid para 117.

Therefore, as far as the tribunal was concerned, there was no situation that was seriously urgent enough nor any crisis, need, or social emergency that could be weighed against the deprivation or neutralization of the economic or commercial value of the claimant's investment. Therefore, the tribunal found that the Order and its effects amounted to an expropriation in violation of Article 5 of the Agreement and international law.

5.3.1.3 LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v Argentine Republic

Three American companies had invested in three Argentine gas distribution companies established during a period of privatization in Argentina in the early 1990s and had been granted licenses until 2027. The dispute started as a result of Argentina promulgating legislation enabling gas distribution tariffs to be calculated in U.S. dollars and the automatic semi-annual adjustments of tariffs to be based on the U.S. Producer Price Index and implementing other guarantees relating to the Argentine tariff regime in order to attract foreign investment during the privatization period. Because of these guarantees granted by the Argentine Government, the claimant invested a large amount in the gas distribution infrastructure. However, because a serious economic crisis occurred during the late 1990s and early 2000s, Argentina abrogated this legislation and canceled the guarantees provided during the privatization period. As a

consequence of Argentina's abrogation, the profitability of the gas distribution business was injured and so were the returns on investments.

Relying on the 1991 Argentina-U.S. BIT, the claimant initiated ICSID proceedings on the grounds of Argentina's breaches of FET, the umbrella clause, nondiscrimination, nonarbitrariness, and expropriation protection. The tribunal carefully examined all of the allegations and dismissed the claims of expropriation and arbitrariness; notably, it found that Argentina was in a State of necessity between 1 December 2001 and 26 April 2003 and therefore should be excused from its international compensation responsibility for that period of time.

This case involved a thorough analysis of the reasons for not finding that there had been indirect expropriation from the perspectives of economic impacts (both the severity of the interference and its duration), the purpose of enacting the measure, the balance between 'the degree of the measure's interference with the right of ownership and the power of the State to adopt its policies',[591] and the measure's context. It was therefore evidenced that this tribunal strongly supported using a balanced approach to determine the occurrence of indirect expropriation.

A. Economic Interference

[591] *LG&E v Argentina* (n 563), Decision on Liability, 3 October 2006, para 189.

This tribunal classified economic interference into two categories: the severity of the economic impact and its duration. With regard to the severity of the economic impact, the rationale was that compensation could be ordered if 'the economic impact unleashed by the measure adopted by the host State was sufficiently severe as to generate the need for compensation due to expropriation'.[592] How then to determine whether or not the interference concerned is 'sufficiently severe'? The tribunal's opinion was that the degree of interference should satisfy a *substantiality* test.[593] In addition, the tribunal opined on the situation in which the degree of interference could not satisfy this test while the investment was continuing to operate, even if the profits thereof were diminished.[594]

As for the duration of the interference, this standard was closely related to the determination of the degree of interference.[595] The tribunal explained why they valued the duration so much in their analysis:

> Generally, the expropriation must be permanent, that is to say, it cannot have a temporary nature, unless the investment's successful development

[592] ibid para 191.
[593] The tribunal stated that '[t]he impact must be substantial in order that compensation may be claimed for the expropriation'; ibid para 191.
[594] ibid.
[595] ibid para 190.

> depends on the realization of certain activities at specific moments that may not endure variations.[596]

B. Purpose

It is important to protect the legitimate rights and interests of foreign investors; it is also extremely important to safeguard the State's right to regulate. As explicitly pointed out by the tribunal, '[i]t is important not to confound the State's right to adopt policies with its power to take an expropriatory measure'.[597]

Therefore, the tribunal admitted the right of a host State to act under the protection of police power as this empowered the State to legitimately regulate its domestic matters. This right should not be infringed in any way. To prove their stance over this issue, the tribunal used the American Law Institute's Restatement (Third) of the Foreign Relations Law of the United States as well as the Permanent Court of International Justice's opinion in the *Oscar Chinn* affair of 1934:

> No enterprise ... can escape from the chances and hazards resulting from general economic conditions. Some industries may be able to make large profits during a period of general prosperity, or else by taking advantages

[596] ibid para 193.
[597] ibid para 194.

> of a treaty of commerce or of an alteration in customs duties; but they are also exposed to the danger of ruin or extinction if circumstances change. Where this is the case, no vested rights are violated by the State.[598]

As for the scope of police power, the tribunal believed it to include 'the right to adopt measures having a social or general welfare purpose'[599] according to general understanding.

C. Proportionality

According to the tribunal's understanding, the State should have no liability to compensate as long as its regulatory measure falls within the scope of police power, except in situations where these measures are 'obviously disproportionate' to the need being addressed.[600]

The tribunal cited *Tecmed* to make its argument stronger and to explain that the proportionality test had been accepted in international arbitration practice. The *Tecmed* tribunal had stated that

> [w]hether such actions or measures are proportional to the public interest presumably protected thereby and the protection legally granted to

[598] ibid para 197, citing from *Oscar Chinn* affair, P.C.I.J, 1934, Ser A/B, Case No. 63.
[599] ibid para 195.
[600] ibid.

investments, taking into account that the significance of such impact, has a key role upon deciding the proportionality.[601]

D. Balanced Approach

The tribunal clarified its own understanding on how to determine indirect expropriation. The economic effect surely plays the most significant role in the course of a determination, but considering the purpose and context of the employed measure is also necessary in order to draw a balanced conclusion. The tribunal illustrated its understanding in the announcement of the award:

> [t]here is no doubt that the facts relating to the severity of the changes on the legal status and the practical impact endured by the investors in this case, as well as the possibility of enjoying the right of ownership and use of the investment are decisive in establishing whether an indirect expropriation is said to have occurred. The question remains as to whether one should only take into account the effects produced by the measure or if one should consider also the context within which a measure was adopted and the host State's purpose. It is this Tribunal's opinion that there must be a balance in the analysis both of the causes and

[601] ibid, citing from *Tecmed v Mexico* (n 561), Award, 29 May 2003, para 122.

> the effects of a measure in order that one may qualify a measure as being of an expropriatory nature.[602]

More importantly, the determination of indirect expropriation should not prevent the State from lawfully adopting its policies and using its regulatory power while protecting the foreign investment. Therefore, it would be better if we could strike a fair balance between the interests of the host States and those of the foreign investors. As stated in the *Tecmed* case,

> [t]his determination is important because it is one of the main elements to distinguish, from the perspective of an international tribunal between a regulatory measure, which is an ordinary expression of the exercise of the state's police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives those assets and rights of any real substance.[603]

5.3.2 Summary: Anything Missing?

So far, the police power doctrine, the sole effect doctrine, and the mixed purpose and effect doctrine, together with their representative cases, have been thoroughly analyzed. We can convincingly conclude that the police power doctrine is more favorable for host States to regulate and the sole effect doctrine

[602] ibid para 194.
[603] ibid, citing from *Tecmed v Mexico* (n 561), Award, 29 May 2003, para 115.

favors the protection of foreign investors.[604] As a relatively balanced approach, the purpose and effect doctrine adopts the method of weighing between the purpose of government measures and their effect and thus can be viewed as an approach that tries to balance the interests of the host countries and the foreign investors.

Nevertheless, beyond testing the purpose, the effect, and the proportionality, there may be other considerations that are highly relevant in the process of examining indirect expropriation in specific cases. As proved in a series of completed arbitrations, these considerations, for instance, the legitimate expectations of foreign investors, the due process requirement, the nondiscrimination requirement, and others, are more than necessary to form the context of a potential expropriatory act.

Although the tribunal in *Tecmed* did not provide too much analysis examining beyond the effect and the purpose, it did consider other factors. In the award, just before the conclusion in the expropriation section, the tribunal reviewed the key facts to prove there was an expectation on the part of the investor of being able to operate the landfill for a reasonable period of time while investing in the project

[604] Mostafa (n 462) 267.

and that the Mexican Government should have been aware of this expectation.[605] The tribunal thus concluded:

> This shows that even before the Claimant made its investment, it was widely known that the investor expected its investments in the Landfill to last for a long term and that it took this into account to estimate the time and business required to recover such investment and obtain the expected return upon making its tender offer for the acquisition of the assets related to the Landfill. To evaluate if the actions attributable to the Respondent — as well as the Resolution — violate the Agreement, such expectations should be considered legitimate and should be evaluated in light of the Agreement and of international law.[606]

The same situation also occurred in *LG&E*. In that case, the tribunal strictly followed the approach of applying the purpose test, the effect test, and even the proportionality test to determine indirect expropriation, but there was a clear indication that the tribunal intended to consider the issue of indirect expropriation on the basis of 'the context within which a measure was adopted'.[607] By referring to the 'context' of a State measure, there must be factors of great relevance that are beyond the mere purpose and effect of the

[605] *Tecmed v Mexico* (n 561), Award, 29 May 2003, para 150.
[606] ibid.
[607] *LG&E v Argentina* (n 563), Decision on Liability, 3 October 2006, para 194.

measure. So, if we want to find the most appropriate method to use, the question of what criteria have to be analyzed in order to determine indirect expropriation remains.

5.4 Proposed Approach: A Balanced, Fact-Based, and Case-by-Case Analysis

Over the decades, the question of how to determine indirect expropriation has not been resolved. The controversy is still left open for discussion and exploitation. There is a trend, however, favoring the use of fact-based and case-by-case analysis to weigh the regulation-expropriation balance. This trend can be seen in the updated Draft U.S. Model BIT that was released in February 2004 which lists three main criteria for finding the existence of indirect expropriation:

> The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a fact-based inquiry that considers, among other factors:
>
> - the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
> - the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

- the character of the government action.[608]

The message sent out from this provision is clear. The three listed factors are all necessary and compulsory in determining the occurrence of indirect expropriation; none of them can be used on their own to make the final decision. Specially pointed out in this test is that the adverse economic effect is not the decisive factor but is necessarily connected with the other two considerations, namely the legitimate expectations of the investor and the character of the government action. The Model BIT goes on to give authority to the weighing of the regulation-expropriation balance on the basis of the police power doctrine: '[e]xcept in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations'. The 2012 U.S. Model BIT confirms all of the aforementioned wording and stipulates the use of this balanced approach to determine indirect expropriation.

In AUSFTA, the provision concerning indirect expropriation almost copies the provision in the Model BIT:

[608] Treaty between the Government of the United States of America and the Government of [Country] concerning the Encouragement and Reciprocal Protection of Investment (US Draft Model BIT), released by the Department of State and the Office of the United States Trade Representative (USTR) in February 2004.

The second situation addressed by Article 11.7.1 is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to indirect expropriation without formal transfer of title or outright seizure.

(a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:

(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

(iii) the character of the government action.[609]

This balanced approach has been mirrored in a number of BITs and FTAs; this provides supportive evidence of the success of this approach.[610] For example, the United States-Singapore FTA, the United States-Australia FTA, the United States-Morocco Free FTA, and the United States-Uruguay BIT all take the same

[609] AUSFTA, annex 11- B (4).
[610] This balanced approach has been incorporated into BITs and FTAs since 2003.

approach that requires, but is not limited to, a full consideration of the government regulatory measure's purpose and its economic effect and the investor's legitimate expectations in determining indirect expropriation, reflecting that a new trend in international investment law has been established and approved.

5.4.1 Recognized by International Practice: A Case Study

Whether or not this balanced approach has been recognized by international practice can be deduced from some recent leading arbitral decisions. These cases can provide a persuasive argument for ceasing to use only the purpose test, the effect test, or the proportionality test and instead determining the context of the measure in order to analyze the case on the basis of its specific facts. This was exactly the approach used in *Generation Ukraine v Ukraine*, in which the tribunal explicitly pointed out and summarized the situation of indirect expropriation in international investment arbitration:

> Predictability is one of the most important objectives of any legal system. It would be useful if it were absolutely clear in advance whether particular events fall within the definition of an 'indirect' expropriation. It would enhance the sentiment of respect for legitimate expectations if it were perfectly obvious why, in the context of a particular decision, an arbitral tribunal found that a governmental action or inaction crossed the

> line that defines acts amounting to an indirect expropriation. But there is no checklist, no mechanical test to achieve that purpose. The decisive considerations vary from case to case, depending not only on the specific facts of a grievance but also on the way the evidence is presented, and the legal bases pleaded. The outcome is a judgment, i.e. the product of discernment, and not the printout of a computer programme.[611]

In this context, some illustrative cases will be provided below to understand how this approach to finding indirect expropriation is conducted in practice and thereby realize its potential and develop it.

5.4.1.1 Azurix Corp. v The Argentine Republic

The claimant - a U.S. corporation - intended to invest in a business operating the privatization of water services in Argentina. Its indirect subsidiary won a tender and was granted a 30-year concession contract. During the performance of the contract, the claimant found that Argentina had breached the agreement in several ways: first, the supervisory authority did not allow the claimant to bill an amount in excess of the amount agreed prior to the contract, which, the claimant alleged, was inconsistent with the information that had been given to the bidders; second, the local government did not respect the tariff regime set out in the concession contract: for instance, it did not continue to use the valuation method indicated in

[611] *Generation Ukraine, Inc. v Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003, para 20.29.

the contract and did not provide any alternative method to the claimant; third, the Argentine Government did not fulfill its obligations under the concession contract to repair some infrastructure, and this caused an algae outbreak. In addition, instead of performing their obligations, the Argentine Government incited public panic and encouraged consumers not to pay their water bills. Consequently, the claimant initiated ICSID arbitration proceedings claiming expropriation and a failure to uphold other treaty protections in accordance with the 1991 Argentina-US BIT.

This case is interesting because the tribunal duly considered and recognized the importance of the issues of legitimate expectations and the proportionality test in determining indirect expropriation even though no such explicit wording was established in the applicable BIT.

In addition to the economic effect, the claimant asserted that 'the Province and the Republic deprived Azurix [the claimant] of the use and enjoyment of the reasonably-to-be-expected economic benefits of the Concession and expropriated its investments'.[612] The respondent denied this allegation and responded that '[l]egitimate expectations are not the basis for expropriation but the measure of compensation'.[613] However, the tribunal used one section of its judgment to explain this issue by comparing the facts with *Tecmed* and clearly pointed out that

[612] *Azurix v Argentina* (n 562), Award, 14 July 2006, para 277.
[613] ibid para 302.

the key difference in these two cases was that '[t]he expectations as shown in that case [*Tecmed*] are not necessarily based on a contract but on assurances explicit or implicit, or on representations, made by the State which the investor took into account in making the investment'.[614]

As regards the issue of the proportionality test, the tribunal considered the ruling in *James and Others*, a case from the European Court of Human Rights. In that case, the court's opinion on indirect expropriation went beyond the consideration of effect or purpose only, arguing that 'a measure depriving a person of his property [must] pursue, on the facts as well as in principle, a legitimate aim "in the public interest"' and have 'a reasonable relationship of proportionality between the means employed and the aim sought to be realized'.[615] Nevertheless, after examining this case, the tribunal held in a separate paragraph that it found that '*these additional elements* [emphasis added] provide useful guidance for purposes of determining whether regulatory actions would be expropriatory and give rise to compensation'.[616]

Therefore, it was evidenced in that case that the legitimate expectations and the proportionality test did serve their roles in determining the existence of indirect expropriation, although the tribunal admitted that the government's interference

[614] ibid para 318.
[615] ibid para 311.
[616] ibid para 312.

did affect the claimant's management, but not 'sufficiently' enough to rule that expropriation had occurred.[617]

5.4.1.2 Metalclad Corporation v The United Mexican States

Metalclad, a U.S. corporation that managed its investment in Mexico through its Mexican subsidy, obtained a permit from the Mexican federal government to construct a hazardous waste landfill. However, after five months of construction, this construction project was prohibited from continuing by the local government because there was no municipal construction permit. Metalclad applied for the construction permit while completing the project.

The permit application was rejected by the municipal government, and as a result, the landfill was barred from operation. In addition, the Mexican Government issued an ecological decree declaring a protected natural area which encompassed the landfill site and thus permanently closed the site. In this situation, Metalclad brought a claim for compensation to the ICSID tribunal. The tribunal held that the municipal government did not have the authority to deny the construction permit issued by the federal government on environmental grounds and that there were no clear rules and procedures regarding applying for a municipal construction permit. These actions constituted indirect expropriation,

[617] ibid para 322.

and the tribunal further found that the ecological decree alone constituted indirect expropriation.

A. The Significance of Legitimate Expectations in Concluding the Occurrence of Indirect Expropriation

In concluding that indirect expropriation had occurred, the tribunal made considerable efforts to elaborate on the investor's legitimate expectations. Even though there was no compulsory requirement to determine the indirect expropriation by making reference to the requirement of legitimate expectations, the tribunal stated that

> [e]xpropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or *reasonably-to-be-expected economic benefit* of property even if not necessarily to the obvious benefit of the host State.[618]

[618] *Metalclad* (n 548) para 103.

The tribunal held that 'the exclusive authority for siting and permitting a hazardous waste landfill resides with the Mexican federal government'.[619] Therefore, the municipal government, by denying the claimant's construction right, 'effectively and unlawfully prevented the Claimant's operation of the landfill'.[620] In arriving at its conclusion, the tribunal explicitly held that

> [t]hese measures, taken together with the *representations of the Mexican federal government, on which Metalclad relied*, and the *absence of a timely, orderly or substantive basis* for the denial by the Municipality of the local construction permit, amount to an indirect expropriation.[621]

5.4.1.3 Marvin Roy Feldman Karpa v United Mexican States

In this case, the claimant was a Mexican company owned and controlled by a U.S. citizen. The claimant sued the Mexican Government for not obeying the tax laws concerning its export of tobacco products. The claimant alleged that through the conduct of its Ministry of Finance and Public Credit, Mexico's refusal to rebate the excise taxes applied to the cigarettes it exported and Mexico's continuing refusal to recognize its right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of several obligations under NAFTA, including the obligation not to expropriate. In its

[619] ibid para 105.
[620] ibid para 106.
[621] ibid para 107.

decision, the tribunal only granted compensation to the claimant for denial of national treatment (NAFTA 1102).

In respect of the expropriation claim, the tribunal duly considered several aspects surrounding the facts. First, the business problem experienced by the owners should be distinguished from expropriation claims. Second, the claimant's 'grey market' cigarettes exports fell outside the scope of the legal protection concerned. Third, at no relevant time had the relevant Mexican tax law, as written, afforded Mexican cigarette resellers, for instance the claimant, a 'right' to export cigarettes (due primarily to technical/legal requirements for invoices stating tax amounts separately and to their status as non-taxpayers). Fourth, the tribunal determined that the claimant's investment, namely its right to engage in an exporting business, was still under its complete control; the claimant could thus engage in exporting alcoholic beverages, photographic supplies, contact lenses, powdered milk, and other Mexican products, which could be purchased upon receipt of the invoices with the tax amounts stated thereon, and receive rebates according to Mexican tax laws. Additionally, the tribunal emphasized that none of these considerations on its own was conclusive, but taken together, they could provide a conclusion on whether or not expropriation had occurred.[622]

A. Purpose and Effect

[622] *Marvin Roy Feldman Karpa v United Mexican States* (*Feldman v Mexico*), ICSID Case No. ARB (AF)/99/1, Award, 16 December 2002, para 111.

The claimant argued that the true intention of the government measures was to 'put the Claimant out of the cigarette export business through manipulation or interpretation of'[623] the relevant legal requirements, which had limited cigarette exports, and that these measures were inconsistent with the purpose of Mexican policy and laws, namely encouraging Mexican exports.[624] So in the tribunal's decision, there was a section focusing on examining the purpose of the tax law amendments. Whether or not the Mexican Government's measures were designed to prevent resellers, including the claimant, from exporting cigarettes from Mexico to other countries was the key issue in examining the public purpose. The claimant raised its concern that these measures were introduced under political pressure from the major owner of Mexico's largest cigarette producer.[625] The tribunal, however, after considering all the relevant facts, believed the innocence of the government measures, arguing that the rational public purposes of the measures, including 'discouraging "grey" market exports and seeking to control the illegal re-exportation of Mexican cigarettes into Mexico', were clear.[626] By requiring the presence of invoices stating the tax amounts as a precondition for a tax rebate, it also manifested the rational public purpose of preventing 'inaccurate or excessive claims for rebates'.[627]

[623] ibid para 91.
[624] ibid para 89.
[625] ibid para 135.
[626] ibid para 136.
[627] ibid.

The tribunal went on to examine the effect of the measures concerned. *Pope & Talbot* was the case that served as the best reference for the tribunal since it also involved a claim of denying the claimant's right to export. The *Pope & Talbot* tribunal established the standard for deciding 'whether a particular interference with business activities amounts to an expropriation'; according to the tribunal, 'the test is whether that interference is sufficiently restrictive to support a conclusion that the property has been "taken" from its owner'.[628] Therefore, it was possible for the tribunal to find an expropriation '[g]iven that the Claimant here has lost the effective ability to export cigarettes, and any profits derived therefrom'.[629] But the fact in the *Marvin Feldman v Mexico* case was that the claimant had never actually possessed a right to export cigarettes, nor had it been deprived of its control over its investment.[630]

B. Other Factors beyond the Purpose and Effect but Surrounding the Facts

The *Marvin Feldman v Mexico* case is of great significance to the current discussion because in addition to examining the purpose and effect of the governmental actions, the tribunal went beyond these two factors and closely examined other factors that were really relevant.

(a) Business Problem

[628] *Pope & Talbot Inc. v The Government of Canada* (*Pope & Talbot*), UNCITRAL Case, Interim Merits Award, 26 June 2000, paras 100 and 102.
[629] *Feldman v Mexico* (n 622) para 152.
[630] ibid.

The tribunal cited *Azinian*[631] to elaborate on this point. In that case, the tribunal had assumed that '[i]t is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities' and went on to state that it 'may be safely assumed that many Mexican parties can be found who had business dealings with governmental entities which were not to their satisfaction'.[632] By using *Azinian* as the foundation of its analysis, the tribunal reached the following conclusion:

> [g]overnments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.[633]

That is to say, the difficulty experienced by investors could not, on its own, allow them to claim a violation of international law.[634] Therefore, the tribunal came to the conclusion that 'many business problems are not expropriations'.[635]

(b) Grey Market Exports and International Law

[631] *Robert Azinian, Kenneth Davitian, & Ellen Baca v The United Mexican States* (*Azinian*), ICSID Case No. ARB (AF)/97/2, Award, 1 November 1999.
[632] ibid para 83.
[633] *Feldman v Mexico* (n 622) para 112.
[634] ibid para 113.
[635] ibid para 41. This is the title of this section (H3.1).

Since this case primarily concerned the question of whether the unauthorized sale of cigarette exports should be permitted under the rules of NAFTA and the principles of customary international law, the tribunal found the rationales for not permitting these activities, including the 'discouragement of smuggling',[636] and other legal documents supported their view.[637]

(c) The Reasonableness of Domestic Law

The key dispute that needed to be settled in this case was whether the denial of rebates for failing to meet with the invoice requirement constituted expropriation under the rules of NAFTA.[638] Then, there was the question of whether this requirement was formalistic and unreasonable.[639] In the view of the tribunal, this requirement was definitely 'a rational tax policy and a reasonable legal requirement'.[640] As the tribunal explained,

> [t]he obvious and legitimate purpose of the requirement that the IEPS tax amounts be stated separately on invoices to be submitted to SHCP authorities on demand as the basis of a tax rebate is to make it possible for the tax authorities to determine in a straightforward manner whether

[636] ibid para 115.
[637] ibid, see n 12.
[638] ibid para 119.
[639] ibid para 129.
[640] ibid.

the tax amounts on exported products for which a rebate is sought are accurate and not overstated.[641]

(d) Transparency

The tribunal understood that the communications, both written and oral, between the government authority and the claimant were 'at best ambiguous and misleading',[642] and were even intended to be so in some instances, leading to the rebates being permitted on some occasions and denied on others.[643] Although the standard of transparency was seriously injured, the tribunal did not believe that 'lack of transparency alone rises to the level of violation of NAFTA and international law, particularly given the complexities not only of Mexican but most other tax laws'.[644]

(e) Nondiscrimination, Due Process, Fair and Equitable Treatment, and Denial of Justice

Subsections b and c of NAFTA Article 1110 (1) require a lawful expropriation to be conducted on a nondiscriminatory basis and in accordance with the due process of law and with treatment under international law.

[641] ibid.
[642] ibid para 132.
[643] ibid.
[644] ibid para 133.

The tribunal, following these standards, continued its analysis on whether or not these standards could prove the occurrence of indirect expropriation in this case. As concluded by the tribunal, it was notable that in the *S.D. Myers* case, the tribunal weighed the allegation of expropriation and found it not established, but it did find that the respondent had violated *national treatment* standards and the *minimum standard of treatment*.[645] However, the violations also constituted a failure to uphold the obligation to provide nondiscriminatory and fair and equitable treatment under international law.[646] Following the indications from *S.D. Myers*, the tribunal believed that it might be appropriate for a NAFTA tribunal to determine a violation of other treatments; at the same time, it declined to support the allegation of expropriation. To quote from the text of the judgment, '[e]ven assuming, arguendo, that the Respondents' actions in the aggregate do constitute a denial of fair and equitable treatment that reaches the relatively egregious level of a violation of international law, this *alone* [emphasis added] does not establish the existence of an illegal expropriation under Article 1110'.[647]

5.4.2 Summary

In this chapter, pages of discussion have been used to illustrate the existing, findable approaches that can be applied in a case to determine the occurrence of indirect expropriation. Through these discussions, we can understand why these

[645] ibid para 137.
[646] ibid.
[647] ibid para 141.

approaches were created and how they have been used and developed. The significance of these discussions is to assist us in viewing indirect expropriation from the perspectives of the host State and the foreign investors and understanding the context of indirect expropriation in a broad and complete way. More importantly, it helps us to decide which approach of all is more reasonable and scientific and thus should be proposed.

Fortier and Drymer once commented on the meaning and what may be the exact protections of indirect expropriation and concluded:

> [W]here does this leave the foreign investor wishing to understand the state of the law with respect to protection from expropriation? How can a foreign investor know whether and which conduct by the host State that affects an investment is compensable? Given that the law is, truly, in a state of flux, the best answer to the question '*when, how, or at what point does otherwise valid regulation become, in fact and effect, an expropriation?*' may be: 'I know it when I see it.'[648]

Probably, this is the most accurate conclusion ever to answer the question of how to find an indirect expropriation: The answer is to see the whole case when processing all of the facts of a case and all applicable legal rules in your mind. In

[648] Fortier and Drymer (n 461) 110.

the coming chapter, this thesis will present a well-organized discussion aimed at providing a detailed analysis, supported by international arbitral case studies and treaty studies, of all the necessary considerations that need to be taken into account when seeking to determine the occurrence of indirect expropriation by using the fact-based and case-by-case analysis.

To summarize, the fact-based and case-by-case analysis is proposed and supported with a philosophy of weighing the balance between the normal regulation and compensable indirect expropriation by concentrating on, and distinguishing between, the distinctive facts or unique nature of each individual case. The balance can be found through discovering every possible fact, or piece of legislation or any other consideration that is relevant to the expropriatory nature of the State measure, and comparing all of those relevant considerations as a whole, to ensure the ultimate fairness and reasonableness in the case. Defining the role of each consideration, or its importance and weight, in the process of concluding indirect expropriation, however, needs further elaboration.

The fact-based and case-by-case analysis is different from other approaches which may focus exclusively on the effect of the measure (sole effect doctrine), or only protect the State's use of its regulatory power (police power doctrine), or a simple weigh-and-balance of the measure's purpose and its effect (purpose and

effect test). As the *Feldman* case suggests that all surrounding facts of one case may be relevant in determining the nature of a State measure. The fact-based and case-by-case approach has a non-exclusive formulation that can be well framed by considering several major factors summarized from previous case studies and other individually established considerations from the specific case at point. For instance, the consideration of investor's expectations is necessary: Foreign investors normally have expectations that the host State will/will not act in a certain way, and thus a violation of such expectations will have adverse influence on foreign investment and thereby constitute indirect expropriation. Therefore, such expectations are possible to constitute a valid consideration in the process of finding indirect expropriation but should be protected with necessary restraints and legal criteria.

Chapter VI The Proposed Approach: Identification and Suggestions

The legal documents in international law have failed to establish the complete criteria for identifying what constitutes indirect expropriation; they only leave vague words recognizing its existence. Arbitral tribunals, however, have struggled to fill this gap through summarizing the pattern of criteria from a series of decisions on the basis of varying and complex facts. As a consequence of this phenomenon, three doctrines have emerged: the sole effect doctrine, the police power doctrine, and the mixed purpose and effect doctrine. But the difficulty in formulating a one-size-fits-all test to fit all specific situations and to ensure justice is undeniable. Scholars have made efforts to fix this problem. In recent years, one opinion seems to have gained general acceptance in international practice, that is, to identify indirect expropriation on the basis of a body of arbitral decisions in order to clarify very distinctive considerations within the facts and draw a conclusion which balances these considerations.

In light of all the discussions in the previous chapters, this chapter attempts to pinpoint the necessary considerations that really matter in the process of determining indirect expropriation. It is impractical and impossible for this thesis to summarize all of the potentially relevant factors at once since every case has its own significance, but it is practical and possible for us to propose a set of key factors that have been proven useful in order to form a basic model that can be

adopted in the initial stage of every case. As concluded from arbitration practice, these necessary considerations are as follows: first, the purpose of the governmental measure; second, the degree of interference with the investor's property rights; third, the proportionality test that determines the reasonableness of the purpose of the measure and the end this measure pursues; fourth, the interference of the measure with reasonable investment-backed expectations; and fifth, other considerations that have been used in a series of awards, for example, due process, non-transparency, nonarbitrariness, nondiscrimination, and denial of justice.

6.1 Purpose of the State's Measure

Someone believing in the *sole effect* doctrine would focus exclusively on the effect of the measure and disregard the purpose, so whether or not there had been indirect expropriation would be determined according to the degree of the economic interference; someone believing in the police power doctrine would protect the State's use of its regulatory power, and so no expropriation would be found if the measure was implemented to promote 'general welfare'; and someone believing in the relevance of both purpose and effect would need to weigh and balance the purpose and the effect of the measure.

Given the broad meaning of 'public purpose', it is not surprising that foreign investors have always questioned this requirement. However, tribunals have

addressed the significance of the term and its limits in some cases.[649] Thus, the answers to the following questions are unclear: What should the proper status of a measure's purpose be in the determination process? What is its scope and how can its significance be weighed?

Let us take China as an example to elaborate on the importance of defining the meaning of 'public purpose'. For the past three decades, China has been, and at least for the near future still is, on the path of embracing fast economic development, and it is now encountering the urgent need to restructure its economic development pattern. In the 2014 Government Working Report, Chinese Premier Li Keqiang emphasized several areas in need of improvement, including industrial reform, environmental protection, and the preservation of social fairness and justice.[650] He even declared war on these issues and demanded the commitment of the whole State in this endeavor.[651]

In such a context, foreign investment would be welcomed, especially investment that introduces advanced technology and contributes to the transformation of the host State's economic development pattern from an industrial economy to a

[649] Rdudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Oxford University Press 2008) 165.

[650] Li Keqiang, *2014 Report on the Work of the Government* (Delivered at the Second Session of the Twelfth National People's Congress on 5 March 2014) <http://www.china.org.cn/chinese/2014-03/17/content_31806665_3.htm> accessed 6 June 2014.

[651] ibid.

services-dominated economy. However, in China, investments with negative outcomes such as pollution may be forced out of business because of some newly promulgated policies or laws issued by the Chinese Government.

In such a special transitional period of time, foreign investments and investors will still be warmly valued, but investors may face the risk of 'sacrificing' themselves in the course of China's restructuring if the business they own has a goal which is at odds with China's future policies or if their existing business cannot fit in with these policies; for example, it was believed that the 2011 ConocoPhillips China oil leak emergency was an alert for the Chinese Government, reminding it of the need to improve its policies and laws aimed at regulating foreign investors' operations and thereby protecting the environment.[652] Consequently, the problem then arises as to whether any new policies or laws would have an expropriatory effect that constituted indirect expropriation and would thus be compensable in accordance with the new generation of expropriation jurisprudence in international investment law. The uncertainty and unpredictability of future public policies continuously remind us of the importance of the law in regulating a country as well as in creating a stable framework for attracting foreign investment and maintaining the level of inflow of foreign investment. This is consistent with the statement in Premier Li's

[652] For more information, see Xinhua, 'Maritime Authority [do] not Verify ConocoPhillips China's Oil-leak-sealed Claim' (published on 1 September 2011) <http://news.xinhuanet.com/english2010/china/2011-09/01/c_131087261.htm> accessed 6 June 2014.

Working Report that the Chinese Government should act and govern the country on the basis of law[653] because only in this way can the discretionary power of a government best be managed and controlled.

In this context, to what extent and in what circumstances the determination of indirect expropriation depends on the purpose of the measure concerned will be clarified in this section. Even though the importance of this criterion has been criticized for a long time, there is still no definite opinion of its role and how it should be considered.

The view of this thesis is that the purpose of the regulatory measure is definitely an important factor in determining the occurrence of indirect expropriation, but whether or not the specific 'purpose' can be accepted by international tribunals depends on its nature.

6.1.1 Nonactions and Omissions of the Host State

In most cases, the indirect expropriation is caused by active actions taken by the host States or its subsidiaries, but, in fact, the nonactions and omissions of the host State could also have the same adverse effects on foreign investors. Would these measures amount to the level of interference required to determine the occurrence of indirect expropriation?

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[653] Li (n 650).

Very few relevant decisions or studies have addressed the question of whether the omissions of States can be considered when interpreting expropriation regulations. With respect to this issue, a case of great importance is *Sea-Land Service, Inc. v Iran*.[654] In this case, the local authorities of the Iranian Government seriously interfered with the claimant's management of its container cargo services and caused the loss of its investment. The claimant blamed the Iranian Government for its nonaction and made a claim for compensation. The tribunal decided that the chaos was actually caused by the Iranian Government's failure to act but that this failure to act did not constitute indirect expropriation. The tribunal explained that

> [a] claim founded substantially on omissions and inaction in a situation where the evidence suggests a widespread and indiscriminate deterioration in management disrupting the functioning of the port of Bandar Abbas can hardly justify a finding of expropriation.[655]

This case is of further relevance because it intended to interpret the expropriation as intentional. It was explicitly stated that

> [a] finding of expropriation would require, at the very least, that the Tribunal be satisfied that there was deliberate governmental interference

[654] *Sea-Land Service, Inc. v Iran* (*Sea-Land*), Award No 135-33-1, Award, 22 June 1984, reprinted in 6 Iran-US CTR 146.
[655] ibid 166.

> with the conduct of Sea-Land's operation, the effect of which was to deprive Sea-Land of the use and benefit of its investment.[656]

An ICSID case also favored the approach taken in the *Sea-Land* case in determining whether or not the nonactions or omissions of States could constitute grounds for investors to claim expropriation compensation. The tribunal in *Eudoro A. Olguín v Republic of Paraguay* stated that

> [e]xpropriation … requires a theologically driven action for it to occur; omissions, however egregious they may be, are not sufficient for it to take place.[657]

However, Professor Sornarajah seems to have different opinions regarding nonaction and omission. He believes that a State's 'omission to act could have consequences that are akin to a taking'[658] and thus it has to be responsible for failing to protect the property of foreign investors. Furthermore, in his book *The International Law on Foreign Investment*, he holds the opinion that in order to hold the host State liable for expropriation, a definite link must be proved between 'the perpetrators of the damage and the State' or there must be 'some attributability of the damage to the State through a theory of negligence'.[659]

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[656] ibid.
[657] *Eudoro A. Olguín v Republic of Paraguay*, ICSID Case No. ARB/98/5, Award, 26 July 2001, para 84.
[658] M Sornarajah, *International Law on Foreign Investment* (2nd edn, Cambridge University Press 2004) 392.
[659] ibid.

Additionally, compensation for some types of interference, such as a physical taking, can be recovered through other treatments, such as full protection and security, under the provisions of investment treaties.[660]

The same opinion was expressed by Guillermo Aguilar Alvarez and William W. Park in their article *The New Face of Investment Arbitration: NAFTA Chapter 11*. They hold the view that '[i]ndirect nationalization through improper administrative measures has long served as a back door to deprive the investor of its assets'.[661] In addition, and more importantly, they expressed their views regarding a host State's nonaction:

> In some cases a taking might occur through non-action, as when a state refuses to interfere with popular seizure of foreign property or fails to fulfill a contractual obligation to grant fiscal benefits.[662]

6.1.2 Enriching the Host State

The international law and arbitral decisions have abandoned the idea that requires the State's acquisition to form the basis of expropriation claims since this idea seriously diminishes the protection against expropriation.[663] However, some cases have been decided according to a different line of analysis.

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[660] ibid 393.
[661] Guillermo Aguilar Alvarez and William W Park, 'The New Face of Investment Arbitration: NAFTA Chapter 11' (2003) 28 Yale J Intl L 365, 387.
[662] ibid.
[663] L Yves Fortier, CC, QC and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2005) 13 Asia Pac L Rev 79, 98.

In the above-mentioned case of *Eudoro A. Olguín v Republic of Paraguay*, the tribunal not only expressed its opinion that 'a theologically driven action' is needed for expropriation to occur but also explicitly regulated the conditions of an expropriation: 'For an expropriation to occur, there must be actions that can be considered reasonably appropriate for producing the effect of depriving the affected party of the property it owns, in such a way that *whoever performs those actions will acquire, directly or indirectly, control, or at least the fruits of the expropriated property* [emphasis added]'.[664]

In the context of this statement, the acquisition of 'fruits of the expropriated property' should most probably be interpreted as 'transfer of the benefits'. Therefore, the occurrence of expropriation would require the host State to have control of the investment or any other benefits derived from this investment.[665]

A similar approach was taken in *Ronald S. Lauder v the Czech Republic*, in which the tribunal summarized its analysis and concluded the following:

> [E]ven assuming that the actions taken by the Media Council in the period from 1996 through 1999 had the effect of depriving the Claimant of his property rights, such actions would not amount to an appropriation - or the equivalent - by the State, since *it did not benefit the Czech*

[664] *Eudoro A. Olguín v Republic of Paraguay* (n 657) para 84.

[665] Andrew Newcombe, 'The Boundaries of Regulatory Expropriation in International Law' (2005) 20 ICSID Review–Foreign Invest L J 15-16 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=703244> accessed 6 October 2013.

> *Republic or any person or entity related thereto* [emphasis added], and was not taken for any public purpose. It only benefited CET 21, an independent private entity owned by private individuals.[666]

S.D. Myers serves as the representative case in this regard. Its tribunal illustrated its understanding of 'expropriation' in the following way:

> In general, the term 'expropriation' carries with it the connotation of a 'taking' by a governmental-type authority of a person's 'property' with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the 'taking'.[667]

In its conclusion, the tribunal found that Canada had not benefitted in any way from its measure and that there had been no 'transfer of property or benefit directly to others'.[668] On the basis of these findings, no expropriation was found in this case.

In *Nykomb Synergetics Technology Holding AB v Latvia*, the tribunal believed that it is important to consider whether there has been an appropriation by the host State. As the tribunal put it, the 'decisive factor for drawing the border line towards expropriation must primarily be the degree of possession taking or

[666] *Ronald S. Lauder v the Czech Republic* (*Lauder v Czech Republic*), UNCITRAL Case, Award, 3 September 2001, para 203.
[667] *S.D. Myers, Inc. v Government of Canada* (*S.D. Myers*), UNCITRAL Case, Partial Award, 13 November 2000, para 280.
[668] ibid para 287.

control over the enterprise the disputed measures entail'.[669]

6.1.3 Deliberate Targeting at the Investor

If a government measure is introduced to deliberately target a particular investor, either explicitly or implicitly, then this measure would be more likely to give the investor the right to claim expropriation compensation. The phrase 'deliberate targeting at the investor' refers to the State's subjective intention to deprive the investor concerned of its property.[670]

In the *Sea-Land* case, no indirect expropriation was found because there was no 'deliberate targeting at the investor'.[671] In this case, the local authorities of the Iranian Government seriously interfered with the claimant's management of its container cargo services and caused the loss of its investment. The tribunal decided that the chaos was actually caused by the Iranian Government's failure to act but that this failure to act did not constitute indirect expropriation. As the tribunal explained,

> [a] finding of expropriation would require, at the very least, that the Tribunal be satisfied that there was deliberate governmental interference with the conduct of Sea-Land's operation, the effect of which was to deprive Sea-Land of the use and benefit of its investment.[672]

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[669] *Nykomb Synergetics Technology Holding AB v The Republic of Latvia*, SCC Case, Award, 16 December 2003, s 4.3.1.
[670] Fortier and Drymer (n 663) 99.
[671] *Sea-Land* (n 654) 166.
[672] ibid para 166.

It is evidenced in the ruling that the *Sea-Land* tribunal interpreted expropriation to include 'deliberate governmental interference' being imposed on the investor's operation; that is to say, there must be 'deliberate interference' by the government directed specifically against the investor.

In *Metalclad*, the claimant had been prohibited from opening and operating a hazardous waste disposal facility even though it had met all of the legal and other relevant requirements. It was further argued that this prohibition was issued after the initial stage of operation. Also, since the Mexican Government had created a preserve in this area, it would be impossible for the facility to continue to operate. Due to these facts, the tribunal found that this denial of a permit based on no legitimate grounds constituted indirect expropriation since 'the complete frustration of the operation of the landfill [eliminated] the possibility of any meaningful return on Metalclad's investment'.[673]

CME Czech Republic B.V. (The Netherlands) v The Czech Republic is another case in which the government measure was targeted specifically at the investor. In this case, the investor was granted the exclusive license to provide broadcasting services and made profits therefrom. This exclusive position was later undermined and finally destroyed due to the actions and omissions of the

[673] *Metalclad Corporation v United Mexican States* (*Metalclad*), ICSID Case No. ARB (AF)/97/1, Award, 2 September 2000, para 113.

governmental authority. The tribunal found that indirect expropriation had occurred as these actions and omissions had destroyed the company's operation, leaving the claimant as 'a company with assets, but without business'.[674] Although the worth of the claimant was not affected, the 'commercial value of the investment' was destroyed.[675] Therefore, expropriation was found to have occurred.

In *Biloune v Ghana*,[676] the investor was prohibited by a government affiliated entity from continuing its construction on the basis of the absence of a building permit when it had already completed a substantial amount of the work. The investor had submitted an application for a permit but never received a response. The tribunal in this case paid due attention to the investor's justifiable reliance on the representations of the government about the permit application. The facts were that the government had known about the construction for more than a year before issuing the stop work order, that building permits had not been required for other projects, and that there was no procedure for dealing with building permit applications. Due to these facts, the tribunal found that indirect expropriation had taken place.

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[674] *CME Czech Republic B.V. (The Netherlands) v The Czech Republic* (*CME v Czech Republic*), UNCITRAL Case, Partial Award, 13 September 2001, para 591.
[675] ibid.
[676] *Biloune and Marine Drive Complex Ltd v Ghana Investments Centre and the Government of Ghana* (*Biloune v Ghana*), UNCITRAL Case, Award on Jurisdiction and Liability, 27 October 1989, paras 207-10.

6.1.4 Promoting General Welfare

Whether the aim of a governmental action is the promotion of general welfare is a crucial factor that should be weighed in the regulation-expropriation balance. However, the scope and boundary of this criterion have never been clearly clarified. To study the appropriate circumstances in which a government can declare its legitimate purpose as being the promotion of general welfare, we need to review the theory of police power discussed in the last chapter.

Undoubtedly, this criterion is well recognized in a range of international and domestic legal tests. The Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens defines police power as 'result[ing] from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State' and states that the exercise of such power 'shall not be considered wrongful'.[677]

Similarly, the Third Restatement of the Foreign Relations Law of the United States regulates that '[a] state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as

[677] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (5).

within the police power of states if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price'.

More evidence can be found in existing BITs and FTAs. In a number of agreements that the United States has signed up to, there is an important presumption that 'except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations'. In addition to this, there is another presumption that emphasizes the importance of the purpose test in determining indirect expropriation in current IIA practice: 'the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred'.

The determination of whether or not a governmental action can constitute indirect expropriation is based on an assessment of the legitimacy of the purpose for enforcing this action; that is to say, the purpose needs to be in good faith, and thus the associated cost could be reasonably assigned to the foreign investors.[678] However, the requirement of good faith is a tricky question since it can be interpreted in different ways and in accordance with different State cultures.[679] What then is the distinction between purposes that should be defined as

[678] Allen Weiner, 'Indirect Expropriations: The Need for a Taxonomy of "Legitimate" Regulatory Purposes' (2003) 5 Intl L Forum 166, 173.
[679] ibid.

legitimate and those that should not? If the host State's actions go beyond merely safeguarding the benefits of its society, it is more probable that these actions would constitute indirect expropriation. For instance, in the *S.D. Myers* case, the Canadian Government declared that its prohibition on the export of PCB waste was based on environmental concerns, but actually it was primarily intended to protect local industries from U.S. competition.

In this context, international law and practice are of great importance because they serve as the most reliable, predictable, and reasonable indication of 'society's current standard of reasonably acceptable behavior'[680] and allow everyone in international investment practice to accept the legitimacy of the purpose. It seems to me that international law has accepted three main categories of legitimate purpose: (1) regulating public order, (2) protecting human health and the environment, and (3) regulating taxation.

6.1.4.1 Regulating Public Order

Public order is essential to the functional operation of a State. Only by securing its power to regulate public order can the State maintain the welfare and safety of its citizens and its foreign investors. This is also the essence of the police power theory. Therefore, a State needs its laws and its power to enforce these laws.

Commonly speaking, a governmental measure must include a compensation

[680] Thomas Waelde and Abba Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law' (2001) 50 Intl & Comp L Q 811, 827.

provision if it is implemented to take or use property, but no compensation provision is required if its goal is to prevent noxious use and therefore is in the interests of public welfare. William Treanor once commented in relation to the *Mugler v Kansas* case that '[i]f something was so harmful as to justify regulation under the police power, it could be regulated without compensation, regardless of the effect of the regulation on value'.[681]

There seems to be no objection to governmental actions that are enacted for the purpose of preventing harmful criminal activities, such as smuggling and drug trafficking, being protected under police power and thus being excused from compensation. The host State cannot be ordered to pay compensation for any illegal items that have no legitimate property rights associated with them. Properties that have legitimate property rights may also be taken due to the nonpayment of fines, duties, or taxes in order to enforce local laws or they may be destroyed or restricted during specific times and events (e.g. civil unrest and war).[682]

6.1.4.2 Protecting Human Health and the Environment

There is no explicit rule clarifying the circumstances when the degree of risk or the type of harm is dangerous enough to allow the host State to take action and to justify the nonpayment of compensation. The determination has to be based on

[681] William Treanor, 'The Original Understanding of the Takings Clause and the Political Process' (1995) 95 Colum L Rev 782, 800-801.
[682] Newcombe (n 665) 23.

scientific study in every individual case. It is possible and reasonable for host States to seize properties for the purpose of controlling an infectious disease[683] or protecting the environment.

In the *Bischoff* case, the claim was based on the taking of a carriage that belonged to the claimant. This happened during a smallpox epidemic when the police received information that two affected persons were being carried in that carriage and put the carriage into detention. The carriage was exposed to the weather for a considerable period of time and was therefore damaged. Compensation was requested, especially since no one affected by smallpox had actually been transported in the carriage. Although the Commissioner for Venezuela and the Commissioner for Germany held different opinions in this case, they both admitted that even though a mistake had been made, there could be no liability for the reasonable exercise of police power during an epidemic of an infectious disease.[684]

A similar case happened in 1894 when there was an outbreak of cholera in Brazil.[685] The government made the decision to destroy a considerable amount of watermelons in order to control this disease. The owners of the watermelons then appealed for compensation, but their claims were dismissed. Some of the American owners asked the American Government to make a claim for

[683] ibid 25.
[684] *Bischoff Case*, Ralston, Venezuelan Arbitrations, 1904, 420-21.
[685] Newcombe (n 665) 25.

compensation on their behalf, but this was again denied as the measures taken by the Brazilian Government to destroy the watermelons could be justified due to the circumstances and were thus not compensable.

International Bank of Washington v Overseas Private Investment Corporation was a case involving an environmental concern while determining the occurrence of indirect expropriation. In this case, a presidential decree had been issued to stop the export of lumber from Dominica, and it was alleged that this had deprived the investor, which specialized in manufacturing almacigo timber, of its business. Afterwards, following negotiations, a second decree was issued to allow the export of almacigo timber, but the investor was forced to cease operations again because of interference from governmental authorities. The tribunal in this case dismissed the investor's claim of expropriation because the government's measures were based on 'a genuine concern with forestry conservation'.[686]

In the *Tecmed* case, the Mexican Government based its argument for not renewing the claimant's permit on the grounds that this measure 'was a regulatory measure issued in compliance with the State's police power within the highly regulated and extremely sensitive framework of environmental protection

[686] *International Bank of Washington v Overseas Private Investment Corporation*, Arbitration of Dispute Involving U.S. Investment Guaranty Program, 8 November 1972, 11 I.L.M 1216, 1227-28.

and public health' and as such was 'a legitimate action of the State that does not amount to an expropriation under international law'.[687]

We can see that the judging power with regard to deciding which measures should be implemented and how belongs to the host States. However, host States may take actions which cause the loss of an investment and which are not accompanied with compensation simply by declaring that these actions are necessary for protecting human health and the environment even though they are pursuing other goals: for example, in *S.D. Myers*, the true intentions of the Canadian Government in prohibiting the export of PCB were to weaken the U.S. competition and to protect the domestic industries.

A major area of controversy is how host States can implement measures to protect human health and the environment and in what ways they can ensure that the nonpayment of compensation is justified. Wagner's study with regard to environmental protection is of great value here, serving especially as guidance for international tribunals:

> An arbitral tribunal considering an expropriation claim arising out of a purported environmental measure should limit its inquiry to determining whether the science underlying the risk determination has the minimal attributes of scientific inquiry— that is, whether the evidence of risk has

[687] *Técnicas Medioambientales Tecmed, S.A. v The United Mexican States* (*Tecmed v Mexico*), ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, para 97.

> been derived through the application of legitimate scientific methods and procedures, and is probative of a potential for adverse effects. This is true even if the evidence is controversial or inconclusive. Once an arbitral tribunal has confirmed that the evidence is scientific and probative, it should accept the legitimate environmental basis for the measure.[688]

This line of analysis is backed up by the WTO Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement), according to Article 2.2 of which '[m]embers shall ensure that any sanitary or phytosanitary measure is applied only to the extent necessary to protect human, animal or plant life or health, is based on scientific principles and is not maintained without sufficient scientific evidence'.

I am not suggesting incorporating this rule directly into international expropriation law since there are clear differences between the situations of the two legal frameworks (Article 2.2. of the SPS Agreement and international expropriation law). However, the principle of the said provision is of great significance if we want to strengthen the jurisprudence of expropriation law, particularly for the sake of clarifying the limitations of the State's power to protect human health and the environment. In this context, Weiler valued this significance and formulated conditions for applying this SPS necessity principle.

[688] JM Wagner, 'International Investment, Expropriation and Environmental Protection' (1999) 29 Golden Gate U L Rev 465, 523.

According to Weiler, and I personally agree with his view, for this necessity principle to be fairly applied, the measure should be 'applied in a manner consistent with its stated objectives (which, in turn, are rationally connected to an appropriate risk analysis)' and 'an alternative avenue of fully addressing that risk - which would have been less harmful to the ownership interests at stake' must not exist.[689]

Regarding the issue of determining whether any alternative measure exists, Weiler made reference to the Australian *Salmon Report*, which stated that the potential alternative measure must be 'reasonably available taking into account technical and economic feasibility' and must achieve an 'appropriate level' of protection and be 'significantly less restrictive' than the current chosen measure.[690] Weiler went on to point out that 'such an alternative still might cause harm to the investment, but it should not result in a near-total deprivation of the right to operate the investment and derive economic benefits from it'.[691]

6.1.4.3 Regulating Taxation

The taxation regime is an integral part of a State's regulatory framework. A State's power to legitimately structure its taxation regime by promulgating new taxation laws or enforcing new taxation regulations should be respected. Foreign

[689] Todd Weiler, 'The Treatment of SPS Measures under NAFTA Chapter 11: Preliminary Answers to an Open-Ended Question' (2003) 26 B C Intl & Comp L Rev 229, 256.
[690] ibid. For more details, see WTO Appellate Body Report on Australia Measures Affecting Importation of Salmon, WT/DS18/AB/R, 20 October 1998, paras 180-81.
[691] ibid.

investors commonly accept this regulatory power as being within the police power doctrine.

The Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens proposed that non-compensable takings that 'result from *the execution of tax laws* … or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful'.[692] A provision with the same effect was established in the Third Restatement of the Foreign Relations Law of the United States, according to which the lawful exercise of police power would not constitute expropriation. Specifically, this document states that '[a] state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide general taxation*, regulation, forfeiture for crime, or other action of the kind that *is commonly accepted as within the police power of states* [emphasis added], if it is not discriminatory … and is not designed to cause the alien to abandon the property to the state or sell it at a distress price'.[693]

Therefore, there are some criteria for taxation regulations to be legitimate under the doctrine of police power. They should be executed in good faith. However, a host State can make it impossible for the foreign investor to profit, which is akin to being expropriated, by introducing 'taxation and regulatory measures designed

[692] Louis B Sohn and Richard Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens* (1961) art 10 (5).
[693] American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States*, vol 2 (American Law Institute Publishers 1987), s 712, Reporter's Note 1.

to make continued economic operation of a project [so] uneconomical … that it is abandoned';[694] here, the word 'designed' means the intentional consequence pursued by the host State, disguising its taxation regulations as the valid exercise of regulatory power whereas in fact they constitute indirect expropriation.

Current IIA practice also confirms that not all regulations enforced by the host State can be automatically protected from expropriation claims. According to the 2010 U.S. Model BIT, '[e]xcept in rare circumstances, *non-discriminatory regulatory actions* by a Party that are *designed and applied to protect legitimate public welfare objectives*, such as public health, safety, and the environment, do not constitute indirect expropriations'. Following this line of argument, if the concerned measure was 'designed and applied' to execute objectives other than protecting the legitimate public welfare or even to impose unfair treatment on foreign investors, this measure can, under certain conditions, constitute indirect expropriation.

If the host State regulates taxation that is directly pointed at specific investors and/or manifests a purpose other than protecting legitimate public welfare concerns, this taxation regulating conduct would most probably unfairly interfere with an investor's right not to be unlawfully expropriated. The tribunal in *EnCana Corporation v Republic of Ecuador* formulated the relationship between

[694] ibid, s 712, nn 6-7.

tax regulations and indirect expropriation in the following way: '[o]nly if a tax law is extraordinary, punitive in amount or arbitrary in its incidence would issues of indirect expropriation be raised'.[695] M. Sornarajah also expressed the view that 'excessive and repetitive tax' measures that have a confiscatory effect are expropriatory.[696]

In the case of *Benvenuti et Bonfant v People's Republic of the Congo*, the Italian investor had entered into a joint venture with the Congo to establish a company producing plastic bottles for mineral water.[697] The Congolese Government promised to establish a preferential tax regime for the purpose of protecting the company's competitive power and ensuring the profits. However, the Government failed to establish such a tax regime and reneged on its promise to fix the price of each mineral water bottle. The tribunal found the cumulative effect of these measures of the Congolese Government 'de facto expropriated [the] corporate shares' of the Italian investor.[698]

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[695] *EnCana Corporation v Republic of Ecuador*, UNCITRAL Case, Final Award, 3 February 2006, para 177.

[696] M Sornarajah, *International Law on Foreign Investment* (Cambridge University Press 1994) 314.

[697] W Michael Reisman and Robert D Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation' (2004) Faculty Scholarship Series Paper 1002, 125. For more information, see *Benvenuti et Bonfant v People's Republic of the Congo*, ICSID Case No. ARB/77/2, Award, 8 August 1980.

[698] *Benvenuti et Bonfant v People's Republic of the Congo* (n 697) para 758.

In another case, *Revere Copper and Brass, Inc. v OPIC*,[699] a tax stability agreement was issued and then violated by the Jamaican Government; this constituted indirect expropriation. The foreign investor entered into an agreement concerning the construction and operation of a mining plant. The Jamaican government at the time of the agreement promised tax stability to the investor. However, a subsequent new government denied this arrangement and increased the taxes and royalties, effectively depriving the investor of the use of its investment and thus constituting expropriation.

In a more recent case, *Quasar de Valores et al. v The Russian Federation*,[700] decided on 20 July 2012, the Spanish investor claimed that the Russian Government had committed indirect expropriation. After the arrest of Mikhail Khodorkovsky, the head of Yukos (Russia's leading oil company), the Russian tax authorities re-examined Yukos's financial situation and decided that the company had not duly performed its tax duties and should pay tax arrears. When Yokus could not afford to pay this debt, it was liquidated and its assets ended up at a State-owned company. By examining several aspects of the facts, including the discriminatory and unreasonable nature of these measures, the tribunal found

[699] *Revere Copper and Brass, Inc. v Overseas Private Investment Corporation*, (1978) 56 I.L.R. 257.

[700] *Quasar de Valores et al. v The Russian Federation,* Arbitration Institute of the Stockholm Chamber of Commerce, Award, 20 July 2012.

that the measures of the Russian tax authorities constituted indirect expropriation in this case.

These case studies are sufficient to prove that the mere label of 'taxation' is not sufficient to provide legitimate grounds for the State to enforce such regulatory rules and be excused from the scrutiny of international law. When enforcing a new taxation regulation, the host State must bear in mind that this is not just a domestic affairs matter but might trigger liability in certain situations under international law.

6.2 Degree of Interference with Investor's Property Rights

Whether or not a claim of 'interference' with an investor's property rights would lead to success for the foreign investor in a case involving an expropriation allegation depends on the 'degree' of that interference. Therefore, the key component of this criterion is the measurement of 'degree'. This is an objective criterion because it is decided on the basis of the consequences of the governmental measure for the investor. If it could be measured quantitatively, it would be possible to generate an objective standard from a body of case law and define the boundaries of this standard. Unfortunately, this standard cannot be measured objectively: it depends on the real consequences imposed upon the investor in every individual case.

Since the examination of interference is actually derived from the *sole effect* doctrine, the cases cited in the section on this doctrine earlier in the thesis may be cited here again but for different purposes. In the earlier discussion, the aim of citing these cases was to prove the importance of the effect criterion, while in this chapter, these cases are used to show to what extent interference could possibly constitute indirect expropriation in accordance with international practice. Although interference is no longer the exclusive factor in the process of determining expropriation, it is still the key factor that this thesis considers.

As a scientific approach to researching the degree of interference, whether or not the interference is serious enough or is permanent or persistent should certainly be taken into account and fully considered. For instance, the *LG&E* tribunal determined the extent of interference from the perspective of both the severity of the economic impact and the duration of the interference; this approach is preferred by several commenters. Therefore, the following sections will provide general clarification on the approach to the issue of 'degree' of interference taken by some arbitral tribunals when seeking to determine whether indirect expropriation has occurred.

6.2.1 Severity of the Economic Impact

The point at which the severity of the economic impact of a governmental

measure would enable it to be deemed indirect expropriation can be explored through legal tests and case law. In *Pennsylvania Coal Co v Mahon*, Justice Holmes believed that '[t]he general rule at least is that while property may be regulated to a certain extent, if a regulation goes too far it will be recognized as a taking'.[701]

It is now broadly supported by international tribunals that the interference in terms of economic impact should be substantial in order to establish the existence of indirect expropriation;[702] that is to say, there probably could be expropriation if the foreign investor is deprived of its fundamental rights of 'ownership, use, enjoyment or management of business' and these rights are rendered useless.[703] It is notable that these rights have to be 'deprived' or 'rendered useless' in order to satisfy the requirements. There would be no expropriation if the investor has not been deprived of its rights but has only had its rights substantially reduced and this situation is not 'irreversible'.[704]

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[701] *Pennsylvania Coal Co v Mahon et al.* (1922) 260 U.S. 393 (43 S.Ct. 158, 67 L.Ed. 322), 415.

[702] See the following cases: *CMS Gas Transmission Company v The Argentine Republic* (*CMS v Argentina*), ICSID Case No. ARB/01/08, Award, 12 May 2005; *Pope & Talbot Inc. v The Government of Canada* (*Pope & Talbot*), UNCITRAL Case, Interim Merits Award, 26 June 2000; *Tokios Tokelés v Ukraine*, ICSID Case No. ARB/02/18, Award, 26 July 2007. For a discussion, see Catherine Yannaca-Small, '"Indirect Expropriation" and the "Right to Regulate" in International Investment Law' OECD Working Papers on International Investment 2004/4, 10; Stephen Olynyk, 'A Balanced Approach to Distinguishing Between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration' (2012) 15 Intl Trade & Bus L Rev 254, 285.

[703] Yannaca-Small (n 702) 10.

[704] For more discussion, see H Ruiz Fabri, 'The Approach Taken by the European Court of Human Rights to the Assessment of Compensation for "Regulatory Expropriations" of the Property of Foreign Investors' (2002) 11(1) NYU Envtl L J 148, 173.

There are other phrases that have been used to identify the severity of the economic impact. Fortier and Drymer, for example, used the following phrases:

> (1) Unreasonable; (2) an interference that renders rights so useless that they must be deemed to have been expropriated; (3) an interference that deprives the investor of fundamental rights of ownership; (4) an interference that makes rights practically useless; (5) an interference sufficiently restrictive to warrant a conclusion that the property has been 'taken'; (6) an interference that deprives, in whole or in significant part, the use or reasonably-to-be-expected economic benefit of the property; (7) an interference that radically deprives the economical use and enjoyment of an investment, as if the rights related thereto had ceased to exist; (8) an interference that makes any form of exploitation of the property disappear (i.e. it destroys or neutralizes the economic value of the use, enjoyment or disposition of the assets or rights affected); and (9) an interference such that the property can no longer be put to reasonable use.[705]

As observed in case law, the phrases 'so useless' in *Starrett Housing*,[706]

[705] Fortier and Drymer (n 663) 90.
[706] *Starrett Housing Corp. v Iran* (*Starrett Housing*), 4 Iran-U.S. Cl. Trib. Rep., 122 (1983), 155.

'sufficiently severe' in *LG&E*,[707] and 'sufficiently neutralize[d] the enjoyment of property' [708] in *Lander* and others all suggest the same viewpoint: that the investor has to be deprived of its investment or the investment has to be substantially impaired. Therefore, mere restrictions would not, and could not, by themselves amount to expropriation. This approach was sufficiently pointed out and explained in *Pope & Talbot Inc. v Canada*, in which the tribunal stated that '[m]ere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required' and further restated that '[t]he test is whether the interference by the government is sufficiently restrictive to support a conclusion that the property has been "taken" from the owner' and that '[u]nder international law, expropriation requires a "substantial deprivation"'.[709]

However, the '*substantial deprivation*' test[710] has to be interpreted in the right way. It does not require the investor to be deprived of a large portion of its investment, but it does demand a real effect. As Sornarajah wrote in his book *International Law on Foreign Investment*, 'it is not only the outright taking of the whole bundle of rights but also the restriction of the use of any part of the bundle

[707] *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v Argentine Republic* (*LG&E v Argentina*), ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, para 191.
[708] *Lauder v Czech Republic* (n 666) para 200.
[709] *Pope & Talbot* (n 702) para 102.
[710] Yves Nouvel contended that the criterion of 'substantial deprivation' could absorb and reconcile other phrases that are used to describe the degree of effect in order to determine indirect expropriation. See Fortier and Drymer (n 663) 91.

that amounts to a taking under the law'.[711] The same issue was also identified in *S.D. Myers*:

> An expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although it may be that, in some contexts and circumstances, it would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary.[712]

Nevertheless, the *S.D. Myers* tribunal also identified that it is not just property rights that fall within this definition: other rights can be expropriated too.[713]

6.2.1.1 Arbitration Practice in Indirect Expropriation Cases

The first case I want to quote here is the *Starrett Housing* case regarding the Iranian Government's appointment of a 'temporary' manager to an American housing project. As asserted by Starrett, the majority shareholder of the company, the appointment had deprived the company of its right to manage and thus constituted indirect expropriation. The case is significant because it began to recognize that the interference caused by the conduct of a State must constitute expropriation if this interference has deprived the investor of the practical use of

[711] Sornarajah (n 658) 368.
[712] *S.D. Myers* (n 667), Partial Award, 13 November 2000, para 283.
[713] ibid para 281. The tribunal wrote that 'in legal theory, rights other than property rights can be expropriated'.

its property rights even though the State never intentionally expropriated the property or deprived the original owner of the legal titles of the property.[714] As stated in the award,

> [t]he Government of Iran had interfered with the Claimant's property rights in the project to an extent that rendered these rights so useless that they must be deemed to have been taken, even though ... the legal title to the property formally remains with the original owner.[715]

In a later case (*Tippetts*), also decided by the Iran-United States Claims Tribunal, the tribunal found that the actions of the Iranian Government's appointed manager constituted indirect expropriation and made the following statement:

> A deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected. While assumption of control over property by a government does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of

[714] *Starrett Housing* (n 706) 154-55.
[715] ibid.

> ownership and it appears that this deprivation is not merely ephemeral…[716]

Sporrong and Lönnroth v Sweden is a representative case in this regard. This case was decided by the European Court of Human Rights and no occurrence of indirect expropriation was found. In this case, the claimant's rights were affected due to land use regulations, but in the view of the Court, 'although the right [of peaceful enjoyment of possessions] lost some of its substance, it did not disappear'; the Court observed in this connection 'that the [Claimants] could continue to utilise their possessions and that, although it became more difficult to sell properties [as a result of the regulations], the possibility of selling subsisted'.[717]

With regard to the scope of indirect expropriation in NAFTA, the *Pope & Talbot* case is significant as it clarified that the wording 'tantamount to' means nothing more than 'equivalent to' and should not be interpreted in a broader way. This case involved decreased export quotas of lumber from Canada to the United States due to the policy of the Canadian Government. Due to this new Canadian policy, the claimant experienced reduced access to the U.S. market and heavier

[716] *Tippetts, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran* (*Tippetts*), 6 Iran-U.S. Cl. Trib. Rep. 219 (1984), 255-56.
[717] Rosalyn Higgins, 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 Recueil des Cours – Académie de Droit International 259, 276-77.

export duties, which resulted in substantially reduced profits. The tribunal, however, did not find indirect expropriation since the claimant's sales abroad were not entirely banned and it could still make profits from the exports. As the tribunal wrote in its explanation,

> [t]he sole 'taking' that the Investor has identified is interference with the Investment's ability to carry on its business of exporting softwood lumber to the US. While this interference has, according to the Investor, resulted in reduced profits for the Investment, it continues to export substantial quantities of softwood lumber to the US and to earn substantial profits on those sales. [718]

The tribunal therefore drew the conclusion that '[m]ere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required'.

In another case, *S.D. Myers*, the Canadian Government issued an order forbidding the U.S. investor to export waste, which adversely affected the claimant's business operations and its economic benefits from the investment. The tribunal fully considered the degree of interference so as to determine whether this prohibition was indirect expropriation or legitimate regulation. It

[718] *Pope & Talbot* (n 702) para 101.

concluded:

> Expropriations tend to involve the deprivation of ownership rights; regulations [are] a lesser interference. The distinction between expropriation and regulation screens out most potential cases of complaints concerning economic intervention by a state and reduces the risk that governments will be subject to claims as they go about their business of managing public affairs.[719]

In *Metalclad v United Mexican States*, the claimant was prohibited from opening and operating a hazardous waste disposal facility even though it had met all of the legal and other relevant requirements. It was argued that this prohibition was issued after the initial stage of operation. Furthermore, since the Mexican Government had created a preserve in this area, it would be impossible for the facility to continue to operate. Due to these facts, the tribunal found that this denial of a permit without legitimate grounds constituted indirect expropriation since 'the complete frustration of the operation of the landfill [eliminated] the possibility of any meaningful return on Metalclad's investment'.[720]

In *Marvin Feldman v Mexico*, the claimant sued the Mexican Government for not obeying the tax laws concerning its export of tobacco products. The claimant

[719] *S.D. Myers* (n 667), Partial Award, 13 November 2000, para 283.
[720] *Metalclad* (n 673), Award, 2 September 2000, para 113.

alleged that through the conduct of its Ministry of Finance and Public Credit, Mexico's refusal to rebate the excise taxes applied to the cigarettes it exported and Mexico's continuing refusal to recognize its right to a rebate of such taxes regarding prospective cigarette exports constituted indirect expropriation. The tribunal believed that 'not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business ... is an expropriation'.[721] Afterwards, the tribunal carefully determined the degree of interference experienced by the investor and found there was no indirect expropriation because 'the regulatory action has not deprived the Claimant of control of his company, interfered directly in the internal operations of the company or displaced the Claimant as the controlling shareholder'.[722] Instead of being deprived of the right to control and operate, the fact was that the claimant was 'free to pursue other continuing lines of business activity'; although the claimant was 'effectively precluded from exporting cigarettes', this did not amount to the 'Claimant's deprivation of control of his Company'.[723]

The case of *CME Czech Republic B.V. (The Netherlands) v The Czech Republic* concerned whether or not the commercial value of an investment being destroyed by a host State can constitute indirect expropriation. In this case, the claimant was granted the exclusive license to provide broadcasting services and made

[721] *Marvin Roy Feldman Karpa v United Mexican States* (*Feldman v Mexico*), ICSID Case No. ARB (AF)/99/1, Award, 16 December 2002, para 112.
[722] ibid para 41.
[723] ibid para 152.

profits therefrom. This exclusive position was later undermined and finally destroyed due to the actions and omissions of the governmental authority. The tribunal found that indirect expropriation had occurred as these actions and omissions had destroyed the company's operation, leaving the claimant as 'a company with assets, but without business'.[724] Although the claimant's worth was not affected, the 'commercial value of the investment' was destroyed.[725] Therefore, expropriation was found to have occurred.

Another case that is highly relevant to our current discussion is *Methanex Corporation v United States of America*. The tribunal in this case gave its decision on the merits of the case and ultimately decided its lack of jurisdiction over the case. However, the case offers some insightful views regarding the scope of economic impact required to determine indirect expropriation. This case concerned an allegation brought by the world's largest methanol producer claiming that the State of California's ban on the use of MTBE, a methanol-based gasoline additive, constituted indirect expropriation. This ban, the claimant alleged, deprived it of 'a substantial portion of their customer base, goodwill, and market for methanol in California'[726] and other interests. However, in the view of the tribunal, the alleged damaged interests, such as goodwill and market share, may have constituted 'an element of the value of an enterprise and as such may

[724] *CME v Czech Republic* (n 674) para 591.
[725] ibid.
[726] *Methanex Corporation v United States of America* (*Methanex*), UNCITRAL Case, Final Award, 9 August 2005, Part IV, ch A, para 2.

have been covered by some of the compensation payments',[727] but the tribunal stated that it was 'difficult to see how they might stand alone in a case like the one before the Tribunal'.[728]

6.2.2 Duration of the Interference

Besides the considerations regarding how much of the investment has been damaged, the duration of the interference could also constitute a legitimate consideration in determining the severity of the economic impact and also the existence of indirect expropriation.[729] The conclusion that can be drawn from the case law is that no specific time requirement is demanded and nor is it possible or practical to make such a demand. The only way to reasonably explore this consideration is to find its weight in the facts: whether the duration of the interference had a serious or severe enough economic impact that it has to be given necessary weight when determining the existence of indirect expropriation. In this context, the case study approach is of great importance and significance.

6.2.2.1 Arbitration Practice in Indirect Expropriation Cases

In following the above-said logic, different tribunals have provided varying understandings in adjudicating cases and have sometimes provided inconsistent understandings within a same case. The *S.D. Myers v Canada* case concerned an

[727] ibid, Part IV, ch D, para 17, citing from Gillian White, *Nationalisation of Foreign Property* (Praeger 1961).
[728] ibid, Part IV, ch D, para 17.
[729] Yannaca-Small (n 702) 14; Wagner (n 688) 538.

American company which had invested in Canada, where its business involved taking a specific type of environmentally hazardous chemical waste (PCB) back to its facility in the United States for treatment. However, the Canadian Government issued an order forbidding the export of PCB waste from Canada to the United States; this adversely affected the claimant's business operations and its economic benefits from the investment. The effect of the prohibition lasted for almost 16 months. The tribunal evaluated the facts and expressed its opinion, at paragraph 283 of the award, that while '[a]n expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights', it may also be that 'in some contexts and circumstances, it would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary'.

Although the tribunal eventually found that there was no expropriation since the measure was 'only for a time' and consequently '[a]n opportunity was [only] delayed',[730] the tribunal did support the view that it was not impossible for a 'temporary deprivation' or 'lasting removal' of an investment to constitute indirect expropriation but argued that the decision really depends on the specific 'contexts and circumstances'.

In contrast with the opinion issued by the *S.D. Myers* tribunal, some tribunals

[730] *S.D. Myers* (n 667), Partial Award, 13 November 2000, para 287.

have strongly held the view that the deprivation of an investment has to be permanent or persistent in order for the economic interference to be deemed severe enough to constitute expropriation. For instance, in *Generation Ukraine v Ukraine*, the regulatory measure concerned was regarded as 'not come close to creating a persistent or irreparable obstacle to the Claimant's use, enjoyment or disposal of its investment'.[731]

This view is more noticeable in *LG&E v Argentina*. Due to an economic crisis, Argentina abrogated legislation concerning the protection of foreign investment and canceled the guarantees provided during a period of privatization. The tribunal in this case believed that 'one must consider the duration of the measure as it relates to the degree of interference with the investor's ownership rights'.[732] In its conclusion to the expropriation claim, the tribunal clearly showed its attitude in taking the consideration of the duration of the interference into account when deciding the occurrence of indirect expropriation:

> The effect of the Argentine State's actions has not been permanent [emphasis added] on the value of the Claimants' shares', and Claimants' investment has not ceased to exist. Without a permanent [emphasis added], severe deprivation of LG&E's rights with regard to its investment, or almost complete deprivation of the value of LG&E's

[731] *Generation Ukraine, Inc. v Ukraine* (n 611) para 20.32.
[732] *LG&E v Argentina* (n 707) para 193.

> investment, the Tribunal concludes that these circumstances do not constitute expropriation.[733]

Therefore, the *LG&E* tribunal concluded the case on the basis of the fact that the regulatory measure was not permanent. Nevertheless, it pointed out that this rule is not absolute. So, what is the exception to this 'permanence' rule? In the opinion of the *LG&E* tribunal,

> [g]enerally, the expropriation must be permanent, that is to say, it cannot have a temporary nature, unless the investment's successful development depends on the realization of certain activities at specific moments that may not endure variations.[734]

So, in accordance with this approach, a possible 'temporary' deprivation is imposed with one condition; that is to say, there would be a high possibility of finding indirect expropriation if the temporary obstruction happens during specific moments or activities when the investment's value needs to be safeguarded.

Experiences from the Iran-United States Claims Tribunal are of great value to our current discussion. The *Tippetts* tribunal found that there had been indirect

[733] ibid para 200.
[734] ibid para 193.

expropriation due to the appointment of the 'temporary' manager, even though prior reasoning required the deprivation to have been 'not merely ephemeral'. The *Starrett Housing* case also involved the appointment of a 'temporary' manager and this was also found to be an expropriatory measure. However, in another similar case, *Eastman Kodak Co. v Government of Iran*, the tribunal found that there had been no indirect expropriation, partly due to the fact that the government appointed manager was only in power for a very short period of time.[735]

Judge Aldrich interpreted these inconsistencies as some implied principles appreciated by the tribunals, such as what the real effect of certain governmental measures was and how long these measures would last, rather than as labels for 'temporary'. As regards to how to deal with the ambiguity of the phrase 'not merely ephemeral', Aldrich proposed some guidelines under the jurisprudence of the Iran-United States Claims Tribunal: (a) that no reasonable prospect exists that control will be returned; or (b) that any losses that may ensue during the period of control are not compensable to the property owner; or (c) that the control has continued for a substantial period of time (perhaps several years) in circumstances where the property owner has not behaved in a manner clearly inconsistent with a claim of deprivation.[736]

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[735] *Eastman Kodak Co. v Government of Iran*, Award No 514-227-3, Award, 1 July 1991, reprinted in 27 Iran-U.S. Cl. Trib. Rep. 3.

[736] George H Aldrich, 'What Constitutes a Compensable Taking of Property? The Decisions of the Iran-United States Tribunal' (1994) 88 Am J Intl L 585, 593, and 602.

6.3 Proportionality Test

As has been explained so far, deciding the most appropriate way to determine indirect expropriation has become even more confusing. Both the purpose of implementing a measure and the measure's effect on an investment have proved highly relevant in this determination process, but a more demanding issue is how to balance these two considerations, using them as a whole, coherent approach that on the one hand enables host States to take necessary regulatory measures and on the other hand provides sufficient scrutiny.[737]

The purpose and the effect of a regulatory measure need to be weighed together to finally determine the nature of the measure; that is to say, the fact that a measure is being implemented in accordance with a public purpose cannot in itself determine whether this measure is expropriatory or not, but it may serve as the basis for the host State to excuse itself from the duty to compensate. Also, the fact that a measure is being implemented in a way that economically interferes with an investment cannot in itself be used to directly decide that expropriation has occurred as actually it depends on the severity of the interference.

The proportionality test links the analysis of purpose and effect together. It still under criticism because it was first established in public law jurisprudence but

[737] Aharon Barak, *Proportionality: Constitutional Rights and Their Limitations* (Cambridge University Press 2012) 463-64.

was later applied in private law cases.[738] How, when, and where to apply this test are questions that should be answered on the basis of origin, methodology, and underlying theory. Only by figuring out the answers to these questions and making references to former arbitral decisions can we build our own understanding of the relationship between purpose and effect under international expropriation law.

6.3.1 Proportionality and International Investment Law

The principle of proportionality has been extensively applied in several fields of law and by international courts and tribunals. The Permanent Court of International Justice, the International Court of Justice, the Dispute Settlement Body of the WTO, and other international arbitral tribunals have transplanted this principle from public law into various branches of law, including 'self-defense, retaliation, counter-measure, humanitarian law and human rights law'.[739] Not only has this principle been recognized as a constitutional principle in the European Union, it is also valued in international law. Some scholars have even argued that the principle of proportionality should be part of customary law.[740] This kind of self-evidenced phenomenon is more than enough to declare the significance of this principle in the area of law and potentially to provide the

[738] Gus Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford University Press 2007) 144-45.
[739] Tanaka Yoshifumi, 'Reflections on the Concept of Proportionality in the Law of Maritime Delimitation' (2001) 16(3) Intl J of Marine and Coastal L 433, note 1.
[740] ibid.

grounds for it being considered in the field of international investment law.

As the key components of international investment law, the various standards of treatment are the subjects argued or disputed between foreign investors and host States. Disputes between host States and foreign investors not only touch on the definition of these treatments but also on their rationales and their applications. How to settle most of these disputes is an issue that demands clarification of what constitutes a reasonable balance of the interests and liabilities of both parties. The incorporation of the proportionality principle can exactly fulfill the purpose of protecting and promoting foreign investments. This principle stresses the need to examine whether the governmental interference is excessive and beyond reasonable endurance. An analysis of the principle of proportionality in the context of foreign investment is also relevant to fair and equitable treatment (FET) and nondiscriminatory treatment; this is the place for international investment law to introduce this principle into its legal framework.

In theory, the principle of proportionality is used in international investment law to examine whether a governmental measure is unreasonable and excessive and thus constitutes indirect expropriation. While excluding the abuse of regulatory power, a tribunal should pay attention to the cultural and political influence that is sometimes the true intention underneath a measure's disguised 'objective'.[741]

[741] Han Xiuli, 'On the Application of the Principle of Proportionality in ICSID Arbitration and Proposals to Government of the People's Republic of China' (2006) 13 James Cook U L Rev 233, 243.

Therefore, in the process of examination, the tribunal must consider the balance between the private interests and the public interests in order to fairly decide the faults and the liabilities. This function has been emphasized by scholars:

> Similarly, the qualification that the regulation be 'designed and applied' to protect 'legitimate objectives' invites consideration of what might be termed 'proportionality', both as to the breadth of the regulation and the manner in which authorities administer the law. Questioning what objectives are 'legitimate' of course only begins the argument. Notwithstanding a legitimate objective, a facially unobjectionable regulatory regime may serve as cover for arbitrary official acts and over-reaching, such that the original objective is beside the point. Similarly, a clumsy or poorly grounded attempt at regulation may produce a regime gravely disproportionate in its impact on the foreign investor in light of the evil to be addressed and the nature of the alternatives available to lawmakers.[742]

It is notable that the consideration of proportionality has been formally established in BITs and FTAs as a compulsory element in distinguishing between a regulatory measure and an indirect expropriation, especially under

[742] Jack J Coe, Jr, 'Emerging Dilemmas in International Economic Arbitration: The State of Investor-State Arbitration - Some Reflections on Professor Brower's Plea for Sensible Principles' (2005) 20 Am U Intl L Rev 929, 943-44.

American investment treaty practice.[743] This formal recognition of the proportionality principle can further prove its necessity in international investment law and is a step towards this principle being formally seen as part of international customary law.[744]

6.3.2 Proportionality: Standard Criteria

In simple words, the essence of this test is that it focuses exclusively on the relationship between ends and means, seeking to balance the interests and conflicts within this relationship.[745] It is not, and cannot be, a definite series of standards that can be orderly adopted in all scenarios on the basis of quantitative analysis; rather, it has to be realized by understanding its underlying principles in every individual circumstance.[746]

So the measurement of the balance we are expecting must be something touching the essence of the proportionality test. Some scholars have linked the

[743] It is argued by the author that some of the treaties have in fact incorporated the principle of proportionality into the text but have done so in a contextual way. For example, in the US Model BIT, the provision regulating the determination of indirect expropriation takes the effect of the measure, the purpose of the measure, the character of the measure, and other factors into full account and implies the prerequisite of a fair and reasonable balance between the measure's effect and its purpose. To be more specific, the economic impact, 'standing alone', cannot decide the occurrence of indirect expropriation, and the nondiscriminatory measures 'do not constitute indirect expropriation' except in 'rare circumstances'. What then are the 'rare circumstances' that can impose liabilities on the host State? How can we measure whether or not these circumstances exist in a particular case? These questions need to be answered with reference to the principle of proportionality. See Han (n 741) 244.
[744] Tanaka (n 739) 433, note 1.
[745] Jud Matthews and Alec Stone Sweet, 'All Things in Proportion? American Rights Review and the Problem of Balancing' (2011) 60 Emory L J 101, 109.
[746] *LG&E v Argentina* (n 707) paras 189-95, 239-42.

measurement with basic legal principles (e.g. fairness, good faith, justice) that give priority to the nature of proportionality, while others have extended their thoughts to the functions of this test, studying whether it was created to restrain State power or whether it is used to protect the benefits of foreign investors.[747] In the view of many scholars, such debates only reinforce the popularity of this test, and they do not see any conflicts in enforcing this test to take care of the interests of both foreign investors and host States.[748]

Yet for a balance to be determined fairly there must be considerable rights and obligations to be carefully weighed. Inside the structural test of proportionality three subtests are highlighted: the test of suitability, the test of necessity, and the test of proportionality *stricto sensu*.[749] Each of these subtests is functionally different, and that is why we have to examine these three tiers of analysis one by one in order to get the whole picture of how to accurately determine indirect

[747] Jasper Krommendijk and John Morijn, '"Proportional" by What Measure(s)? Balancing Investor Interests and Human Rights by Way of Applying the Proportionality Principle in Investor-State Arbitration', in Pierre-Marie Dupuy, Ernst-Ulrich Petersmann and Francesco Francioni (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press 2009) 436-37.

[748] Mads Andenas and Stefan Zleptnig, 'Proportionality: WTO Law in Comparative Perspective' (2006) 42 Tex Intl L J 371, 395.

[749] Some commenters, like Stone Sweet and Mathews, included the principle of legitimacy in the subtests of proportionality and put it as the first step. The application of this principle is intended to make sure that the concerned measure is constitutionally authorized and that, therefore, the purpose of implementing this measure has a legitimate basis. This thesis, however, does not take this approach because the legitimacy of the purpose has been separately examined in prior studies. The discussion in this specific section therefore concentrates exclusively on how to weigh the legitimate purpose of a State measure against the effect it brings with it so as to conclude whether the measure is proportionate or not. For more information and discussion, please see Alec Stone Sweet and Jud Mathews, 'Proportionality Balancing and Global Constitutionalism' (2008) 4 J Transnatl L 73, 76, <http://works.bepress.com/alec_stone_sweet/11> accessed 17 September 2013.

expropriation.

6.3.2.1. Suitability

The first step in the proportionality test is to examine the 'suitability' of the measure. A measure is required to be suitable or beneficial to the achievement of a legitimate objective.[750] Any intentionally arbitrary or discriminatory influence associated with the measure would not be considered suitable, and thus 'suitable' means *bona fide*.[751] Nevertheless, when examining the 'suitability' of a measure, a tribunal has to rely on the evidence and information available at the time the measure was adopted.[752] Any subsequently obtained information has to be excluded when judging whether the measure was adopted suitably.[753] The suitability test will be more relevant when the measure was adopted at a time of crisis or in an urgent situation.[754]

6.3.2.2. Necessity

The second step in determining proportionality is to test whether the measure concerned was 'necessary'. This necessity test requires the adopted measure to

[750] Han (n 741) 234.
[751] Caroline Henckels, 'Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and the Standard of Review in Investor-State Arbitration' (2012) 15(1) J Intl Econ L 223, 247.
[752] Nicholas Emiliou, *The Principle of Proportionality in European Law: A Comparative Study* (Kluwer 1996) 174; Andenas and Zleptnig (n 748) 388-89. In addition, Andenas and Zleptnig provide information regarding the distinction between *ex ante* perspective (the moment when the measure was conducted) and *ex post* perspective (the moment when the case is before the tribunal) in their article (p 388).
[753] Emiliou (n 752) 174.
[754] ibid; Henckels (n 751) 248.

be necessary to achieving the expected outcome but with the least restriction or interference to foreign investors.[755] This means that the measure should not be adopted or should be replaced if there is any other less restrictive measure capable of producing the same outcome.[756]

Normally, the host State has the authority to judge which measure is reasonable for completing its objective and the costs of any alternative measures.[757] For this reason, the necessity requirement is manifested within the effectiveness of a State's administrative and legislative system.[758] However, this does not mean that a strict responsibility is imposed on the State to implement a measure in the most perfect way to arrive at the expected outcome. The value of the necessity test in this context has been testified to in various tribunals and courts, especially where this test was being weighed in reaching a finding on the appropriateness of a State's measure in dealing with complex social problems.[759] The standpoint of tribunals and courts on this issue is that instead of a strict necessity test, a measure can be determined necessary as long as it is selected from a range of reasonable alternatives. In *Sporrong and Lönnroth*, the European Court of Human Rights expressed its opinion on the application of the necessity test, an opinion that has received general support: a regulatory measure would generally

[755] Han Xiuli, 'The Application of the Principle of Proportionality in *Tecmed v Mexico*' (2007) 6 Chinese J Intl L 635, 636.
[756] ibid 637.
[757] Henckels (n 751) 248 and 252.
[758] Mark Elliott, *Beatson, Matthews, and Elliott's Administrative Law* (4th edn, Oxford University Press 2010) 271.
[759] Henckels (n 751) 248. The writer cites the relevant cases to support her statement in footnote 133.

not fail the necessity test as it is not obviously inappropriate or disproportionate, however it would if its effect is clearly harsh or if another less restrictive measure is clearly available.[760]

6.3.2.3. Proportionality Stricto Sensu

Last but not least is the test of proportionality *stricto sensu*. This test to a great extent shows the philosophical understanding of the proportionality test. Following the suitability test (whether the measure was enacted directly according to the objective) and the necessity test (whether any other clearly less restrictive measure was available to the host State), it serves as the final examination stage before declaring the nature of the measure. It compares the interests affected by the measure with the interests pursued by the measure and determines the appropriate degree of interference in order to balance all of the interests involved.[761] If the measure has an excessively harmful effect, it would most probably be considered expropriatory in accordance with this strict proportionality analysis. As one scholar put it, 'the greater the interference, the more compelling the measure's objective should be'.[762]

The issue of what degree of strictness should be favored is still awaiting

[760] William Burke-White and Andreas von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties' (2008) 48 Virginia J Intl L 307, 347; Pieter Van Dijk and Godefridus JH van Hoof, *Theory and Practice of the European Convention on Human Rights* (3rd edn, Martinus Nijhoff Publishers 1998) 629.
[761] Takis Tridimas, *The General Principles of EC Law* (Oxford University Press 1999) 91-92; Emiliou (n 752) 26-36.
[762] Henckels (n 751) 253.

resolution. Some international tribunals, for example the European Court of Human Rights, prefer this issue to be weighed in favor of the host State as long as the measure was implemented in good faith; some other tribunals, like the European Court of Justice (ECJ) tribunals, have made their decisions on the basis of a strict proportionality analysis in a range of cases.[763] However, it really depends on the facts and real circumstances of the case. One general rule, which was evidenced in *LG&E*,[764] might be helpful for concluding that proportionality *stricto sensu* should be applied in an indirect expropriation analysis. The rule is that host States are obligated to act in good faith with the purpose of promoting, at least *prima facie*, general public welfare, any expropriatory effect generated from which should be carefully weighed with this purpose to determine whether this effect is 'manifestly disproportionate'.[765]

6.3.2.4 Summary

The regulatory powers of a State need to be honored if, and only if, their purpose is legitimate and the way they are implemented passes a suitability and necessity assessment. As for the test of proportionality *stricto sensu*, a finding that indirect expropriation has occurred can only be made in situations where the expropriatory effect is so excessive that it creates a clear imbalance between the

[763] ibid 252.
[764] In *LG&E*, the standard as to whether the regulatory measure would amount to indirect expropriation depended on whether the measure was conducted in an 'obviously disproportionate' way. For specific discussions, see *LG&E v Argentina* (n 707) para 195.
[765] William Burke-White and Andreas von Staden, 'Private Litigation in a Public Law Sphere: The Standard of Review in Investor-State Arbitrations' (2010) 35 Yale J Intl L 283, 343.

interests of the investor and the interests of the host State.[766] Using this way of applying the proportionality test gives foreign investors more confidence to invest and host States more room to regulate their affairs in the interest of their citizens. The interests of both can thus be protected and balanced.

6.3.3 Arbitration Practice of the Proportionality Test in Indirect Expropriation Cases

As early as in *S.D. Myers* and *Feldman*, there were indications that tribunals intended to weigh the effect of the measure with its purpose but would not provide a complete analysis of how exactly these two things should be linked and balanced.

The *S.D. Myers* case concerned an American company that had invested in Canada and had obtained its business to take a specific type of environmentally hazardous chemical waste back to its facility in the United States for treatment; however, the Canadian Government later issued an order forbidding the export of this type of waste, which adversely affected the claimant's business operations and its economic benefits from its investment. In this case, the tribunal thought that 'international law makes it appropriate for tribunals to examine the purpose

[766] In *Tecmed*, the case of *James and Others v United Kingdom* was cited for the purpose of analyzing the contents of the proportionality test. The approach taken in that case is consistent with our approach here, except that this thesis, unlike the arrangement in *James and Others v United Kingdom*, discusses the test to examine the legitimacy of the regulatory purpose in a separate section ('6.1 Purpose of the State's Measure') in this chapter. See *Tecmed v Mexico* (n 687) para 122.

and effect of governmental measures'[767] and that a government should adopt the measure which has the least restrictive impact on an investment.[768]

In the *Feldman* case, the claimant was a Mexican company owned and controlled by a U.S. citizen. The claimant sued the Mexican Government for not obeying the tax laws concerning its export of tobacco products. The claimant alleged that through the conduct of its Ministry of Finance and Public Credit, Mexico's refusal to rebate the excise taxes applied to the cigarettes it exported and Mexico's continuing refusal to recognize its right to a rebate of such taxes regarding prospective cigarette exports constituted a breach, including expropriation, of several obligations under NAFTA. The tribunal believed that '[r]easonable governmental regulation … cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this [principle]'.[769] Therefore, the determination of the 'reasonableness' of a governmental measure is the key to deciding whether or not it is expropriatory.

Tecmed is the case that to great extent demonstrates the relationship between the purpose of governmental measures and their effect and further elaborates on the application of the principle of proportionality. A 'weighing and balancing'

[767] *S.D. Myers* (n 667), Partial Award, 13 November 2000, para 281.
[768] ibid paras 215, 221 and 255.
[769] *Feldman v Mexico* (n 721) para 103. At para 105, the tribunal also made reference to the restatement that '[a] state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory'.

between purpose and effect can justify the reasonableness of a measure and, furthermore, can distinguish compensable indirect expropriation from the legitimate exercise of non-compensable State regulatory power. In this case, the claimant, a Spanish company with two subsidiaries in Mexico, wanted to seek remedies for its investment by alleging violations of treaty protection by Mexico. The claimant invested in a hazardous industrial waste landfill in 1996 but was unable to renew its license to operate from the Mexican Government two years later. It thus claimed for its investment loss due to the arbitrary and non-substantiated decision of the Mexican Government and sued Mexico for expropriation. The tribunal ruled in favor of the claimant and supported its expropriation claim.

The key issue for the tribunal to answer was '*whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality*'.[770] In the opinion of the tribunal regarding the content of the proportionality test,

> [t]here must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure. To value such charge or weight, it is very important to measure the size of the ownership

[770] *Tecmed v Mexico* (n 687) para 122.

deprivation caused by the actions of the state and whether such deprivation was compensated or not.[771]

However, this decision has been criticized in academia for its flawed methodology that neglects the considerations of suitability and necessity in its proportionality test.[772] The tribunal went directly to a strict proportionality analysis without giving proper consideration to whether the adopted measure was effective or whether or not there was any other less restrictive measure clearly available for the host State to choose. The consequence of neglecting these two considerations is that only the lawfulness of a measure is dealt with but not necessarily concretely enough to decide that the measure is proportionate.

Although the proportionality analysis in *Tecmed* is not complete, the efforts within it to reconcile the interests of host States and foreign investors through this concept somehow show the potential of determining the difference between non-compensable regulatory measures and indirect expropriation.[773] Some scholars have even viewed this case as a strong precedent established in

[771] ibid.
[772] Henckels (n 751) 233.
[773] Stephan Schill, 'Revisiting a Landmark: Indirect Expropriation and Fair and Equitable Treatment in the ICSID Case *Tecmed*' (2006) 3 Transnatl Dispute Mgmt 1, 3.

international investment law regarding regulatory measures and indirect expropriation.[774]

Subsequent cases have been willing to determine the occurrence of indirect expropriation with the help of the proportionality test, but these determinations were not developed enough, employing only a part of the whole theory.

The *LG&E* case concerned three American companies that had invested in three Argentine gas distribution companies which had been established during a period of privatization, attracted by Argentine legislation that enabled the gas distribution tariffs to be calculated in U.S. dollars and the automatic semi-annual adjustments of tariffs to be based on the U.S. Producer Price Index as well as by other guarantees relating to the Argentine tariff regime. The claimant therefore invested a large amount in the gas distribution infrastructure. However, as a result of a serious economic crisis that occurred during the late 1990s and early 2000s, Argentina abrogated these laws and canceled the guarantees. This case involved a thorough analysis of the reasons for not finding that indirect expropriation had occurred from the perspectives of economic impacts (both the severity of the interference and its duration), the purpose of enacting the measure, the balance between 'the degree of the measure's interference with the right of

[774] Jack J Coe, Jr and Noah Rubins, 'Regulatory Expropriation and the *Tecmed* Case: Context and Contributions' in Todd Weiler (ed), *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May 2005) 653-56.

ownership and the power of the State to adopt its policies',[775] and the measure's context.

As for the scope of State regulatory power, the tribunal believed it to include 'the right to adopt measures having a social or general welfare purpose'.[776] According to the tribunal's understanding, the State should have no liability to compensate as long as its regulatory measures fall within the scope of police power, except in situations where these measures are 'obviously disproportionate' with the need being addressed.[777] Furthermore, the tribunal cited *Tecmed* to clarify its stance on this issue: '[w]hether such actions or measures are proportional to the public interest presumably protected thereby and the protection legally granted to investments, taking into account that the significance of such impact, has a key role upon deciding the proportionality'.[778] In its conclusion, the tribunal again stated that its opinion was 'that there must be a balance in the analysis both of the causes and the effects of a measure in order that one may qualify a measure as being of an expropriatory nature'.[779]

The tribunal in the *Azurix v Argentina* case supported the proportionality test in *Tecmed* and cited the case of *James v the United Kingdom* to illustrate that the

[775] *LG&E v Argentina* (n 707) para 189.
[776] ibid para 195.
[777] ibid.
[778] ibid, citing from *Tecmed v Mexico* (n 687) para 122.
[779] ibid para 194.

determination of indirect expropriation went beyond considerations of *effect* or *purpose* only, adding that 'a measure depriving a person of his property [must] pursue, on the facts as well as in principle, a legitimate aim "in the public interest"' and must bear 'a reasonable relationship of proportionality between the means employed and the aim sought to be realized'.[780] In *CMS v Argentina*, the Argentine Government argued that 'the measures adopted were reasonable and proportional to the objective pursued'.[781] Argentina's position on whether or not to consider the proportionality test in determining the indirect expropriation can be implied from this argument. In *Total v Argentina*, the opinion of the tribunal was that regulatory measures judged to be 'legitimate, proportionate, reasonable and non-discriminatory do not give rise to compensation in favour of foreign investors'.[782] The *El Paso v Argentina* tribunal made a similar statement in its award, arguing that general regulatory measures would not constitute indirect expropriation unless they were 'unreasonable, i.e. arbitrary, discriminatory, disproportionate or otherwise unfair'.[783] The tribunal in *Continental Casualty v Argentina* used the wording 'intolerable, discriminatory or disproportionate' to define the threshold at which regulatory measures became indirect expropriation.[784] The tribunal in *Archer Daniels v Mexico* also viewed whether

[780] *Azurix Corp. v The Argentine Republic* (*Azurix v Argentina*), ICSID Case No. ARB/01/12, Award, 14 July 2006, para 311.
[781] *CMS v Argentina* (n 702) para 288.
[782] *Total S.A. v The Argentine Republic* (*Total S.A. v Argentina*), ICSID Case No. ARB/04/01, Decision on Liability, 27 December 2010, n 232.
[783] *El Paso Energy International Company v Argentine Republic*, ICSID Case No. ARB/03/15, Award, 31 October 2011, paras 241 and 243.
[784] *Continental Casualty v Argentine Republic* (*Continental v Argentina*), ICSID Case No. ARB/03/09, Award, 5 September 2008, para 276.

the measure was 'proportionate or necessary for a legitimate purpose' as one of several factors to be considered in determining the occurrence of indirect expropriation.[785] In *Telenor Mobile Communications A.S. v Hungary*, the claimant summarized the grounds for claiming expropriation, one of which was '[r]egulatory measures pursuing aims other than the interest of the public [lack of a legitimate aim] or that are *disproportional* [lack of fair balance between the aim sought and means employed] qualify as *expropriation* with no doubt'.[786] In the case of *Siemens A.G. v Argentina*, the claimant referred to Professor Schreuer's legal opinion that 'proportionality and reasonableness may play a role in assessing whether the power to expropriate has been exercised properly'.[787] Argentina, in the meantime, cited *Tecmed*, seeking the proportionality test developed in this case, to emphasize the importance of 'the measures taken and the public interest pursued by them'.[788]

6.4 Legitimate Expectations of Foreign Investors

> *The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the*

[785] *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v United Mexican States* (*Archer Daniels v Mexico*), ICSID Case No. ARB (AF)/04/5, Award, 21 November 2007, para 250.
[786] *Telenor Mobile Communications A.S. v Republic of Hungary*, ICSID Case No. ARB/04/15, Award, 13 September 2006, para 40.
[787] *Siemens A.G. v The Argentine Republic* (*Siemens v Argentina*), ICSID Case No. ARB/02/8, Award, 17 January 2007, n 76.
[788] ibid para 223.

foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.[789]

The main participants in international investment law are the host States and the foreign investors. Their relationship directly affects how disputes are generated and where foreign investment goes. As regards the interests of the investors, they would expect the investment environment of the host country to be as stable, predictable, and consistent as possible.[790] However, the host countries would like to attract foreign investments but would never give up their regulatory power to achieve this. Thus, there is the issue of legitimate expectations that is based on a changing balance between the host State's power to regulate the investment and the investor's expectation of an unchanged beneficial investment environment. The essence of this doctrine, therefore, 'is rooted in fairness'.[791]

This doctrine has been debated, developed, and recognized in a range of jurisdictions, although its forms are somehow different. German law, for example, links this doctrine to the fundamental principle of *Vertrauensschutz* (protection of trust), while French law embodies it in other legal principles

[789] *Tecmed v Mexico* (n 687) para 154.
[790] Kenneth J Vandevelde, 'A Unified Theory of Fair and Equitable Treatment' (2010-2011) 43 NYU J Intl L & Pol 43, 66.
[791] *R v IRC, ex p MFK Underwriting Agents Ltd* [1990] 1 WLR 1545, 1569-1570.

(including 'the right to be heard, the protection of vested rights, and legal certainty').[792] However, EU law has accepted legitimate expectations as a general principle of law within its jurisprudence.[793] In English courts, the main function of legitimate expectations was initially to enforce procedural rights; however, in subsequent cases, it has also been used in regard to substantive rights protection. In *R v North and East Devon Health Authority, ex Parte Coughlan*, the Court of Appeal in England held that

> [w]here the Court considers that a lawful promise or practice has induced a legitimate expectation of a benefit which is *substantive*, not simply procedural, authority now establishes that here too the court will in a proper case decide whether to frustrate the expectation is so unfair that to take a new and different course will amount to an abuse of power.[794]

In what circumstances and on what grounds then could we incorporate the doctrine of legitimate expectations into international investment law for the sake of clarifying the positions of the host States and the foreign investors? Under this doctrine, which types of expectations are 'legitimate' for investors to rely upon

[792] Michele Potesta, 'The Doctrine of Legitimate Expectations in Investment Treaty Law' (2012) The Society of International Economic Law Working Paper No. 2012/53, 6-7; Chester Brown, 'The Protection of Legitimate Expectations as a "General Principle of Law": Some Preliminary Thoughts' (2009) 6(1) Transnatl Dispute Mgmt 5.

[793] Potesta (n 792) n 30.

[794] *R v North and East Devon Health Authority, ex Parte Coughlan* [2000] 3 All ER 850, para 57.

in making an investment and, if these expectations are not met, in claiming compensation in cases of indirect expropriation? How can the frustration of legitimate expectations that has an adverse influence on an investment be measured? These questions are waiting to be answered.

6.4.1 Legitimate Expectations and International Investment Law

Under international investment law, there are two main situations in which tribunals would apply the doctrine of legitimate expectations: indirect expropriation and FET. The rationale behind this application is to encourage a suitable legal environment for an investment to begin and grow because a stable, predictable, and consistent regulatory framework is a crucial condition for the host State to attract foreign investments and for these investments to profit as planned.[795] This framework is mutually beneficial to both the host States and their foreign investors.

In this context, regulatory authority cannot be invalidly exercised, exceeding the legal framework in which the host State operates and damaging constitutional standards, legal protections, and human rights.[796] Nevertheless, the protection for investors cannot be understood to mean restrictions imposed on the regulatory

[795] Christoph Schreuer and Ursula Kriebaum, 'At What Time Must Legitimate Expectations Exit?' in Jacques Werner and Arif Hyder Ali (eds), *A Liber Amicorum: Thomas Walde—Law Beyond Conventional Thought* (CMP Publishing 2010) 265.
[796] Francisco Orrego Vicuna, 'Legitimate Expectation in the Case-Law of the World Bank Administrative Tribunal' (2006) 5 L & Prac Intl Cts & Tribunals 41, 41.

authority not to issue new laws and new measures. Newcombe has commented on this aspect, arguing that 'it is not reasonable to expect laws never to change' and that 'the mere fact that the activity was legal in the past does not make the regulatory transition arbitrary or give rise to a distinct, reasonable investment-backed expectation that the policy would not change'.[797] In addition, Thomas Wälde and Abba Kolo stated:

> Investors are ready, and can be expected to be ready, to accept the regulatory regime in situations in which they invest. Investment protection rather turns around the issue of unexpected change with an excessive detrimental impact on the foreign investor's prior calculation, and the - in domestic politics natural - favouring of national competitors.[798]

Arbitration practice has also witnessed support for the doctrine of legitimate expectations in distinguishing between compensable indirect expropriation and non-compensable regulatory measures. For example, in 1999, the *Azinian* tribunal rejected the claim of indirect expropriation and held that

> [i]t is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities, and disappointed yet again when

[797] Newcombe (n 665) 33, 36.
[798] Wälde and Kolo (n 680) 819.

> national courts reject their complaints … NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment, and nothing in its terms so provides.[799]

Another example with a different outcome is the *Tecmed* case. In 2003, the *Tecmed* tribunal considered the State's refusal to issue a license and reached the following conclusion:

> Even before the claimant [had] made its investment, it was widely known that the investor expected its investments in the Landfill to last for a long term and that it took this into account to estimate the time and business required to recover such investment and obtain the expected return … such expectations should be considered legitimate…[800]

The tribunal went on to conclude that

> this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the

[799] *Robert Azinian, Kenneth Davitian, & Ellen Bacca v The United Mexican States* (*Azinian*), ICSID Case No. ARB (AF)/97/2, 1 November 1999, para 83.
[800] *Tecmed v Mexico* (n 687) para 150.

basic expectations that were taken into account by the foreign investor to make the investment….[801]

These two cases, with completely opposite outcomes, both involved the consideration of legitimate expectations in their awards but did not explain where this consideration came from. Legitimate expectations were in fact used as factual considerations by the tribunals in determining the real situations of the cases and in reinforcing their reasoning. As Dolzer and Schreuer believe, 'the investor's legitimate expectations are protected even without a treaty guarantee […]'.[802]

The fact is that there were more than 2300 BITs in existence as of 2003, none of which had 'legitimate expectations' formally established in the text.[803] In the 2004 U.S. Model BIT, the term 'distinct, reasonable investment-backed expectations' was mentioned in the section on regulating indirect expropriation in Annex B. Ever since, the doctrine of legitimate expectations has been hotly debated in academia and extensively used by arbitral tribunals in determining indirect expropriation in international investment law. The 2004 clause was maintained in the 2010 U.S. Model BIT, providing stand-alone evidence of the recognition of 'legitimate expectations' in international investment law.

[801] ibid para 154.
[802] Dolzer and Schreuer (n 649) 135.
[803] UNCTAD, *International Investment Agreements: Key Issues* (vol I, United Nations 2004) 9.

6.4.2 Legitimate Expectations: Standard Criteria

Legitimate expectations, as a well-recognized principle in a range of jurisdictions,[804] is well founded on the general principles of law. As Judge Bingham pointed out, this principle is rooted in fairness. It is also founded on the principles of good faith and reasonableness that require the extent of foreign investors' expectations to be appropriate.[805]

6.4.2.1 Criteria for the Investor

For investors' expectations to be legitimate under international law, they need to conform to the principle of reasonableness from a subjective perspective and an objective perspective.[806] In order to satisfy the reasonableness criteria, an investor needs to act diligently and prudently and to be aware of the inconsistent information that it knows or should have known about.[807]

Being a diligent and prudent investor, the investor must have full account knowledge of the circumstances of an investment, including 'the political,

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[804] It includes Germany, the UK, the ECJ, Canada, the United States, and others. For more information, see Robert Thomas, *Legitimate Expectations and Proportionality in Administrative Law* (Hart Publishing 2000) 42, 49.

[805] Elizabeth Snodgrass, 'Protecting Investors' Legitimate Expectations – Recognizing and Delimiting a General Principle' (2006) 21 ICSID Review–Foreign Invest L J 1, 43.

[806] ibid 41.

[807] ibid 41-43.

socioeconomic, cultural and historical conditions'[808] of the host State, and conduct an independent investigation and inquiry if necessary.[809] Since investment treaties 'are not insurance policies against bad business judgments',[810] it is unreasonable and unjustifiable for the host State to compensate the investor for its own bad business judgments.

Also, the investor would be subjectively unreasonable if, as indicated by Elizabeth Snodgrass, its expectations 'conflicted with other knowledge the individual had about the administration's intentions'.[811] *Thunderbird* is a representative case on this point, elaborating on the misrepresentations of the investor. The tribunal in this case stated:

> It cannot be disputed that Thunderbird knew when it chose to invest in gaming activities in Mexico that gambling was an illegal activity under Mexican law. By Thunderbird's own admission, it also knew that operators of similar machines … had encountered legal resistance from [the regulators]. Hence, Thunderbird must be deemed to have been aware of the potential risk of closure of its own gaming facilities and it should

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[808] *Duke Energy Electroquil Partners and Electroquil S.A. v Ecuador*, ICSID Case No. ARB/04/19, Award, 18 August 2008, para 340.

[809] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v Republic of Chile* (*MTD*), ICSID Case No. ARB/01/7, Award, 25 May 2004, para 173.

[810] *Amilio Agustin Mafezini v The Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction, Award, 25 January 2000, para 64.

[811] Snodgrass (n 805) 41.

have exercised particular caution in pursuing its business venture in Mexico.[812]

This case also concerns the issue of the disclosure duty of the investor, which is largely based on the investor's honesty and good faith.[813] In this case, the tribunal determined the facts and concluded that the disclosure given by the investor 'was not a proper disclosure and that it puts the reader on the wrong track'.[814] The tribunal further explained that the government's advice to the investor was given on the basis of the investor's misrepresentations and thus was not a valid source of legitimate expectations. Therefore, the protection of legitimate expectations would be worthless if the assurance, promise, or representation given by the host State was based on the investor's fraud, misrepresentation, or omission of relevant facts.[815]

6.4.2.2 Criteria for the Host State

The good faith principle has been established in international customary law and can be found in explicit legal documents (e.g. Article 31 of the Vienna Convention).[816] One significant aspect of good faith that is closely related to legitimate expectations is the international rule of estoppel, which requires the

[812] *International Thunderbird Gaming Corporation v The United Mexican States* (*Thunderbird*), UNCITRAL Case, Arbitral Award, 26 January 2006, para 164.
[813] Snodgrass (n 805) 43.
[814] *Thunderbird* (n 812), Arbitral Award, 26 January 2006, para 155.
[815] Potesta (n 792) 35.
[816] Anthony D'Amato, 'Good Faith' in Rudolf Bernhardt (ed), *Encyclopedia of Public International Law*, vol IV (North Holland 1992) 599-661.

State not to benefit from its own inconsistent commitments while the party who relied on such commitments in making decisions suffers losses.[817] In international law, the rule of estoppel has three key elements: first, '[t]he statement of fact must be clear and unambiguous'; second, '[t]he statement of fact must be made voluntarily, unconditionally and must be authorized'; and third, '[t]here must be reliance in good faith upon the statement either to the detriment of the party so relying on the statement or to the advantage of the party making the statement'.[818]

However, good faith itself cannot be the source of obligations, but it can be used as grounds for including legitimate expectations in the analysis of indirect expropriation to determine whether the State's violation of its commitment amounts to a substantial deprivation of the interests of the foreign investors. It is notable that some of the arbitral decisions that will be discussed below come from the analysis of FET rather than indirect expropriation. The discussion aims to strengthen the findings on how to apply legitimate expectations in international investment law and will show that the frustration of the investor's legitimate expectations can be claimed on the grounds of both FET and indirect expropriation. Therefore, this thesis will categorize the arbitral decisions on legitimate expectations into the following groups in order to illustrate the types

[817] DW Bowett, 'Estoppel Before International Tribunals and its Relation to Acquiescence' (1957) 33 Brit Y B Intl L 176, 177.
[818] ibid 202.

of ‘legitimate expectations’ that host States should be better aware of: specific representation and assurance; contractual commitment or license; general administrative regulation and amendment of law.

6.4.2.2.1 Specific Representation and Assurance

> *Where a host State which seeks foreign investment acts intentionally, so as to create expectations in potential investors with respect to particular treatment or comportment, the host State should […] be bound by the commitments and the investor is entitled to rely upon them in instances of decision.*[819]
>
> *Michael Reisman and Mahnoush Arsanjani*

In *Duke Energy International Peru Investments No. 1, Ltd. v Republic of Peru*, the tribunal concluded that the claimant had failed to establish reasonable expectations on the basis of an unofficial document because this document ‘did not induce comfort and reliance. If it had, such reliance would not have been reasonable’.[820] In *Duke Energy Electroquil Partners and Electroquil SA v*

[819] W Michael Reisman and Mahnoush H Arsanjani, ‘The Question of Unilateral Governmental Statements as Applicable Law in Investment Disputes’ in PM Dupuy et al (eds), Völkerrecht als Wertordnung — Common Values in International Law, Festschrift für: Essays in Honour of Christian Tomuschat (2006) 422.
[820] *Duke Energy International Peru Investments No. 1, Ltd. v Republic of Peru*, ICSID Case No. ARB/03/28, Award on the Merits, 18 August 2008, para 322.

Republic of Ecuador, the tribunal believed that 'the expectation could only have been deemed reasonable if it had been based on clear assurances from the Government'[821] and the investor 'was reasonably entitled to rely on the commitment of the Government'.[822] Therefore, the tribunal ruled that the respondent had breached the investor's expectations by 'not implementing the payment guarantee'.[823]

The tribunal in *Glamis Gold v USA* further clarified this issue in the following statement: 'a State may be tied to the objective expectations that it creates in order to induce investment. Such an upset of expectations thus requires something greater than mere disappointment; it requires, as a threshold condition, the active inducement of a quasi-contractual expectation'.[824] This point was also stressed in *Parkerings v Lithuania*: 'an expectation is legitimate if the investor received an explicit promise or guaranty from the host-State, or if implicitly, the host-State made assurances or representation that the investor took into account in making the investment. Finally, in the situation where the host-State made no assurance or representation, the circumstances surrounding the conclusion of the

[821] *Duke Energy Electroquil Partners & Electroquil S.A. v Republic of Ecuador* (n 808), Award, 18 August 2008, para 351.
[822] ibid para 363.
[823] ibid para 364.
[824] *Glamis Gold, Ltd. v The United States of America*, UNCITRAL Case, Award, 8 June 2009, para 799.

agreement are decisive to determine if the expectation of the investor was legitimate'.[825]

As Wälde commented in his separate opinion on *Thunderbird*, 'a legitimate expectation is assumed more readily if an individual investor receives specifically formal assurances that display visibly an official character'.[826] From Wälde's opinion, the above-mentioned comment of Michael Reisman and Mahnoush Arsanjani, and the arbitral decisions, we can draw the conclusion that in cases involving specific representations or assurances that the host State made directly to the foreign investors (individually or to a group of investors or an industry) and that these investors relied on in making their investment decisions, these representations or assurances should be honored by the host State. Other cases have proved the validity of legitimate expectations. For instance, in *Tecmed*, the governmental authority's nonrenewal of the permit 'frustrated Cytrar's [the Mexican subsidy of the Claimant] fair expectations upon which Cytrar's actions were based and upon the basis of which the Claimant's investment was made',[827] which was a breach of the claimant's legitimate expectations.

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[825] *Parkerings-Compagniet AS v Republic of Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, para 331.

[826] *Thunderbird* (n 812), Separate Opinion of Thomas Wälde, 1 December 2005, para 32.

[827] *Tecmed v Mexico* (n 687) para 173.

The question of how specific the representation should be in order for the legitimate expectations criterion to be triggered, called the *specificity* requirement in international investment law, really matters. Will letters sent by a governmental authority showing the possibility of cooperation satisfy the requirement of specificity?[828] Or will the words said by a governmental official at an unofficial event satisfy this requirement?[829]

If the alleged 'legitimate expectations' of investors are not specific enough, investors can be disappointed by the host State if it does not respect these expectations. An investment a host State promises is 'needed, encouraged and welcome' can only amount to a 'general policy',[830] while '[l]egitimate

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[828] In the case of *Frontier Petroleum v Czech Republic*, the Czech Ministry of Industry and Trade sent two letters to the claimant and expressed the view that there was a possibility for the two parties to negotiate. The tribunal found that these two letters were only a 'signal' to negotiations but not 'an adequate basis for the Claimant to rely on some form of representation or expectation' since they did 'not exhibit the level of specificity necessary to generate legitimate expectations'. See *Frontier Petroleum Services Ltd v Czech Republic*, UNCITRAL/PCA, Final Award, 12 November 2010, paras 76, 455, 465, 468.

[829] In *White Industries v India*, the Indian officials had made representations to the director of the claimant while this director was traveling in India and seeking an opportunity to invest. The tribunal decided that the claimant could not rely on the officials' representations about India's safe investment environment and its good legal system because 'the alleged representations suffer from vagueness and generality, such that they are not capable of giving rise to reasonable legitimate expectations that are amenable to protection under the fair and equitable treatment standard'. See *White Industries Australia Limited v India*, UNCITRAL Case, Final Award, 30 November 2011, paras 5.2.6. and 10.3.17.

[830] *PSEG Global, Inc., The North American Coal Corporation, and Konya Ingin Electrik Üretim ve Ticaret Limited Sirketi v Republic of Turkey* (*PSEG v Turkey*), ICSID Case No. ARB/02/5, Award, 19 January 2007, para 243.

expectations by definition require a promise of the administration on which the Claimants rely to assert a right that needs to be observed'.[831] Compared with a valid exercise of legitimate expectations, a general policy does 'not entail a promise made specifically to the Claimants about the success of their proposed project'.[832] On this point, the *PSEG v Turkey* tribunal clarified the grounds for investors to invoke legitimate expectations when there is something from the government that the investors could probably rely upon but not necessarily legitimately. *Continental v Argentina* was a case dealing with the representations of government authorities that was determined not to involve a valid exercise of legitimate expectations. The tribunal examined the specificity requirement in this case, concluding that 'the specificity of the undertaking allegedly relied upon … is mostly absent here, considering moreover that political statements have the least legal value, regrettably but notoriously so'.[833] In the *El Paso* case, the declaration of the President of the State was determined to be a political statement.[834] The tribunal admitted the possibility of some investors being induced to make an investment by this kind of statement.[835] This kind of statement, however, was not 'a specific commitment to foreign investors not to modify the existing framework, which was designed to attract them'.[836]

[831] ibid para 241.
[832] ibid para 243.
[833] *Continental v Argentina* (n 784) para 261.
[834] *El Paso Energy International Company v Argentina* (n 783) paras 395-96.
[835] ibid.
[836] ibid.

Consequently, there is no definite answer as to the threshold of the specificity requirement since this requirement should necessarily be built upon the circumstances of the case.[837] The tribunal in *El Paso Energy International Company v Argentina* tried to manage this specificity requirement by categorizing the specific commitments in the case into (1) those specific as to their addressee and (2) those specific as regards their object and purpose (the precise objective of the commitments in the *El Paso Energy International Company v Argentina* case was to give a real guarantee of stability to the investor).[838] The significance of this classification should be noted.

Nevertheless, in another set of cases involving inconsistent representations among different governmental authorities, it was argued that the host State should also take responsibility for not respecting the investor's legitimate expectations. Relying on the representations of the federal government, the claimant in *Metalclad* started its construction project 'openly and continuously' and with the 'full knowledge of the federal, State, and municipal governments' until it was stopped because, the municipal government alleged, it failed to obtain a municipal construction permit.[839] In cases like this, the host State issued inconsistent opinions which confused the investors and thereby caused the losses of the investors. This situation also occurred in the *MTD* case, where the tribunal

[837] ibid para 375.
[838] ibid paras 375-77.
[839] *Metalclad* (n 673), Award, 30 August 2000, para 87.

focused on 'the inconsistency of action between two arms of the same Government vis-à-vis the same investor even when the legal framework of the country provides for a mechanism to coordinate'.[840]

6.4.2.2.2. Contractual Commitment or License

A contract has to be protected under even higher protection since this legal instrument is created to provide more legal stability and predictability in the legal framework.[841] When the contract is between an investor and the host State, it is a highly individualized agreement involving bargaining and communication between both sides and all of its terms should be honored.[842] However, in the context of treaty protection, not all contractual breaches can be elevated to a disappointment of legitimate expectations.[843] Only those expectations being frustrated by sovereign power can be protected under international law.[844] Other

[840] *MTD* (n 809) para 163.

[841] Dolzer and Schreuer (n 649) 140.

[842] GR Delaume, 'State Contracts and Transnational Arbitration' (1981) 75 Am J Intl L 784, 805-806; Snodgrass (n 805) 38. It is notable that the interpretation of the contract terms should not be restricted to benefiting the interests of the investors. As in *Duke Energy International Peru Investments No. 1, Ltd. v Republic of Peru*, the tribunal concluded the effect of a legal stability agreement, stating that '[t]ax stabilization does not provide a guarantee against the risk that the Government or the courts will interpret the law in a manner that is unfavourable to the investor'. See *Duke Energy International Peru Investments No. 1, Ltd. v Republic of Peru* (n 820) para 228.

[843] Vandevelde (n 790) 72; Dolzer and Schreuer (n 649) 132.

[844] Vandevelde (n 790) 72.

contractual breaches in which the host State performs its duty as a private party should be more appropriately protected before a national tribunal.[845]

The *Gustav F W Hamester GmbH & Co KG v Ghana* tribunal clearly pointed out that '[i]t is important to emphasise that the existence of legitimate expectations and the existence of contractual rights are two separate issues'.[846] The tribunal in *Saluka* stated in this respect that '[t]he Treaty cannot be interpreted so as to penalise each and every breach by the Government of the rules or regulations to which it is subject and for which the investor may normally seek redress before the courts of the host State'.[847]

The *Waste Management, Inc. v United Mexican States* tribunal emphasized the breaches of contractual commitments and stated that 'NAFTA Chapter 11 is not

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[845] *Parkerings-Compagniet AS v Republic of Lithuania* (n 825) para 344. In this case, the tribunal highlighted the issue of contractual expectations, stating that '[i]t is evident that not every hope amounts to an expectation under international law. The expectation a party to an agreement may have of the regular fulfilment of the obligation by the other party is not necessarily an expectation protected by international law. In other words, contracts involve intrinsic expectations from each party that do not amount to expectations as understood in international law. Indeed, the party whose contractual expectations are frustrated should, under specific conditions, seek redress before a national tribunal'.

[846] *Gustav F W Hamester GmbH & Co KG v Republic of Ghana*, ICSID Case No. ARB/07/24, Award, 18 June 2008, para 335.

[847] *Saluka Investments BV (The Netherlands) v The Czech Republic* (*Saluka v Czech Republic*), UNCITRAL Case, Partial Award, 17 March 2006, para 442.

a forum for the resolution of contractual disputes'.[848] Therefore, whether or not the host State uses its sovereign power to frustrate the investors' legitimate expectations regarding the State's continuous compliance with its contractual commitment is the major distinction between a general contractual commitment and a commitment individualized under international law. In *Duke Energy Electroquil Partners and Electroquil SA v Ecuador*, the tribunal concluded that the governmental act concerned 'did not imply the exercise of sovereign power' and that the expectations of the claimant in this situation 'must be regarded as "mere" contractual expectations which are not protected under the BIT'.[849]

The expectations of investors have to be safeguarded if the host State performs its sovereign power in a way that is inconsistent with its commitment in a contract or license. In *Continental Casualty Company v Argentina*, the tribunal tried to conclude the circumstances in which an investor's legitimate expectations could most likely be frustrated, including the 'unilateral modification of contractual undertakings by governments ... since they generate as a rule [of] legal rights and therefore expectations of compliance'.[850] *MTD v Chile* is a typical case explaining the importance of the host State's commitment

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[848] *Waste Management, Inc. v United Mexican States* (*Waste Management v Mexico*), ICSID Case No. ARB (AF)/00/3, Award, 30 April 2004, para 114.

[849] *Duke Energy Electroquil Partners and Electroquil S.A. v Ecuador* (n 808), Award, 18 August 2008, para 358.

[850] *Continental v Argentina* (n 784) para 261.

in a contract or license. In this case, the claimant secured land in Chile for an investment project and concluded a contract with the relevant governmental body. The claimant believed that the project would be a success and thus invested in it. However, another governmental body rejected the project because it violated Chilean laws. In the end, the Chilean Government was ruled liable since it had created and encouraged strong expectations that the project would be implemented in the specified proposed location. *CME v Czech Republic* is another case in which the host State breached its promise of an exclusive license to the investor. In this case, the claimant was granted the exclusive license to provide broadcasting services and made profits therefrom. This exclusive position was later undermined and finally destroyed due to the actions and omissions of the governmental authority. The tribunal found that indirect expropriation had occurred as these actions and omissions had destroyed the company's operation, leaving the claimant as 'a company with assets, but without business'.[851]

6.4.2.2.3. General Administrative Regulation and Amendment of Law

Some claims have been brought to arbitral tribunals on the grounds of legitimate expectations being frustrated by changes to the host State's general administrative and legislative regulations. Would such expectations be 'legitimate' enough and be relied upon by investors to succeed in an

[851] *CME v Czech Republic* (n 674) para 591.

expropriation case? Here, a thorough analysis will be given by examining the cases in which there was no specific assurance and representation made by the host State, summarizing the application of legitimate expectations in these cases, and testifying to its use in expropriation cases.

After an investment has been made, to what extent can investors expect the investment environment of the host State to remain unchanged? Some tribunals believed that this requirement is established in the nature of a government's regulatory power. For example, the tribunal in *Saluka v Czech Republic* found that 'the Claimant's reasonable expectations to be entitled to protection under the Treaty need not be based on an explicit assurance from the Czech Government',[852] arguing that it was sufficient for the investor to reasonably expect that the host State would act 'in a consistent and even-handed way' when he made the investment.[853] The *Total S.A.* tribunal also expressed the same open-minded view that '[e]xpectations based on [principles of economic rationality, public interest, reasonableness and proportionality] are reasonable and hence legitimate, even in the absence of specific promises by the government'.[854]

Another theory is that the host State should maintain the stability of the regulatory framework in its country as provided in preamble of the applicable

[852] *Saluka v Czech Republic* (n 847) para 329.
[853] ibid.
[854] *Total S.A. v Argentina* (n 782) para 333.

BIT. In *CMS v Argentina*, the tribunal chose the words from the preamble of the BIT concerned and expressed the importance of maintaining a 'stable legal and business environment'.[855] The *Occidental Exploration & Production Co. (OEPC) v Ecuador* tribunal also repeatedly stated the issue of stability by making reference to the wording 'make a stable framework for investment' from the preamble.[856] The tribunal further stressed that the core issue at point was 'whether the legal and business framework meets the requirements of stability and predictability under international law' and concluded that 'there is certainly an obligation [for the State] not to alter the legal and business environment in which the investment has been made'.[857] *Enron v Argentina* is another case that took the same approach of protecting the 'stable framework for the investment'.[858]

On the other hand, some tribunals have explicitly held the view that the regulatory power of the host State cannot be sacrificed for the mere expectations of the investors. This regulatory power is vested within the sovereignty of the host State and should not be unreasonably diminished. *Parkerings v Lithuania* is a case at point. Its tribunal stated:

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[855] *CMS v Argentina* (n 702) para 274.

[856] *Occidental Exploration and Production Company v Ecuador* (*Occidental v Ecuador*), UNCITRAL/LCIA Case No. UN 3467, Final Award, 1 July 2004, para 183.

[857] ibid para 191.

[858] *Enron Corporation Ponderosa Assets, L.P. v Argentina* (*Enron v Argentina*), ICSID Case No. ARB/01/3, Award, 22 May 2007, para 260.

> In principle, an investor has a right to a certain stability and predictability of the legal environment of the investment [.] The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.[859]

The tribunal in *Continental Casualty Company v Argentina* provided a strong opinion which questioned the protection laid down in the preamble of the applicable BIT:

> It would be unconscionable for a country to promise not to change its legislation as time and needs change, or even more to tie its hands by such a kind of stipulation in case a crisis of any type or origin arose. Such an implication as to stability in the BIT's Preamble would be contrary to an effective interpretation of the Treaty; reliance on such an implication by a foreign investor would be misplaced and, indeed, unreasonable.[860]

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[859] *Parkerings-Compagniet AS v Republic of Lithuania* (n 825) para 333.

[860] *Continental v Argentina* (n 784) para 258.

EDF (Services) Limited v Romania is a case in international investment law holding that legitimate expectations cannot be regulated in an 'overly-broad and unqualified formulation'.[861] The tribunal in this case provided that

> [e]xcept where specific promises or representations are made by the State to the investor, the latter may not rely on a bilateral investment treaty as a kind of insurance policy against the risk of any changes in the host State's legal and economic framework. Such expectation would be neither legitimate nor reasonable.[862]

Thus, the expectations of investors can be in conflict with the State's regulatory power. The question is how to balance the stability of the investment environment so as to fulfill the legitimate expectations of foreign investors on one hand and to protect the host State's power to regulate its domestic affairs and amend the law on the other. More tribunals have arrived at the conclusion that the expectations must have a reliable and concrete basis in order to be 'legitimate'. Such a basis can be in the form of a contractual commitment (e.g. a stabilization clause in a treaty which clearly indicates that the host State will not

[861] *EDF (Services) Limited v Romania* (*EDF v Romania*), ICSID Case No. ARB/05/13, Award, 8 October 2009, para 217.
[862] ibid.

alter the general regulatory and legal system) or a specific representation made by the host State.[863]

Stabilization clauses, as stated in the *Total S.A.* award, are 'clauses which are inserted in State contracts concluded between foreign investors and host States with the intended effect of freezing a specific host State's legal framework at a certain date, such that the adoption of any changes in the legal regulatory framework of the investment concerned (even by law of general application and without any discriminatory intent by the host State) would be illegal'.[864] In this respect, the *Parkerings v Lithuania* tribunal opined:

> It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment.[865]

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[863] The *PSEG* tribunal explicitly stated that general policy 'did not entail a promise made specifically to the Claimants about the success of their proposed project'. See *PSEG v Turkey* (n 830) paras 242-43, 250. The *Parkerings-Compagniet AS v Republic of Lithuania* tribunal stated in the award that '[t]he legitimate expectations of the Claimant that the legal regime would remain unchanged are not based on or reinforced by a particular behaviour of the Respondent'. See *Parkerings-Compagniet AS v Republic of Lithuania* (n 825) paras 334.

[864] *Total S.A. v Argentina* (n 782) para 101.

[865] *Parkerings-Compagniet AS v Republic of Lithuania* (n 825) para 332.

However, a general stabilization clause would still be too broad and vague to include the specific legitimate expectations of the investor. The *PSEG v Turkey* tribunal found that stability in the context of development cannot be maintained forever, arguing that this concept 'cannot exist in a situation where the law kept changing continuously and endlessly, as did its interpretation and implementation'.[866] The *Total S.A.* tribunal cited Schreuer's view on legitimate expectations in a stabilization clause: '[a] general stabilization requirement would go beyond what the investor can legitimately expect'.[867] A stabilization clause, therefore, is manifested with the specificity requirement deriving from the specific contract term in the treaty.[868] Thus, respect for a specific stabilization clause in connection with legitimate expectations needs to be upheld.

Not only the facts that are useful in determining the legitimacy of the investor's expectations but also other considerations, including 'the political,

[866] *PSEG v Turkey* (n 830) para 254.

[867] *Total S.A. v Argentina* (n 782) para 120; see C Schreuer, 'Fair and Equitable Treatment in Arbitral Practice' (2005) 6 J World Invest & Trade 357, 374.

[868] A significant change of tax regime would be serious for foreign investors. However, it is very hard to prove that there were 'legitimate expectations' of investors when there were no appropriate guarantees such as a stability agreement. See *Sergei Paushok, Cjsc Golden East Company, Cjsc Vostokneftegaz Company v Mongolia*, UNCITRAL Case, Award on Jurisdiction and Liability, 28 April 2011, para 302.

socioeconomic, cultural and historical conditions'[869] of the host State, may be relevant to the assessment of legitimate expectations. It has been suggested that the determination of legitimate expectations should be based on all the circumstances of a case so as to precisely determine its reasonableness. A case in point is *Methanex*: In the part of its ruling dealing with indirect expropriation, the tribunal examined the legitimate expectations, which included the 'political economy' of the State concerned. [870] Furthermore, in *Continental Casualty Company v Argentina*, the tribunal asserted the following in relation to the issue of what has to be considered when seeking to determine whether legitimate expectations have been met: 'centrality to the protected investment and impact of the changes on the operation of the foreign owned business in general including its profitability is also relevant; good faith, absence of discrimination (generality of the measures challenged under the standard), relevance of the public interest pursued by the State, accompanying measures aimed at reducing the negative impact are also to be considered in order to ascertain fairness'.[871]

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[869] *Duke Energy Electroquil Partners and Electroquil S.A. v Ecuador* (n 808), Award, 18 August 2008, para 340.

[870] *Methanex* (n 726) Part IV, ch D, para 9.

[871] *Continental v Argentina* (n 784) para 261.

6.4.3 Arbitration Practice of Legitimate Expectations in Indirect Expropriation Cases

The doctrine of legitimate expectations is given due attention nowadays for its role and function in cases of indirect expropriation and FET. This chapter has provided a thorough and complete analysis clarifying when, where, and how to apply this doctrine on basis of current arbitration practice, both in cases that involve a claim of expropriation and those that involve FET. The arbitration practice is indeed the best evidence of the significance of the doctrine and the best regulator for clarifying the boundaries of this doctrine for future application. As Blades commented in relation to the *Methanex* case, 'the Tribunal's central focus upon an Investor's expectations - and whether a State has done anything to foster those expectations - is a new, and perhaps welcome, development in NAFTA expropriation jurisprudence'.[872]

The *Starrett Housing* case concerned the Iranian Government's appointment of a 'temporary' manager to an American housing project, an action which was ruled by the tribunal to constitute indirect expropriation. The tribunal, however, pointed out that foreign investors 'have to assume a risk that the country might experience strikes, lock-outs, disturbances, changes of the economic and political system and even revolution' and that the fact that 'any of these risks materialized

[872] Bryan W Blades, 'The Exhausting Question of Local Remedies: Expropriation under NAFTA Chapter 11' (2006) 8 Oregon Rev Intl L 33, 98.

does not necessarily mean that property rights affected by such events can be deemed to have been taken'.[873]

The tribunal in *Azinian* examined the Mexican Government's termination of a concession agreement due to the investor's misrepresentations and concluded this did not constitute expropriation. The tribunal held in the award that '[i]t is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities, and disappointed yet again when national courts reject their complaints' and that 'NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment, and nothing in its terms so provides'.[874]

A representative case in the field of legitimate expectations concerning indirect expropriation is *LG&E*. This case concerned three American companies that had invested in three Argentine gas distribution companies, which had been established during a period of privatization in the early 1990s, and had been granted licenses until 2027. In order to attract foreign investment during the period of privatization, Argentina promulgated legislation enabling the gas distribution tariffs to be calculated in U.S. dollars and the automatic semi-annual adjustments of tariffs to be based on the U.S. Producer Price Index and also implemented other guarantees relating to the Argentine tariff regime. Because of

[873] *Starrett Housing* (n 706) 156.
[874] *Azinian* (n 799) para 83.

these guarantees granted by the Argentine Government, the claimant invested a large amount in the gas distribution infrastructure. However, during the late 1990s and early 2000s, a serious economic crisis occurred in Argentina, and as a result, the Argentine Government abrogated these laws and canceled the guarantees provided during the privatization period. As a consequence of Argentina's abrogation, the profitability of the gas distribution business was injured and so were the returns on the investments. Although the tribunal dismissed the expropriation claim, such guarantees were in fact the specific representations made by Argentina to the gas distribution companies and that is why the tribunal determined that these guarantees were not merely 'an economic and monetary policy of the Argentine Government' but rather 'a guarantee laid down in the tariff system'.[875]

'Relying on the representations of the federal government', the claimant in *Metalclad* started its construction project 'openly and continuously' and with the 'full knowledge of federal, state, and municipal governments' until it was stopped because, the municipal government alleged, it failed to obtain a municipal construction permit.[876] The claimant was prohibited from opening and operating a hazardous waste disposal facility even though it had met all of the legal and other relevant requirements and had actually been encouraged by the

[875] *LG&E v Argentina* (n 707) paras 34-71, 134.
[876] *Metalclad* (n 673), Award, 30 August 2000, para 87.

federal government.[877] It was further argued that this prohibition was issued after the initial stage of the operation. Furthermore, since the Mexican Government had created a preserve in this area, it would be impossible for the facility to continue to operate. Due to these facts, the tribunal found that this denial of permit with no legitimate grounds constituted indirect expropriation since 'the complete frustration of the operation of the landfill [eliminated] the possibility of any meaningful return on Metalclad's investment'.[878]

In *Biloune v Ghana*,[879] the investor was prohibited by a government affiliated entity from continuing its construction on the basis of the absence of a building permit when it had already completed a substantial amount of the work. The investor had submitted an application but never received a response. The tribunal in this case paid due attention to the investor's justifiable reliance on the representations of the government regarding the permit application. The facts were that the government had known about the construction for more than a year before issuing the stop work order, that building permits had not been required for other projects, and that there was no procedure for dealing with building permit applications. Due to these facts, the tribunal found that indirect expropriation had taken place.

[877] ibid paras 37-59, 74-101.
[878] ibid para 113.
[879] *Biloune v Ghana* (n 676) paras 207-10.

In *Tecmed*, the claimant wanted to seek remedies for its investment by alleging Mexico's violations of treaty protection. In this case, the claimant invested in a hazardous industrial waste landfill in 1996 but could not obtain a renewal of its license to operate from the Mexican Government two years later. It thus claimed for its investment loss due to the arbitrary and non-substantiated decision of the Mexican Government and sued Mexico for expropriation. The tribunal held that this nonrenewal of the license amounted to indirect expropriation, partly because '[e]ven before the claimant had made its investment, it was widely known that the investor expected its investments in the landfill to last for a long term and that it took this into account to estimate the time and business required to recover such investment and obtain expected return' and 'such expectations should be considered legitimate'.[880]

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

Beyond the examination of the State's regulatory purpose, its effect on the investment, the proportionality criteria in between, and the frustration of the investor's legitimate expectations, there are other factors believed to be relevant in determining the occurrence of indirect expropriation. Recent, if not all, arbitration practices have witnessed the focus being shifted from a purpose-or effect-based approach to a fact-based, case-by-case approach to determining

[880] *Tecmed v Mexico* (n 687) para 150.

indirect expropriation. Thus, any facts related to a State measure could possibly be of value to an examination of its true nature, that is, whether or not it was expropriatory.

This new approach tries to explore the nature of the regulatory measure by taking all of its relevant characteristics into account. *Feldman* is a case in point. In this case, the tribunal used a tailored framework of analysis to explain the reasons for not finding indirect expropriation: Was the regulatory measure conducted transparently? Was it arbitrary or discriminatory to the investor? Did it follow the due process of law? Or did it involve a denial of justice in and after the process of regulating? These issues should normally be clarified under other treaty protections, such as minimum standard of treatment or FET, not in the determination of expropriation. However, until recently, the use of these factors to determine the existence of indirect expropriation has gradually been recognized in the jurisprudence of international expropriation law.

6.5.1 Other Considerations and International Investment Law

The above-mentioned factors are connected to international investment law in different ways and manifested in several treaty protections. It is hard to tell which exact treaty protection these factors come from since these treaty protections often overlap each other and are based on the same fundamental legal

principle.[881] However, these factors ought not to be ignored in the process of determining whether or not indirect expropriation has occurred as the most appropriate analysis has to be framed in accordance with all the necessary factors, especially those based on the same legal principle that can be adopted to determine the same international treaty obligation.

For instance, the arbitrariness and discrimination tests can, at least in principle, test the purposes and motives of expropriation, and these tests should be used together to determine whether the host State exercised its regulatory power with due diligence.[882] In the context of expropriation, Article 17.2 of the Universal Declaration of Human Rights states that '[n]o one shall be arbitrarily deprived of his property'. Nevertheless, Article II (2) (b) of the 1992 U.S. Model BIT states that '[n]either party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments'.

Specifically concerning expropriation, many BITs have incorporated a 'legality' test provision to distinguish between legitimate expropriation and illegitimate expropriation; this provision includes 'nondiscrimination' and due process of law

[881] For instance, the nondiscrimination principle, in its broader context, is embodied in most-favored-nation treatment and national treatment. See AFM Maniruzzaman, 'Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview' (1998) 8 J Transnatl L & Pol 57, 69.
[882] Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (Martinus Nijhoff Publishers 1995) 61.

elements.[883] Although these elements are intended for use in determining whether an expropriation is lawful, they have been used before the occurrence of expropriation has been established. International arbitration practice has made full use of this test, incorporating it into the process for determining whether or not indirect expropriation has occurred;[884] this will be discussed further in the next section.

The transparency requirement is also highly relevant in the process of determining indirect expropriation. U.S. BIT practice has at least once provided that '[e]ach party shall make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investment'.[885] NAFTA Article 102, in this regard, defines the objectives of this Agreement, 'as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and *transparency*', as being to 'increase substantially investment opportunities in the territories of

[883] For example, in the 2012 U.S. Model BIT, Article 6 ('Expropriation and Compensation') states in its first paragraph that States can neither expropriate nor nationalize an investor's property, either directly or indirectly, except when the expropriation can satisfy four conditions: 'for a public purpose'; 'in a non-discriminatory manner'; 'on payment of prompt, adequate, and effective compensation'; and 'in accordance with due process of law and Article 5 [Minimum Standard of Treatment] (1) through (3)'.

[884] Olynyk (n 702) 280.

[885] See Art II (7) of 1991 US-Argentina BIT.

the Parties' and to 'create effective procedures for the implementation and application of this Agreement'.

Denial of justice has also been given due attention for its role in determining the host State's international responsibility. In the case of *Loewen v United States* decided by an ICSID tribunal, Professor Greenwood QC stated in his second opinion that the State's responsibility for maintaining and making 'a fair and effective system of justice' available to aliens was accepted in international customary law.[886] Also, according to the *Waste Management* tribunal, 'a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process'[887] is a key element in due process that can be triggered under the State's international responsibility.

These factors have been accepted in international customary practice, as established in international customary law, for use in arbitral proceedings to establish the State's responsibility.

As regards expropriation, the responsibility of the host State exists in situations where the implementation of the governmental measures concerned is inconsistent with the international standards that govern the exercise of such

[886] *Loewen Group, Inc. and Raymond L. Loewen v United States of America* (*Loewen v United States*), ICSID Case No. ARB (AF)/98/3, Second Opinion of Christopher Greenwood, Q.C. (a reply to Sir Ian Sinclair), 16 August 2001, para 79.
[887] *Waste Management v Mexico* (n 848) para 98.

measures. Among these standards, 'arbitrariness' has been 'adopted as the basis for determining whether international responsibility arises, applies, although not always to the same extent',[888] and it has been contended that 'discrimination' is the element that can trigger State responsibility.[889] The methods or procedures through which laws or governmental regulations are employed, such as transparency, due process, and denial of justice, and 'the individual, or general and impersonal character'[890] of such measures are also relevant in determining the State's international responsibility.[891]

By appreciating the potential of these factors in the process of finding indirect expropriation, some tribunals have successfully concluded the existence of indirect expropriation. However, the appropriateness of these tribunals' use of these factors and the criteria they use in applying these factors have been criticized. The following sections will take a close look at these factors in the context of expropriation claims.

[888] R Doak Bishop, James Crawford and W Michael Reisman, *Foreign Investment Disputes: Cases, Materials, and Commentary* (Kluwer Law International 2005) 838.
[889] ibid.
[890] ibid 839.
[891] There are the considerations of transparency, due process, and denial of justice. If the State employs the wrong methods in the course of regulating, then State responsibility should definitely arise.

6.5.2 Standard Criteria for Other Considerations

To explore the standard criteria for these factors, we must bear in mind the truth that there is no definite formula but rather only general rules to frame the boundaries of each concept.

6.5.2.1 Nondiscrimination

The principle of nondiscrimination in the context of expropriation appears not just in the provision regulating the 'legality' of the expropriation but also in the provision which distinguishes legitimate regulatory power from indirect expropriation. For example, in the 2012 U.S. Model BIT, in addition to Article 6 where the phrase 'in a non-discriminatory manner' is clearly stated, Article 4 (b) in Annex B ('Expropriation') also concerns the same principle. It provides that '[e]xcept in rare circumstances, non-discriminatory regulatory actions … do not constitute indirect expropriations'. 'Nondiscrimination' here seems to be a precondition for concluding the nature of a regulatory measure and thus can serve as a criterion for determining whether or not indirect expropriation exists.

In the concept of nondiscrimination, there are two notable elements. First, the reason for a governmental measure directed at a specific investor must not be related to the substance of the matter:[892] for instance, the nationality of the investor must be irrelevant to the implementation of the measure. Second,

[892] Maniruzzaman (n 881) 59.

nondiscrimination requires like persons to be treated equally;[893] that is to say, in similar situations, investors have to be treated in the same way.

There was a case concerning the application of this principle in examining indirect expropriation: *ADC Affiliate Ltd. v Hungary.* In this case, the claimant, who was the only foreign investor, was prohibited from operating an airport and claimed this to be expropriation. The respondent argued that all investors other than the 'statutorily appointed operator' had been prohibited from operating the airport in question and thus this action was not discriminatory[894] and that, in addition, 'since discrimination can only be argued when a comparable party which was treated differently exists, it is not possible to refer to discrimination in the present case due to the fact no such comparable parties exist'.[895]

The tribunal, however, concluded the case by saying that

> [i]t is correct for the Respondent to point out that in order for a discrimination to exist, particularly in an expropriation scenario, there must be different treatments to different parties. However and unfortunately, the Respondent misses the point because the comparison of

[893] ibid 57 and 59.
[894] *ADC Affiliate Limited and ADC & ADMC Management Limited v The Republic of Hungary* (*ADC Affiliate Ltd. v Hungary*), ICSID Case No. ARB/03/16, Award, 2 October 2006, para 397.
[895] ibid para 420.

> different treatments is made here between that received by the Respondent-appointed operator and that received by foreign investors as a whole.[896]

The tribunal, therefore, concluded that the State's prohibition of operation was indeed discriminatory in nature.[897]

Another case which is highly relevant to the current discussion is *Methanex*. In this case, the principle of nondiscrimination served as a key consideration in establishing expropriation.[898] The tribunal concluded that

> ...as a matter of general international law, a *non-discriminatory* regulation for a public purpose, which is enacted in accordance with *due process* and which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.[899]

[896] ibid para 442.
[897] ibid para 443.
[898] *Methanex* (n 726) Part IV, ch D, para 7.
[899] ibid.

Although expropriation was not found in this case, the tribunal contributed their thoughts on formulating a new approach to distinguishing lawful regulations from indirect expropriations that involves taking into account the considerations of nondiscrimination and due process.

6.5.2.2 Due Process

Due process was initially used as a 'legality' criterion to determine whether or not an expropriation was lawful, and thus the application of this principle came after expropriation had been found. Arbitration practice has shifted this trend by applying this principle as one of the criteria used to determine the occurrence of indirect expropriation. It was proved in *Methanex* that 'a *non-discriminatory* regulation for a public purpose, which is enacted in accordance with *due process* … is not deemed expropriatory and compensable'.[900]

The tribunal in *Middle East Cement Shipping and Handling Co v Egypt* examined the fact that the port authorities had seized and auctioned the claimant's ship, which constituted expropriation. The tribunal explained that although 'normally a seizure and auction ordered by the national courts do not qualify as a taking', they can be a 'measure, the effects of which would be tantamount to expropriation' if they are not taken '*under due process of law*'.[901]

[900] ibid.
[901] *Middle East Cement Shipping and Handling Co. S.A. v Arab Republic of Egypt* (*Middle East Cement v Egypt*), ICSID Case No. ARB/99/6, Award, 12 April 2002, para 139.

In *ADC Affiliate Ltd. v Hungary*, the tribunal, in order to determine whether the government's prohibition of operations constituted proper expropriation, conducted a step-by-step analysis, including consideration of whether this measure was discriminatory and whether it followed due process. The claimant, by making reference to the concept of due process in the context of expropriation, demanded that the host State should have provided the investor an opportunity to seek judicial review and to receive 'reasonable notice and the right to a fair hearing and an impartial adjudicator'.[902] The tribunal agreed with the claimant. It opined:

> …'[D]ue process of law', in the expropriation context, demands *an actual and substantive legal procedure for a foreign investor to raise its claims against the depriving actions already taken or about to be taken against it*. Some basic legal mechanisms, such as reasonable advance notice, a fair hearing and an unbiased and impartial adjudicator to assess the actions in dispute, are expected to be readily available and accessible to the investor to make such legal procedure meaningful. In general, the legal procedure must be of a nature to grant an affected investor a reasonable chance within a reasonable time to claim its legitimate rights and have its claims

[902] *ADC Affiliate Ltd. v Hungary* (n 894) para 376.

heard. If no legal procedure of such nature exists at all, the argument that 'the actions are taken under due process of law' rings hollow.[903]

6.5.2.3 Nonarbitrariness

In the jurisprudence of expropriation, the responsibility of the host State can be triggered when governmental measures are implemented in a manner that is inconsistent with the international standards that govern the exercise of such measures. The standard of nonarbitrariness has been 'adopted as the basis for determining whether international responsibility arises, applies, although not always to the same extent',[904] a determination which could be relied upon for testing the purposes and motives of the governmental measure concerned, which definitely play an integral role in determining whether the host State exercised its regulatory power with due diligence and thus whether its measure was expropriatory or not.[905] As has been mentioned, Article 17.2 of the Universal Declaration of Human Rights states that '[n]o one shall be *arbitrarily* deprived of his property'. Nevertheless, Article II (2) (b) of the 1992 U. S. Model BIT stated that '[n]either party shall in any way impair by *arbitrary* or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments'.

[903] ibid para 435.
[904] Doak Bishop, Crawford and Reisman (n 888) 838.
[905] Dolzer and Stevens (n 882) 61.

As regards the standard criteria for a governmental measure to be identified as 'arbitrary', in the *ELSI* case, the governmental measure was described as 'a typical case of excess of power, which is of course a defect in respect of lawfulness of an administrative act'.[906] Furthermore, a four-tier test was proposed by Kurt Hamrock: (1) the action taken was not authorized by law; (2) the action was taken for an improper purpose; (3) the action was taken because of irrelevant circumstances; or (4) the action was patently unreasonable.[907]

6.5.2.4 Denial of Justice

In contrast with nonarbitrariness and nondiscrimination, 'denial of justice' has been widely criticized in the literature for its scope (procedural matters and/or substantive matters) and for the circumstances under which it would be applied. In the context of expropriation, the rationale behind denial of justice is that the host State should provide an effective judicial and administrative mechanism for settling disputes regarding property taking.[908] Francisco Orrego Vicuña once commented:

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[906] *Case Concerning Elettronica Sicula, SpA (ELSI)* case (*US v Italy*), 1989 I.C.J. 15, Judgment, 20 July 1989, 76.

[907] Kurt Hamrock, 'The ELSI Case: Toward an International Definition of "Arbitrary" Conduct' (1992) 27 Tex Intl L J 837, 852. For more discussion on the content of this four-tier test, please see 853-62.

[908] Francisco Orrego Vicuña, 'Some International Law Problems Posed by the Nationalization of the Copper Industry by Chile' (1973) 67 Am J Intl L 711, 715.

> If there is unjustified delay in the administration of justice, grave procedural irregularities, manifestly unjust decisions, or failure to execute judgments in cases involving foreigners, the state can be made answerable for these denials of justice. Another related consideration is the composition of and access to judicial or administrative bodies having jurisdiction in such disputes.[909]

It was evidenced in the case of *Azinian v Mexico*, where the denial of justice issue was examined to determine whether 'the state exercises its executive or legislative authority to destroy the contractual rights as an asset',[910] which constitutes indirect expropriation.[911] The tribunal pointed out that the international tribunal is not a place like the courts of appeal. It argued:

> The possibility of holding a State internationally liable for judicial decisions does not, however, entitle a claimant to seek international review of the national court decisions as though the international jurisdiction seised has plenary appellate jurisdiction. This is not true generally, and it is not true for NAFTA. *What must be shown is that the court decision itself constitutes a violation of the treaty.*[912]

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[909] ibid.

[910] Ian Brownlie, *Principles of Public International Law* (5th edn, Clarendon Press 1998) 550.

[911] *Azinian* (n 799) para 89.

[912] ibid para 99.

The tribunal, however, explained the exceptions to this principle:

> A denial of justice could be pleaded if the relevant courts refuse to entertain a suit, if they subject it to undue delay, or if they administer justice in a seriously inadequate way…[913]

> There is a fourth type of denial of justice, namely the clear and malicious misapplication of the law.[914]

Although indirect expropriation was not found in this case, the tribunal certainly established the threshold for indirect expropriation claims in applying the principle of denial of justice.

6.5.2.5 Transparency

A governmental measure has to be implemented transparently in order for it not to trigger the State's international responsibility. Thus, transparency requires the State to act in a way that is necessarily predictable and consistent to foreign investors for the sake of maintaining stability and ensuring the confidence of

[913] ibid para 102.
[914] ibid para 103.

foreign investors.[915] The tribunal in *Metalclad* implied its consideration of transparency in concluding the occurrence of indirect expropriation. The tribunal concluded that the absence of a 'timely, orderly or substantive basis for the denial by the Municipality of the local construction permit' was one of the reasons that these governmental measures constituted indirect expropriation.[916] Although this ground seemed to be removed in concluding indirect expropriation in subsequent decisions of the Supreme Court of British Columbia, it is still of great significance in the current discussion.

One can seek guidance for understanding the underlying principle of transparency in bilateral investment treaties. BITs, for instance the 2012 U.S. Model BIT, have created a specific provision regulating the standard of transparency for the purpose of respecting investment.[917] In that provision, host States are required to follow duly and orderly publication procedures,[918] to

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[915] In the *Metalclad* case, the tribunal interpreted the principle of 'transparency' to be 'the idea that all legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another party. There should be no room for doubt or uncertainty in such matters'. See *Metalclad* (n 673), Award, 30 August 2000, para 76.

[916] ibid para 107.

[917] In the 2012 U.S. Model BIT, the detailed rules are in Article 11 ('Transparency'), especially in Article 11.2(a) which emphasizes the importance of Article 10 ('Publication of Laws and Decisions Respecting Investment') to ensuring that the legislative and administrative change has to respect foreign investment.

[918] 2012 U.S. Model BIT, arts 11.2 to 11.5.

provide an opportunity for comments from affected investors,[919] to give reasons for adopting such measures publicly,[920] to administer 'in a consistent, impartial, and reasonable manner'[921] and, in particular, to give reasonable notice to foreign investors regarding the measure,[922] and to ensure fair opportunity of 'review and appeal'.[923]

In the *Tecmed* case, the tribunal reviewed the government's refusal to renew the investor's permit to operate a landfill and took the duty of ensuring transparency into account in its analysis. The tribunal provided, although in the context of FET, that a government should act 'in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor' so that the foreign investor 'may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives' and 'be able to plan its investment and comply with such regulations'.[924]

However, in the *Feldman* case, which was discussed in the last chapter, the tribunal weighed the consideration of transparency with the facts of the case. According to the tribunal, they believed that the communications, both written

[919] ibid art 11.2(b).
[920] ibid arts 11.3(c) and 11.4(b).
[921] ibid art 11.6.
[922] ibid art 11.6(a).
[923] ibid art 11.7.
[924] *Tecmed v Mexico* (n 687) para 154.

and oral, between the governmental authority and the claimant were 'at best ambiguous and misleading',[925] and were even intended to be so in some instances, leading to the rebates being permitted on some occasions and denied on others.[926] Although the standard of transparency was seriously injured, the tribunal did not believe that a 'lack of transparency alone rises to the level of violation of NAFTA and international law, particularly given the complexities not only of Mexican but most other tax laws'.[927]

Even though it has not been recognized by international law, transparency can entitle foreign investors to claim direct remedy from the host State. The tribunal in the *Waste Management* case proposed that a transparency claim can trigger the host State's international obligation when the governmental measure constitutes a serious violation of due process and nonarbitrariness. It accepted due process to be part of the minimum standards of customary international law. The requirement of ensuring transparency is embodied in due process; however, 'a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process'[928] is a substantive component of due process.

[925] *Feldman v Mexico* (n 721) para 132.
[926] ibid.
[927] ibid para 133.
[928] *Waste Management v Mexico* (n 848) para 98.

6.5.3 Arbitration Practice of Other Considerations in Indirect Expropriation Cases

In *El Paso Energy International Company v Argentine Republic*, the claimant was from the United States. The claim was that the claimant had been persuaded by the Argentine Government's specially designed regulatory and legal framework to invest in the country's electricity and hydrocarbon industries. Subsequently, the government took a series of measures, during and after its economic crisis, which constituted fundamental breaches of its BIT obligations, and it was alleged that indirect expropriation had occurred. The tribunal thoroughly examined the theory of indirect expropriation, in particular for situations involving general regulations. By basing their analysis on non-compensable general regulations and compensable unreasonable general regulations, the tribunal distinguished the difference in their nature:

> In sum, a general regulation is a lawful act rather than an expropriation if it is non-discriminatory, made for a public purpose and taken in conformity with due process. In other words, *in principle, general non-discriminatory regulatory measures, adopted in accordance with the rules of good faith and due process, do not entail a duty of compensation*.[929]

[929] *El Paso Energy International Company v Argentine Republic* (n 783) para 240.

The tribunal went on to clarify the nature of compensable general regulations by pointing out that

> [i]f general regulations are unreasonable, i.e. *arbitrary, discriminatory, disproportionate or otherwise unfair*, they can, however, be considered as amounting to indirect expropriation if they result in a neutralisation of the foreign investor's property rights.[930]

Ultimately in this case, indirect expropriation was not found since the tribunal insisted that the necessary condition for indirect expropriation to be established is the 'neutralisation of property rights',[931] which means that 'the investor should be *substantially* deprived not only of the benefits, but also of the use of his investment. A mere loss of value, which is not the result of an interference with the control or use of the investment, is not an indirect expropriation'.[932]

In *Biloune v Ghana*,[933] the investor had been prohibited by a government affiliated entity from continuing its construction on the basis of the absence of a building permit when it had already completed a substantial amount of the work. The investor had submitted an application but never received a response. The tribunal in this case paid due attention to the investor's justifiable reliance on the

[930] ibid para 241.
[931] ibid para 254.
[932] ibid para 256.
[933] *Biloune v Ghana* (n 676) paras 207-10.

representations of the government about the permit application. The facts were that the government had known about the construction for more than a year before issuing the stop work order, that building permits had not been required for other projects (*discrimination*), and that there was no procedure for dealing with building permit applications (*transparency*). Due to these facts, the tribunal found that indirect expropriation had taken place.

In the *Methanex* case, the tribunal gave their decisions on the merits of the case and ultimately decided their lack of jurisdiction over the case. However, this case offers some insightful views as regards the determination of indirect expropriation. This case concerned an allegation brought by the world's largest methanol producer claiming that the State of California's ban on the use of MTBE, a methanol-based gasoline additive, constituted indirect expropriation. The tribunal opined as follows: 'Methanex is correct that an intentionally discriminatory regulation against a foreign investor fulfils a key requirement for establishing expropriation. But as a matter of general international law, a *non-discriminatory* regulation for a public purpose, which is enacted in accordance with *due process* … is not deemed expropriatory and compensable'.[934]

In *Feldman*, the claimant was a Mexican company owned and controlled by a U.S. citizen. The claimant sued the Mexican Government for not obeying the tax

[934] *Methanex* (n 726) Part IV, ch D, para 7.

laws concerning its export of tobacco products. The claimant alleged that through the conduct of its Ministry of Finance and Public Credit, Mexico's refusal to rebate excise taxes applied to cigarettes it exported and Mexico's continuing refusal to recognize its right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of several obligations under NAFTA, including an exercise of expropriation. According to the tribunal, they believed that the communications, both written and oral, between the governmental authority and the claimant were 'at best ambiguous and misleading',[935] and were even intended to be so in some instances, leading to the rebates being permitted on some occasions and denied on others.[936] Although the standard of transparency was seriously injured, the tribunal did not believe that 'lack of transparency alone rises to the level of violation of NAFTA and international law, particularly given the complexities not only of Mexican but most other tax laws'.[937]

In the *Tecmed* case, the claimant, a Spanish company with two subsidiaries in Mexico, wanted to seek remedies for its investment by alleging Mexico's violations of treaty protection. The claimant invested in a hazardous industrial waste landfill in 1996 but was unable to renew its license to operate from the Mexican government two years later. It thus claimed for its investment loss due

[935] *Feldman v Mexico* (n 721) para 132.
[936] ibid.
[937] ibid para 133.

to the arbitrary[938] and non-substantiated decision of the Mexican Government and sued Mexico for expropriation. The tribunal ruled in favor of the claimant and supported its expropriation claim. The tribunal further reviewed the government's refusal to renew the investor's permit to operate the landfill and took the duty of ensuring transparency into consideration in its analysis. The tribunal believed that a government should act 'in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor' so that the foreign investor 'may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives' and 'be able to plan its investment and comply with such regulations'.[939]

The tribunal in *Azinian* scrutinized the Mexican Government's termination of a concession agreement and examined the denial of justice issue to determine whether 'the state [exercising] its executive or legislative authority to destroy the contractual rights as an asset'[940] constitutes indirect expropriation.[941] According to the tribunal, indirect expropriation could be found 'if the relevant courts refuse to entertain a suit, if they subject it to undue delay, or if they administer justice in

[938] *Tecmed v Mexico* (n 687) para 98.
[939] ibid para 154.
[940] Brownlie (n 910) 550.
[941] *Azinian* (n 799) para 89.

a seriously inadequate way'[942] or if there is 'the clear and malicious misapplication of the law'.[943]

In a word, only by taking all necessary considerations into account and finding reasonable links between them, can an examiner finally conclude whether an alleged expropriatory measure constitutes indirect expropriation. By proposing and identifying the possible considerations in determining indirect expropriation, the fact-based and case-by-case approach has improved the reasonableness and predictability of this determination process and ensured the fairness of the final finding. In line with this analysis, a scientific examination would include, but not necessarily be limited to, following considerations: (1) legitimacy of the State's regulatory purpose, (2) degree of the State interference, (3) proportionality between the first two considerations, (4) legitimate expectations of foreign investors, and (5) transparency, nonarbitrariness, nondiscrimination, due process and denial of justice.

The legitimacy of the State's regulatory purpose can to a great extent testify whether the exercise of State regulatory power is bona fide and reasonable or not. If a State enforces measures with a purpose of preserving the health, safety or the environment, these measures are normally considered as general and non-

[942] ibid para 102.
[943] ibid para 103.

compensable, except that there are other considerations indicating the excessive unfairness of the measures' interferences.

These interferences should be measured according to their severity and duration; they should also be determined by examining whether or not they are proportionate to that purpose of enforcing such measures and whether or not there is a State's violation of investor's legitimate expectations. In addition, the determination of indirect expropriation should also consider whether the State measure was enacted in a nondiscriminatory and nonarbitrary manner; whether it was conducted transparently, and in accordance with the due process of law; and whether the host State has used its sovereign power to obstruct judicial justice and as a result indirectly expropriated the investor' property.

CONCLUSION

Expropriation is in the eye of the beholder.[944]

Barry Appleton

I know it when I see it.[945]

L. Yves Fortier

Indirect expropriation is a kind of expropriation but involves no physical taking or direct deprivation. Its effects, however, can substantially destroy the economic value of the investment or make the owner impossible to manage, use or control its property in a meaningful way. In practice, indirect expropriation may be exercised in a disguised and furtive way, making it look like general regulatory measures. Since these two kinds of measures are exercised by the same types of individuals and are through the same channels (e.g. administrative, legislative, or judicial), the major difference between them may only be that the outcome of indirect expropriation is so unfair and excessive for the foreign investor.

Identifying indirect expropriation needs clear and detailed rules due to the complexity of its factual situations. However, current legal rules have failed in

[944] Barry Appleton, 'Regulatory Takings: the International Law Perspective' (2002) 11 NYU Envtl L J 35, 48.
[945] L Yves Fortier, CC, QC and Stephen L Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2005) 13 Asia Pac L Rev 79, 110.

this task: Most IIAs only point out that unlawful expropriation is prohibited, or only cover general and open-ended provisions stating that foreign investment should not be expropriated indirectly. Most investment treaties and free trade agreements state this issue implicitly, concluding no principled approach to determine whether indirect expropriation has occurred or not.

The scope of the term has largely been left to international courts and tribunals to determine based on general rules of international law. Unfortunately, the arbitration practice has indicated that individual tribunals have reasoned and decided their cases to fit particular benefit and convenience. For instance, the sole effect doctrine was used to prevent investors from State's economic interference, and the police power doctrine was used to protect State's use of its regulatory power. As it turns out, there is still no principled approach which can resolve all conflicts and disagreements when determining indirect expropriation.

Current debates under international investment law center on whether, when and how indirect expropriation can be found, and thus the host State should make compensations to its foreign investors. This is never an easy task, especially confronted with the reality that only vague and general descriptions of indirect expropriation are provided by most IIAs and that highly case-specific reasoning has been given in various arbitral decisions. One scholar asserted: 'one gets the

impression that the tribunals are making their decisions primarily by applying broad equitable principles to the particular at hand'.[946]

Against this background, this thesis, through a step-by-step discussion ranging from an exploration of the very basic conflict between the host State's power/freedom and the associated responsibilities to regulate foreign investment to an examination of the detailed classification of all the necessary considerations that need to be taken into account in distinguishing a non-compensable regulatory measure from a compensable expropriatory measure, has concentrated on clarifying this issue on the basis of varying State practice, jurisprudence, doctrines, and criteria and by researching all associated materials to support the evidentiary process.

Consequently, this thesis argues that a balanced, fact-based, and case-by-case analysis should be encouraged and promoted to deal with the issue of how to determine the occurrence of indirect expropriation in current international investment law. The benefits of adopting such a determination approach are obvious: It balances the rights and interests of both States and foreign investors and creates a relatively consistent and predicable analytical framework for all practitioners to follow, removing the confusion that exists regarding this particular issue that has already caused so much chaos in today's expropriation

[946] Joel C Beauvais, 'Regulatory Expropriations under NAFTA: Emerging Principles and Lingering Doubts' (2002) 10 NYU Envtl L J 245, 279.

jurisprudence. By this token, 'it is evident that the question of what kind of interference short of outright expropriation constitutes a "taking" under international law presents a situation where the common law method of case by case development is pre-eminently the best method, in fact probably the only method, of legal development'.[947]

It has been proposed and suggested that only by taking all necessary considerations into account and finding reasonable links between them can an examiner finally conclude whether an alleged expropriatory measure constitutes indirect expropriation. Therefore, in line with the findings of this thesis, the following analytical steps and considerations are of great importance:

1. As the first step, it is necessary to find out whether the measure (or measures) was attributable to the host State: that is to say, whether the concerned measure was an exercise of the State's sovereign power (either executive, legislative, or judicial power or all of these) and thus could be held liable for compensation according to the applicable domestic law and international law.

2. Secondly, one needs to examine whether the State measure has interfered with the foreign investment. To successfully hold a State liable for its

[947] GC Christie, 'What Constitutes a Taking of Property under International Law' (1962) 38 Brit Y B Intl L 307, 338.

conduct, the concerned investment must be made in accordance with applicable legal requirements; it must not be used for dangerous or noxious purposes. Furthermore, the linkage between the State measure and its consequences on the investment should not be too remote.

3. Thirdly, the legitimacy of the State's regulatory purpose has to be properly established. For instance, a legitimate public welfare purpose such as preserving *health, safety, and the environment* can, to the greatest extent, be accepted as the bona fide exercise of State police power and thereby reduce the potential risk of the host State being accused of enacting expropriatory measures.

4. Fourthly, whether the interference of the State measure is serious enough to find indirect expropriation is another issue to be considered. Such a determination of State interference should be divided into two parts – examining (a) the severity of the interference and (b) its duration.

5. Fifthly, the purpose and the effect of a regulatory measure need to be weighed together to finally determine the nature of the State measure. That is to say, the fact that a measure is being implemented in accordance with a public purpose cannot in itself determine whether this measure is expropriatory or not, but it may serve as the basis for the host State to

excuse itself from the duty to compensate, and even if the regulatory purpose is legitimate, one still needs to consider whether (a) the measure was enacted directly according to the purpose, (b) any other clearly less restrictive measure was available to the host State, and (c) the enacted measure has an excessively harmful effect. Legitimate expectations of foreign investors are an additional consideration: According to this doctrine, a foreign investor has expectations that the host State will/will not act in a certain way; a violation of such expectations will have adverse influence on foreign investment and may hold the State liable for its act.

6. Last but not least, the determination of indirect expropriation should also consider whether the State measure was enacted in a nondiscriminatory and nonarbitrary manner with transparency and in accordance with the due process of law. Additionally, whether the host State used its sovereign power to obstruct judicial justice and as a result indirectly expropriated the investor' property is another consideration that needs to be taken into account when seeking to determine the occurrence of indirect expropriation.

This suggested sequence of analytical steps is not fixed and invariable: It outlines a possible formulation with necessary considerations that is feasible for dealing with indirect expropriation claims, but it also needs to be fitted into the exact facts of each individual case, bearing in mind that it is not a mechanical tool.

Moreover, the considerations outlined above are more useful than the actual analytical steps in determining the occurrence of indirect expropriation: previous arbitral decisions and current treaty law have testified to their relevance and usefulness. These considerations can be well managed according to the specific case under consideration, allowing a determination formulation to be established for each individual case.

Nevertheless, the findings of this thesis can also be contributive to the States' legislative process at the time when they are designing their own national legal framework or participating in the globalized treaty practice. States, as the rule-makers and major participants in international investment activities, have to be legally responsible for what they do and also responsible for how their national investors are treated abroad. From the perspective of both national and international law, some suggestions in related to the issue of indirect expropriation are offered below for host States' considerations based on the findings of this thesis.

On one hand, host States need to strengthen the legality of their own regulatory measures. A country under the constitutional demand of the rule of law and the extensive impact of globalization has to strengthen the construction of its legal framework, setting up the legal requirements for enforcing administrative and legislative measures. Specifically, the increase in cross-border activities has

demanded the integration of international experience and a country's own customs in the globalized economy. In-depth research on the definition and limitations of police power both in the United States and in international law has evidenced the importance of seeking a balance between private property protection and public regulatory power as a core value and underlying philosophy. Every decision on, and every interpretation of, the State's regulatory power is based on a thorough examination of a case's specific facts and a review and analysis of previous decisions. Therefore, these decisions and interpretations are produced after going through a weighing and balancing process to reach a balance between reasonably limiting public power and fairly protecting private rights.

It is more important for host States to strengthen the legality of their own regulatory measures, defining where, when, and how the State can legitimately regulate the foreign investments in its territory. Unlike the practice in the United States where the doctrine of police power has been well argued and counter-argued through case law, some other States need to promulgate a well-framed legal regime of regulatory rights and regulatory boundaries in their own written law frameworks. Then, by incorporating detailed legislative and judicial interpretations, their legal regimes would be capable of dealing with future expropriation claims, as well as other foreign administrative claims, according to the law and foreign investors would be able to confidently invest in these States

as they would all have a predictable, consistent, and stable investment protection environment.

On the other hand, States have to improve their treaty language for determining indirect expropriation. By concluding IIAs, States have devoted themselves to the goal of integrating themselves into the international legal framework, thereby increasing the predictability and stability of their investment environment. To advance along this path of progress, States need to seriously formulate their treaty language regarding the issue of expropriation and indirect expropriation. From at least three main perspectives, this issue can be well managed and balanced, which is in the interests of all participants. The intention of this thesis is not to change the entire landscape of international investment law but rather to provide a basis for future development and to offer reasonable guidance to ensure that the issue of indirect expropriation is examined in a consistent and correct way. After all, a well-founded legal system is the ultimate regime for settling investor-State disputes.

A. Clarifying the Definitions of Direct and Indirect Expropriation

First of all, it is important to explain the basic nature of expropriation by emphasizing what direct expropriation is and what form it takes. To further explore how traditional expropriation has developed, the characteristics of indirect expropriation should be elaborated, explaining that the effect of indirect

expropriation is tantamount, or equivalent, to that of direct expropriation and pointing out the essence of the differences between them (e.g. no transfer of legal title). It has been suggested that an expropriation provision could be formulated as follows:

> *Expropriation may be either direct or indirect:*
>
> *(a) Direct expropriation occurs where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure;*
>
> *(b) Indirect expropriation occurs where a measure or series of measures by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.*[948]

B. Establishing the Analytical Framework of Indirect Expropriation

Identifying the necessary factors that have to be considered in determining the occurrence of indirect expropriation, and thereby framing the reasonable boundaries for it, is crucial. All of these factors should be 'used in combination, as part of a global assessment, and on a case-by-case basis'.[949] Great value is attached to the economic effect of a measure or measures, but this is not the exclusive consideration. Other considerations include the following: What is the nature or character of these measures? Are there any legitimate expectations of

[948] UNCTAD, *Expropriation: A Sequel* (United Nations 2011) 128.
[949] ibid.

the foreign investor? What kinds of expectations are legitimate and specific enough to be reasonably relied upon by investors? These questions rule out the application of the sole effect test and indicate the need to adopt a case-by-case and fact-based approach to balance the regulation-expropriation determination. The following could be a possible formulation:

> *The determination of whether a measure or series of measures of a Party constitute an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:*
>
> *(a) The economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;*
>
> *(b) The extent to which the measure or series of measures interfere with distinct, reasonable investment-backed expectations [arising out of the Party's prior binding written commitment to the investor]; and*
>
> *(c) The character of the measure or series of measures.*[950]

C. Preserving the Legitimate Exercise of Police Power

The State's power to regulate its domestic matters with the aim of promoting the public interest and public welfare has to be safeguarded. The police power

[950] ibid 129.

provision is intended to preserve the legitimate and non-compensable regulatory freedom of the host State on condition that the measure or measures it implements are exercised in good faith (against arbitrariness and discrimination) and in accordance with applicable legal requirements (for example, due process, transparency, and justice). Nevertheless, a well-balanced measurement should be made between the ends of these measures and their means as this would question whether the governmental measure is unreasonable and excessive and thus constitutes indirect expropriation. Therefore, the police power clause is designed to organize these considerations as a whole in order to build a compensation-free mechanism. A possible formulation to preserve the State's legitimate exercise of police power would be as follows:

> *Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, nondiscriminatory and nonarbitrary measures of a Party that are lawfully designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.*

Giving indirect expropriation a conclusive definition is impossible. What is possible is to set certain legal criteria on such a flexible concept and bring these

criteria to life in a diversity of factual situations. Therefore, these detailed suggestions for determining indirect expropriation are not intended to change the entire landscape of international expropriation law. They aim to resolve the current disagreements, conflicts and confusions in determining indirect expropriation through improving legal consistency, predictability and stability as well as balancing the rights and interests of both host States and foreign investors.

All in all, this thesis has preferred using a balanced, fact-based, and case-by-case analysis among other approaches to deal with the issue of how to determine indirect expropriation in current international investment law. The benefits and advantages of this analysis still wait to be fully discovered through the development of international treaty law and the observation from investor-State arbitration practice. Work in search of a unified method or formulation for determining indirect expropriation, however, is clearly important and necessary, and will likely occupy the international investment law scholars and practitioners in next several years.

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