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**Indirect and Regulatory Expropriation in International
Investment Law:
A Critical Review**

Submitted in fulfilment of the requirements for the Degree of Masters of Laws (LL.M) by
Research

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Abstract

The task of this thesis is to critically review the established position, regarding the distinction that exists between compensable indirect and non-compensable regulatory expropriation by states. It is commonly asserted that indirect expropriation by states will merit swift and adequate compensation for investors that suffer damage to their property. However indirect expropriation that is the result of the exercise of state regulatory practices will not result in any such award to investors. In order to be convincing the distinction between these two practices must be clearly identifiable. Moreover the concepts used to construct these doctrines must be sufficiently robust to withstand logical scrutiny. The central argument of this thesis is that the distinction is not sufficiently clear to be credibly defended in the context of investment disputes.

Throughout, this thesis draws on the rulings of investment tribunals and the writings of scholars on how this distinction has been created and subsequently defended in international investment law. Furthermore it also seeks to grapple with the challenges that appear evident in reconciling the rights of states and investors when dealing with a claim of expropriation.

The intention in doing so is to appraise the accepted wisdom, and to highlight the underpinning rationale so as to demonstrate the fundamental flaws that have created the current state of affairs in international investment law.

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The responsibility for any errors within this thesis is my own.

I declare that, except when explicit reference is made to the contributions of others, that this thesis is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution

Signature: _____

Name: _____

Chapter 1

Introduction

The law of foreign investment is one of the most dynamic areas of international law.¹ Within this sphere, investors and host state's come together and form a relationship which will, hopefully, be to their mutual advantage.

One of the most topical areas within the field of international investment law is that of expropriation. Arguably, the subject of the greatest debate in this field is the difference that is said to exist, between compensable expropriatory acts and non-compensable expropriatory acts.² In the past the distinction was said to have been quite clear, until it was 'befuddled' by the expansion of the concept of expropriation in international law.³ Central to this challenge is the question of the relationship between the essential regulatory powers, the 'police powers' and the legitimate protection of investors in international investment law.⁴ From the doctrinal point of view the main controversy lies in distinguishing what in the standard international investment law vocabulary is commonly described as indirect expropriation from bona fide, police power regulatory expropriation.⁵ The basic framework, in principle, is very clear: Indirect expropriation is a form of expropriation that can be caused by regulation. However it is distinct from direct expropriation due to the fact that while it does not transfer title to property, it still attracts the principle of compensation. Opposed to this is the idea of regulatory expropriation which is distinguished from indirect expropriation, not because regulation is involved but the fact that there is no compensation due to be paid to aggrieved investors.

¹ R. Dolzer, and C. Schreuer, *Principles of International Investment Law* (Oxford, 2012) p12; See also K. Miles, *The Origins of International Investment Law*, (Cambridge, 2013)

² *ibid* p120; A. Newcombe, '*The Boundaries of Regulatory Expropriation in International Law*', (2005) ICSID Review, Vol. 20(1), p3; R. Higgins, '*The Taking of Property by the State: Recent Developments in International Law*', (1982-III) 176 *Recueil des Cours* 259, p331

³ M. Sornarajah, *The International Law on Foreign Investment*, (Oxford, 2012), p363. In the US the practice is to refer to expropriations as 'takings', but this terminology will not be adopted in this thesis.

⁴ *Ibid* p374.

⁵ A. Newcombe, '*The Boundaries of Regulatory Expropriation in International Law*' (2005) ICSID Review, Vol.20 (1), p25

Both international investment law scholarship and tribunal practice broadly reflect that states are entitled to regulate domestic affairs under the rubric of ‘police powers’. However, there is often some confusion as to what precisely the concept of ‘police powers’ actually means,⁶ which causes some concern in the context of investment disputes where a state’s adoption of regulatory measures results in no compensation being paid to the investor. As a result, some scholars have questioned whether the distinction between indirect expropriation and regulatory expropriation is able to stand up to logical scrutiny.⁷ Unfortunately there has been little consensus on this issue in international investment law. It is for this reason that it will be the subject of discussion in this thesis.

The methodology of this thesis is derived to a large extent from the work of Jacques Derrida and in particular his theory of ‘deconstruction’.⁸ ‘Deconstruction’, as it is understood here, is an analytical operation that has as its central aim the identifying of “hierarchical oppositions, followed by a temporary reversal of the hierarchy”.⁹ The point of this reversal is not only to demonstrate a false dichotomy between the two ends of the opposition.¹⁰ The aim is to demonstrate the similarities and differences that exist within this hierarchy and which are otherwise commonly suppressed or overlooked,¹¹ and to highlight the inconsistent manner in which the hierarchy is thus maintained. In international investment law it is a well-recognised rule that a state’s expropriation of the property of foreign investors, whether exercised for public purposes or not, warrants swift and adequate compensation.¹² However where a state expropriates the said property through the use of ‘police powers’ and in pursuit of *bona fide* public interest, it is often assumed also that there should be no requirement to compensate investors for any

⁶ *ibid*; see also V. Been and J. Beauvais, ‘*The Global Fifth Amendment? NAFTA’s Investment Protections and the Misguided Quest for an International “Regulatory Takings” Doctrine*’, (2003), N.Y.U. L. Rev., Vol. 78, p53

⁷ See R. Higgins, ‘*The Taking of Property by the State: Recent Developments in International Law*’, (1982-III) 176 *Recueil des Cours* 259, p331 where she asks “Is this distinction intellectually valid? Is not the State in both cases (that is, either by taking of a public purpose, or by regulating) purporting to act in the common good? And in each case has the owner of property not suffered loss?”

⁸ See J. Derrida, *Of Grammatology* (Gaytri Chakravorty Spivak trans., Johns Hopkins University Press 1976, 1967)

⁹ J. Balkin, ‘*Deconstructive Practice and Legal Theory*’ (1986) *Yale L.J.*, Vol.96 (4), p746. The author does appreciate that the idea of being able to define the approach of Deconstructivism is controversial, given that Derrida himself famously remarked that he did not want future disciples of his to simply act and write as he does. See J.Derrida, *The Politics of Friendship* (2005, Verso) p42. However, for practical purposes a definition here aims to provide a grounding for the use of Deconstruction and its application to law.

¹⁰ J. Balkin, “*Deconstruction’s Legal Career*” (2005) Vol. 27 *Cardozo L.Rev* p729

¹¹ *Ibid* p730

¹² OECD ““Indirect Expropriation” and the “Right to Regulate” in International Investment Law”, OECD Working Papers on International Investment, (2004, OECD Publishing) p2. Available at http://www.oecd.org/daf/inv/investment-policy/WP-2004_4.pdf

detrimental impact they may have suffered.¹³ The conceptual framework that underpins this distinction, thus, seems to be premised on a clear – and as Derrida would argue – clearly hierarchical distinction between two oppositional concepts: expropriation and regulation. This thesis will attempt to demonstrate the fundamental instability of this conceptual framework by, firstly, highlighting the essential similarities shared by the two opposite concepts; and secondly, by arguing that the opposition between them is not intellectually viable.

The use of deconstruction in legal scholarship is traditionally associated with Critical Legal Studies (CLS), to which the author owes a debt of gratitude for providing a framework as to how to apply deconstructive theory to the law.¹⁴

¹³ C. Henckels, “*Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and The Standard of Review in Investor-State Arbitration*” (2012) J Intl Econ L, Vol. 15 (1), p225

¹⁴ See D. Kennedy, “*A Semiotics of Critique*” (2001) Cardozo L. Rev Vol. 22 (2), p1189: “There are four steps to follow as one gets ready to do some critical theory within law...First: identify a distinction that drives you crazy...Second: find in each half of the distinction the traits, things, aspects, qualities, characteristics, or whatever was supposed to be located in the other half, and vice versa...Third: put the question whether the distinction which you have just destabilized corresponds to a real division in reality on hold...and instead try to figure out why people who use the distinction work so hard to maintain belief in it in the face of their own doubts...Fourth: trace the consequences of the distinction”. The author does appreciate that the idea of the analytical tool of Deconstruction being reduced to a formula to be repeated over and over again in non-philosophical fields is in direct opposition to what Derrida had in mind. See R. Mailey ‘*Deconstruction and the law: a prelude to a deconstructive theory of judicial interpretation*’ (2012) LL.M (R) thesis, University of Glasgow p68. However, the framework which Kennedy offers makes Deconstruction more palatable to the author.

Chapter 2

Expropriation

One cannot understand the meaning of the concept of indirect expropriation in modern international investment law, without first understanding the founding principles of the law of expropriation more broadly. Since its infancy as the ‘law governing the protection of alien property’,¹⁵ international investment law has developed into a highly sophisticated system for the protection of investors interests. The purpose of this chapter is to establish the distinctions which exist within the conceptual framework that is used in the law of expropriation, and to illustrate how these distinctions are identified in practice by investment tribunals and commentators.

The concept of expropriation in international law has been traditionally defined as “...individual measures taken for a public purpose”.¹⁶ Much of what would be traditionally considered expropriation occurred historically in the context involving actions by developing state’s who sought to reassert control over their resources, as part of their anti-colonial struggle.¹⁷ The act of expropriation, or the taking of title to property of foreign investors is not in itself an illegal act, a fact long recognised in customary international law.¹⁸ Nevertheless, the established consensus holds, certain criteria have to be met for expropriation to be valid. Thus the Restatement (Third) state’s:

[a] state is responsible under international law for injury resulting from: (1) a taking by the state of the property of a national of another state that (a) is not for a public purpose, or (b) is discriminatory, or (c) is not accompanied by provision for just compensation.¹⁹

This same view is supported by international judicial practice. As noted by the Permanent Court of International Justice (PCIJ):

¹⁵ Dolzer and Schreuer, *supra*, n1, p1

¹⁶ OECD, *supra* n12, p3

¹⁷ S. Ratner, ‘*Corporations and Human Rights: A theory of Responsibility*’ (2001) Yale. L.J, Vol.111 (3) pp454-457.

¹⁸ K. Schefer, *International Investment Law: Texts, Cases and Materials*, (2013, Glos) p168

¹⁹ Restatement (Third) of the Foreign Relations Law of the United States (1987)

[O]ne of the essential elements of sovereignty is that it is to be exercised within territorial limits, and that failing proof to the contrary, the territory is co-terminous with the Sovereignty.²⁰

The Permanent Court of Arbitration also recognised the sovereign right of states to expropriate under international law:

the power of a sovereign state to expropriate, take or authorize the taking of any property within its jurisdiction which may be required for the "public good" or for the "general welfare".²¹

This same position is held also by the scholarly authorities. Thus Reinisch writes that expropriation is lawful and within a state's sovereign authority under international law provided that the terms of the Restatement (Third) are observed.²² Sornarajah notes that "...the state has a right to control property and economic resources within its territory to enhance its economic, political and other objectives".²³ Furthermore as Haque and Burdescu write, the power of state's to expropriate stems from "...principles of sovereignty" in international law.²⁴

In modern practice, the use of direct expropriation by states has become increasingly rare, owing to the negative international political consequences that attach to such actions.²⁵ Investors will understandably invest in state's that operate a stable economy in a prudential way, which have a history of honouring international commitments. State's will attempt to provide such a forum, with a view to using foreign investment to develop their domestic interests. As a result it is unlikely that a state will consciously seek to directly expropriate foreign investments, if such action can be avoided

²⁰ *North Atlantic Fisheries Arbitration* (Great Britain v United States of America) (1910) 11 RIAA 167, para 180

²¹ *Norwegian Shipowners Claims* (Norway v United States), Award, 13 October 1922, Vol.1, p332. Available at http://legal.un.org/riaa/cases/vol_1/307-346.pdf

²² A. Reinisch, 'Expropriation' in *The Oxford Handbook of International Investment Law*, ed. P. Muchlinski, F. Ortino and C. Schreuer (2008, Oxford), p437. See also P. Isakoff, 'Defining the Scope of Indirect Expropriation for International Investments', (2013), *Global Bus. L. Rev* Vol.3, p191 and A. Lowenfeld, *International Economic Law*, 2nd edition (2008, Oxford) p559

²³ Sornarajah, *supra* n3, p364

²⁴ I. Haque and R. Burdescu, 'Monetary Consensus on Financing for Development: Response Sought from International Economic Law' (2004) *B.C. Int'l & Comp. L. Rev* Vol.27, p249

²⁵ Schefer, *supra* n18, p203

Expropriation can occur through other, less obvious means.²⁶ The concept of indirect expropriation was developed to accommodate for this fact. What exactly this concept is supposed to cover, however, remains a matter of considerable contention. Some commentators have proposed to identify indirect expropriation as any act short of direct expropriation that "... leaves the investor's title untouched but deprives him of the possibility of utilizing the investment in a meaningful way".²⁷ An alternative definition that has been suggested is of its being "...the result of a progression of [state] regulatory measures".²⁸ Still others have suggested the broad definition of "wealth deprivation".²⁹ In light of the various opinions on the meaning of indirect expropriation that exist, as noted by Olynyk, "...most investment treaties do not expressly address the issue of indirect expropriation"³⁰. Different legal texts have addressed indirect expropriation in different ways. Most investment treaties will "...prohibit expropriations and 'measures having equivalent effect'".³¹ In the Harvard Draft Convention on the International Responsibility of State's for Injuries to Aliens, indirect expropriation is defined as,

any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an interference 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.³²

Furthermore the 1992 World Bank Guidelines state that:

²⁶ L. Fortier and S. Drymer, 'Indirect Expropriation in the law of International Investment: I Know It when I see It or Caveat Investor?' (2004) ICSID Review, Vol.19(2), p297

²⁷ Dolzer and Schreuer, Supra n1, p101

²⁸ P. Isakoff, 'Defining the Scope of Indirect Expropriation in International Investments' (2013) Vol.3 Global Bus. L. Rev p195

²⁹ OECD, supra n12, p3. See also B. Weston, 'Constructive Takings under International Law: A Modest Foray into the Problem of Creeping Expropriation' (1975) Va. J. Int'l L. Vol.16 (1), p112

³⁰ S. Olynyk, 'A Balanced Approach to Distinguishing Between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration' (2012), Intl'l Trade & Bus. L. Rev, Vol.15, p260

³¹ R. Dolzer and M. Stevens, *Bilateral Investment Treaties* (1995, The Netherlands), p.245

³² Draft Convention on International Responsibility of States for Injuries to Aliens, Art.10(3)(a), in L.Sloan and R. Baxter, 'Responsibility of States for Injuries to the Economic Interests of Aliens' (1961) Am. J. Int'l L., Vol.55, p553

A state may not expropriate or otherwise take in whole or in part a foreign private investment in its territory, or take measures which have similar effects, except where this is done in accordance with applicable legal procedures, in pursuance of good faith of appropriate compensation.³³

Moreover the Energy Charter Treaty provides that:

Investments of investors of a Contracting Party in the Area of any Contracting Party shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation...³⁴

Many of the investment treaties that have been entered into by France refer to “measures of expropriation or nationalisation or any other measures the effect of which would be direct or indirect dispossession”.³⁵ Furthermore UK investment treaties refer to measures “having effect equivalent to nationalisation or expropriation”.³⁶ This is also the practice of the United States:

Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization.³⁷

This practice is also reflected in Chinese investment treaties:

Neither contracting Party shall expropriate, nationalize or take other similar measures (hereinafter referred to as ‘expropriation’).³⁸

However these treaty provisions do little to provide clarity on what are largely vague and wide-ranging definitions of indirect expropriation.

³³ World Bank, *World Bank Guidelines on the Treatment of Foreign Direct Investment* (1992), available at <http://ita.law.uvic.ca/documents/WorldBank.pdf>

³⁴ Energy Charter Treaty, opened for signature 17 December 1994, 2080 UNTS 95 (entered into force 16 April 1998)

³⁵ OECD, *supra* n12, p6

³⁶ *ibid*

³⁷ US Model BIT 2012, art.61.

³⁸ Agreement between the Government of the People’s Republic of China and the Government of the Republic of Cote d’Ivoire on the Promotion and Protection of Investments of 30 September 2002, art.4.1

The common theme that emerges from the various definitions seems to be that in principle, the question of how to distinguish between direct and indirect expropriation ought not to pose any problems: direct expropriation by a state will see an investor lose legal title to their property, indirect expropriation in contrast will leave the legal title to property intact, but may have some other negative impact on the value of the investment, "...depriving an owner of fundamental rights of property".³⁹ Reading through the literature suggests another important distinction: indirect expropriation unlike direct expropriation will typically occur following a series of state actions, as opposed to a single act.⁴⁰ The language used in many bilateral investment treaties (BITs), as evidenced above, reflects this understanding.⁴¹

Both states and investors will present different views on what will or will not constitute an indirect expropriation, with a view to protecting their own interests. The work of international courts and tribunals is instructive in pointing out how international investment law identifies instances of an indirect expropriation across vastly differing factual circumstances.

One of the more well known instances of a claim by investors that their investments had been the subject of indirect expropriation was in the *German Interests in Polish Upper Silesia*⁴² case. The case concerned a dispute between Germany and Poland following the signing by the German Government in 1915, with the Bayerische Stickstoffwerke Company of Trostberg, Upper Bavaria, of a contract which provided for, amongst other things, the construction of a nitrate factory at Chorzow (Upper Silesia). Land had been acquired on behalf of Germany which was entitled to exercise a degree of control over the factory, a share in its profits and the conditional right to terminate the contract. The machinery and equipment were to be installed by the Company, which would be responsible for managing the factory and for this purpose, was permitted to make use of all its patents and licenses. In December 1919 the German Government sold its interest in the Chorzow factory – the land, buildings, stocks etc – to a new company while the management and operation of the factory was to remain with Bayerische. However the

³⁹ Fortier and Drymer, *supra* n26, p294

⁴⁰ *ibid*, p297

⁴¹ *ibid*

⁴² *Certain German Interests in Polish Upper Silesia* (Germany v Poland) (Jurisdiction) [1926] PCIJ Ser A No 7.

decision by a domestic court reversed the sale, and provided for the property rights in the company to be returned to Poland. A Polish representative took possession of the factory and all patents and licenses. The matter was eventually brought before the PCIJ where it was claimed that the rights of the Bayerische had been infringed following the decision by Poland to take over the factory.

The Court ultimately ruled that the taking of the factory did constitute an indirect expropriation of the patents and licences to which the Bayerische had a right:

Moreover it is clear that the rights of the Bayerische to the exploitation of the factory and to the remuneration fixed by the contract for the management and exploitation and for the use of its patents, licenses, experiments, etc, have been directly prejudiced by the taking over of the factory by Poland. As these rights related to the Chorzow factory and were, so to speak, concentrated in that factory, the prohibition contained in the last sentence of Article 6 of the Geneva Convention [adopted to implement the Treaty of Versailles] applies in respect of them...and the attitude of Poland in regard to the Bayerische has therefore...been contrary to Article 6 and the following articles of the Geneva Convention.⁴³

As noted by Kriebaum, the Court "...did not distinguish between a direct and indirect expropriation as far as the legal consequences and effects of the interference were concerned".⁴⁴ As such, the ruling is not as sophisticated as that of later decisions by investment tribunals. However the decision is sufficiently clear to demonstrate the occurrence of indirect expropriation by states in international law.

The PCIJ dealt with issues of expropriation in a number of other cases, most notably in the *Oscar Chinn* case.⁴⁵ The case concerned a dispute between the UK and Belgium regarding the support given by Belgium to state ran businesses. Mr Chinn was a British national who ran a shipping business on the Belgian Congo in 1929. His main competitor was a company that was controlled by the Belgian state. During the 1930's Belgium experienced an economic crisis during which, the government ordered all state owned businesses to

⁴³ *ibid*, para 44

⁴⁴ U. Kriebaum, 'The PCIJ and the Protection of Foreign Investments' in *Legacies of the Permanent Court of International Justice*, (ed.) C.Tams and M. Fitzmaurice Vol.13, p157

⁴⁵ *The Oscar Chinn Case* (Britain v Belgium), Judgement, 12 December [1934], PCIJ. Available at http://www.worldcourts.com/pcij/eng/decisions/1934.12.12_oscar_chinn.htm

reduce their carriage charges and assured them that the government would reimburse them for any losses they suffered. This had a severe impact on the shipping business on the Congo. Mr Chinn was forced to close his business before the Belgian state offered any reimbursement to non-state controlled businesses. The UK government exercised diplomatic protection for Mr Chinn and brought a claim before the PCIJ alleging, amongst other things, that the measures of the Belgian state indirectly deprived Mr Chinn of “...any prospect of carrying on his business profitably”⁴⁶ and that this “constituted a breach of the general principles of international law, and in particular of respect for vested rights”.⁴⁷

The Court acknowledged that the measures taken by the Belgian state did have a negative impact on Mr Chinn’s financial position.⁴⁸ However it was not persuaded that his having to endure a less than favourable business environment was indicative of a breach of international investment law on the part of Belgium:

The Court...is unable to see in [Mr Chinn’s] original position - which was characterized by the possession of customers and the possibility of making a profit - anything in the nature of a genuine vested right. Favourable business conditions and goodwill are transient circumstances, subject to inevitable changes ; the interests of transport undertakings may well have suffered as a result of the general trade depression and the measures taken to combat it.⁴⁹

The Court made clear that a change in the economic conditions is a typical hazard of operating in a commercial environment, and that it is not evidence of a violation of vested rights by a state.⁵⁰ It went on to state that the actions of the Belgian Government:

... cannot, however, be regarded in itself as an admission by the Belgian Government of a legal obligation to indemnify the transporters for an encroachment on their vested rights; it is rather to be ascribed to the desire of every government to show consideration for different business interests, and to offer them some

⁴⁶ Ibid, para 98

⁴⁷ ibid

⁴⁸ Ibid, para 99

⁴⁹ ibid

⁵⁰ Ibid, para 100

compensation, when possible. The action of the Government appears to have been rather in the nature of an act of grace.⁵¹

This ruling of the PCIJ is further evidence of how traditional international law dealt with allegations of indirect expropriation in early investment disputes: while the Court recognised the impact of the measures taken by Belgian state on Mr Chinn, it refused to recognise them as amounting to a case of indirect expropriation.

The approach of the PCIJ towards claims of indirect expropriation should be compared with that of modern international investment law, as in the case of *Goetz v Burundi*,⁵² where an International Centre for the Settlement of Investment Disputes (ICSID) tribunal had to rule on the revocation, by the host state, of a free-zone status accorded to a foreign investor. The company AFFIMET, incorporated in Burundi, was involved in the production and marketing of valuable metals, and was owned by a group of Belgian investors. AFFIMET was provided with a ‘certificate of free zone’ by Burundi in 1993, which bestowed tax and customs exemptions on the company. However, two years after having granted the certificate, Burundi withdrew AFFIMET’s tax and customs exemptions, arguing that the free zone regime no longer applied to companies involved in the extraction and sale of ore. As a result of the withdrawal of the certificate of free zone, the Belgian investors suffered losses.⁵³ Although the tribunal found that there had been no formal taking of property – no direct expropriation – it found that the government’s actions constituted a measure having similar effect to expropriation and agreed that an indirect expropriation had taken place:

Since...the revocation for the Minister for Industry and Commerce of the free zone certificate forced them to halt all activities...which deprived their investments of all utility and deprived the claimant investors of the benefit which they could have expected from their investments, the disputed decision can be regarded as a ‘measure having similar effect’ to a measure depriving of or restricting property within the meaning of Article 4 of the Investment Treaty.⁵⁴

⁵¹ Ibid, para 101

⁵² *Antoine Goetz v Republic of Burundi*, Award, 2 September 1998 ICSID Reports 5.

⁵³ Introductory Note, *Antoine Goetz v. Republic of Burundi* (ICSID Case No.ARB/95/3). Available at <https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC536&caseId=C151>

⁵⁴ *Goetz v Burundi*, supra n52, para 124

Note the tribunal's reasoning as to what constitutes indirect expropriation. While it was conceded that there was no direct expropriation, the tribunal had regard for the fact the free zone certificate was the only thing that allowed AFFIMET's operation to be commercially viable in Burundi and its removal was deemed sufficiently detrimental to fall foul of anti-expropriation provisions.

International investment law practice has also had to deal with claims concerning questions of indirect expropriation, in cases where the main issue at hand involved the organisation of the administrative system of a state. A classic illustration of this was in *Metalclad v Mexico*.⁵⁵ Metalclad, a US company, had been given permission to develop and operate a dangerous waste landfill by the Mexican Federal Government, which was built in March 1995. The company had concluded an agreement with federal authorities on how the facility would operate, but the local authority challenged this and issued a denial of construction permit that was requested thirteen months earlier. The local authority also obtained a judicial injunction that prevented the facility from operating through May 1999. As a result, Metalclad suffered losses on its investment and argued that Mexico had violated Article 1110 of the North Atlantic Free Trade Agreement (NAFTA), which provides that "no Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of an investment". The arbitral tribunal found that Mexico had indirectly expropriated Metalclad's investment,⁵⁶ through a combination of (i) an untimely and disorderly procedure for the granting of construction permits⁵⁷; (ii) the fact that no other organisation other than Metalclad required a permit to construct in that area⁵⁸ and; (iii) the denial of a permit by the authorities without any sound, verifiable reasoning.⁵⁹ The main argument that led to this conclusion, thus, was the argument that in modern international investment law the concept of expropriation will include not only instances of a direct taking or transfer of legal title from investor to state, but also instances of covert taking or interfering with the economic benefit due to the investor even if this benefit is not

⁵⁵ *Metalclad Corp v Mexico*, Award, 30 August 2000 ICSID Case No. ARB(AF)/97/1. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0510.pdf>

⁵⁶ *Ibid*, para 107

⁵⁷ *Ibid*

⁵⁸ *Ibid*, para 108

⁵⁹ *Ibid*, para 106

obviously accrued to the state.⁶⁰ In arriving at this conclusion, crucially it also held that even if state measures did not provide for a financial or other kind of benefit to be amassed for the state, it could still be deemed to be an indirect expropriation. The ruling of the tribunal in *Starrett Housing v Iran*⁶¹ endorses this point where it stated that:

[I]t is recognised by international law that measures taken by a State can interfere with property rights to such an extent that these rights have been rendered so useless that they must be deemed to have been expropriated, even though the State does not purport to have expropriated them and the legal title to the property formally remains with the original owner.⁶²

Arguments about indirect expropriation often revolve around a state's alleged confiscation of property in some form or another. In *Metalclad*, the tribunal took issue with the actions of state authorities because they had failed to observe the requisite due process:

By permitting or tolerating the conduct of Guadalcazar in relation to Metalclad which the Tribunal has already held amounts to unfair and inequitable treatment breaching Article 1105 and by thus participating or acquiescing in the denial to Metalclad of the right to operate the landfill, notwithstanding the fact that the project was fully approved and endorsed by the federal government, Mexico must be held to have taken a measure tantamount to expropriation in violation of NAFTA Article 1110(1).⁶³

This was deemed sufficiently detrimental to Metalclad's operation to be deemed an indirect expropriation and demonstrates the depth of analysis that tribunals can engage in when deciding claims of expropriation.

⁶⁰ Ibid at para 103. It should be noted that this dispute was brought before the Tribunal under the provisions of NAFTA. The Tribunal, when issuing its decision, spoke specifically about expropriation under the NAFTA.

⁶¹ *Starrett Housing Corp v Islamic Republic of Iran* (1983) 4 Iran-US CTR 122

⁶² Ibid, p154

⁶³ *Metalclad v Mexico*, supra n55, para 104

From a brief review of the decisions of investment tribunals regardless as to the specifics of a given dispute, tribunals are still able to identify an instance whereby a substantive aspect of an investment has been removed by a state's actions. Furthermore this has been deemed sufficiently severe to result in a finding of indirect expropriation having taken place. While this evidence is instructive it does present an issue: how is state regulation of investors property, and any accompanying impact thereon dealt with in international investment law?

The majority of legal texts in international investment law reflect the view that where a state enacts a measure which is considered to be within the accepted limits of state sovereignty, there is no need to compensate an investor for any ensuing damage to its property interests.⁶⁴ Higgins draws attention to this and states:

The position seems to be (and the present writer finds the underlying policy difference hard to appreciate) that a taking for a public use requires just compensation to be paid; whereas an indirect taking for regulatory purposes does not. The distinction seems to lie not between formal and indirect taking, but rather in the *purpose* of the taking.⁶⁵

Thus formulated the legal position of the host government clearly enters into a conflict with the right of foreign investors to the protection of their investment.⁶⁶ As Weiner notes: "...a great deal of the activity of the modern state entails regulating social and economic activity in ways that interfere substantially with the enjoyment of property rights".⁶⁷ As a result, the impact of state regulatory measures on investments has become the subject of intense debate in investment tribunals.

⁶⁴ See Art. 10 (5) of the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens; "Restatement of the Law Third, the Foreign Relations of the United States", American Law Institute, Vol I, 1987, Section 712, comment g

⁶⁵ Higgins, supra n7, pp330-331

⁶⁶ Fortier and Drymer, supra n26, p298

⁶⁷ A. Weiner, 'Indirect Expropriation: The Need for a Taxonomy of "Legitimate" Regulatory Purposes', International Law Forum 166 (2003), p.167. Available at <http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0CCYQFjAB&url=http%3A%2F%2Fwww.ila-hq.org%2Fdownload.cfm%2Fdocid%2F5AA21CEF-29AC-4835-A0E4BA9706340EE1&ei=LjOOVNKWKNH7QbUIIHICg&usq=AFQjCNFVE8mHy87vbl0zflp6UrLVgn3D9g>; Commentators note that in cases where investors question the use of state regulations that have had a detrimental impact on their investment, the language used to describe such occurrences is that of 'regulatory expropriation' as opposed to indirect expropriation, see Newcombe, supra n5, p25

As Nikiema writes,⁶⁸ one of the first cases to distinguish between regulatory expropriation, and indirect expropriation in modern investment practice was the case of *Too v USA*.⁶⁹ The case concerned an Iranian national who was also the owner of a cold-storage trailer found in the state of Arizona that he argued was wrongfully expropriated by the United States. The authorities of Arizona had made attempts to inform Mr Too about this trailer and the impending auction for abandoned property. Mr Too failed to try and recover the trailer, which was later sold at auction by Arizona. The tribunal dealt with the claim that the trailer had been indirectly expropriated by United States in the following terms:

[A] State is not responsible for the 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 State's, provided 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.⁷⁰

A similar approach was followed also in the case of *Methanex v United States*.⁷¹ Methanex Corporation was a Canadian-based manufacturer of methanol, an ingredient in a gasoline additive commonly called MTBE. Methanex did not manufacture the MTBE itself; however, a significant percentage of the methanol it produced was used in the making of MTBE. Methanex was a leading manufacturer of methanol for the American market, but approximately 47 per cent of the market was supplied by domestic U.S. companies. Following concerns raised by environmental groups, the state of California banned the use of MTBE as a gasoline additive because it was polluting surface water and groundwater in the state. Methanex argued, however, that the state imposed the ban due to a political deal with a rival company that made ethanol, a substitute for methanol and MTBE as a gasoline additive. Amongst other things, Methanex argued that California had and should have used alternative approaches less damaging to Methanex's investment. Methanex claimed that the state of California's failure to pursue such measures resulted in an occurrence of

⁶⁸ S. Nikiema, 'Best Practices, Indirect Expropriation', International Institute for Sustainable Development (2012, Manitoba), p17

⁶⁹ *Emmanuel Too v Greater Modesto Insurance Associates and the United States of America*, Award, 29 December 1989, Iran-US CTR, vol.23; see also *Suez Sociedad General de Aguas de Barcelona SA, and InterAgua Servicios Intergales del Agua SA v Argentina* ICSID Case No. ARB/03/17 Decision on Liability, 30 July 2010. Available at <http://italaw.com/sites/default/files/case-documents/ita0813.pdf>

⁷⁰ *Ibid*, p378

⁷¹ *Methanex v United States*, Final Award, 3 August 2005. UNCITRAL. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0529.pdf>

indirect expropriation.⁷² The tribunal, in dealing with Methanex's claim that its investment had been subject to expropriation as a result of the Californian ban on gasoline additive MTBE, said the following;

In the Tribunal's view, 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 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.⁷³

As noted by Reinisch the implication of both the *Too* and the *Methanex* rulings was, that those measures that are non-discriminatory state actions that serve some kind of public purpose would be removed from the scope of what would otherwise be deemed a compensable loss of property.⁷⁴ This is precisely what has happened in international investment law, in the sense that there is now a categorisation in expropriation law that accords a special status to state regulatory measures that interferes with investors property. As Kreibaum writes:

...it is established in international law that not every regulatory interference with property rights that has negative effects, is an expropriation requiring compensation. To question that State's regulatory power would make the exercise of many State functions impossible.⁷⁵

The challenge as Sornarajah writes, "...is to find a rational basis for the distinction"⁷⁶ between instances of compensable indirect expropriation and non-compensable regulatory expropriation.

⁷² *Methanex v United States* Case Summary, pp82-83. Available at http://www.iisd.org/pdf/2011/int_investment_law_and_sd_key_cases_2010.pdf

⁷³ *Methanex v United States*, supra n71, Part IV, Ch D, p4, para 7

⁷⁴ Reinisch, supra n22, p437

⁷⁵ U. Kriebaum, '*Regulatory Takings: Balancing the Interests of the Investor and the State*' (2007) J. World Investment & Trade, Vol.8, pp720-721

⁷⁶ Sornarajah, supra n3, p374

At the heart of the doctrine of regulatory expropriation lies the concept of police powers. Defining the concept ‘police powers’ is, as Newcombe writes, problematic.⁷⁷ Some suggest that ‘police powers’ refers to those powers held by State’s “...to protect essential public interests from certain types of harms”.⁷⁸ Another definition that is often suggested is that ‘police powers’ is “All forms of domestic regulation under a state’s sovereign powers”.⁷⁹ Neither of these definitions give any detail on what are ‘essential public interests’ or what forms of ‘domestic regulation’ fall under a sovereigns power. Despite this lack of clarity, in the international investment law context, the operative consequences of the use of ‘police powers’ by a State is understood to refer “...to the measures that justify a state action that would otherwise amount to a compensable deprivation or appropriation of property”.⁸⁰

The use of state police powers was the subject of debate in the of *Sedco v Iran*,⁸¹ which is largely representative of the doctrinal position of ‘police power’ regulatory expropriation in international investment law.⁸² Sedco owned a 50% share of Seridian Drilling Company in Iran, and controlled its operations in Iran through the 1970s. Following a surge of unrest in Iran in late 1978, Sedco removed its expatriate personnel, and ended its activities in 1979. Later following a request from the Iranian government, Seridan restarted partial operations in March 1979, although Sedco notified the government that certain drilling rigs could not be operated without the return of expatriate personnel. The National Iranian Oil Company cancelled the contracts connected to the inoperative rigs and began operating the rigs themselves. In the summer of 1979, the Iranian government requested that a Sedco supervisor be stationed in Iran. In response, Sedco asked for information concerning the number of rigs still needed by the Iranian government. Instead of responding, in late 1979 the Iranian government appointed “provisional directors” of Sediran to replace those appointed by Sedco, as well as a supervisor of Sediran’s drilling operations. Having received no favourable reply to its request for information, Sedco terminated its contract in November 1979. On August 2, 1980, the Iranian government ordered the transfer of Sedco’s ownership shares of Sediran to the government. At the same time, Sediran’s

⁷⁷ Newcombe, supra n5, p26

⁷⁸ *ibid*

⁷⁹ *Ibid*; see also Nikiema, supra n68, p19

⁸⁰ *ibid*

⁸¹ *Sedco, Inc v National Iranian Oil Co.*, 9 Iran-US Claims Trib. Rep. 248(1985)

⁸² See I. Brownlie, *Public International Law* (2003, Oxford) 6th edn, p509.

drilling rigs and other equipment were retained and used by the government.⁸³ As a result Sedco brought a claim before the Iran-United States Claims Tribunal, alleging that its operation had been the subject of expropriation by the National Iranian Coal Company and the Islamic Republic of Iran. In dealing with the claim of expropriation, the tribunal held that;

[it is] an accepted principle of international law that a State is not liable for economic injury which is a consequence of a bona fide ‘regulation’ within the accepted police power of state’s.⁸⁴

However the application of the ‘police powers’ doctrine to investment disputes has not been consistent.⁸⁵ Tribunals have noted that while they support the principle,

...international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered ‘permissible’ and ‘commonly accepted’ as within the police power or regulatory power of State’s and, thus, non-compensable.⁸⁶

This has caused some difficulty both for tribunals in attempting to apply the law consistently, and for investors hoping to understand when conduct by a state affecting their property will be compensable.⁸⁷ In an attempt to provide clarity, Weiner suggests that

⁸³ L. Monroe, “*Decisions of the Iran-United States Claims Tribunal*”, Am J Intl L Vol.80 (2) (1986), p969

⁸⁴ *Sedco v Iran*, supra n81, p275; This ruling was followed in a number of other investment disputes including, *Sociedad General de Aguas de Barcelona SA, and InterAgua Servicios Integrales del Agua SA v Argentina*, Decision on Liability, ICSID Case No. ARB/03/17, available at <http://italaw.com/sites/default/files/case-documents/ita0813.pdf>; *Tecmed v Mexico*, Award, 29 May 2003, ICSID Case No. ARB(AF)/00/2, available at <http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>. Similar language was also used in the exchange of letters between the United States and Singapore, in the signing of a Free Trade Agreement on the 6th May 2003. Trade Representatives of both states came to a mutual understanding in their letters that, “[e]xcept in rare circumstances, non-discriminatory regulatory actions by a party that are designed and applied to protect legitimate public welfare objectives...do not constitute indirect expropriations”. Paragraph 4(b) of exchange of letters on expropriation between United States Trade Representative Robert B.Zoellick and Singapore Minister for Trade and Industry George Yeo (construing Article 15(1) of the United States-Singapore Free Trade Agreement), as cited in OECD, supra n12, p21

⁸⁵ See D. Schneiderman, *Constitutionalising Economic Globalisation: Investment Rules and Democracy’s Promise* (2008, Cambridge), p63 where it is noted that there is no “...clear distinction in international law between compensable takings and non-compensable regulations that fall within the scope of a state’s police power jurisdiction”

⁸⁶ *Saluka Investments BV v The Czech Republic*, Partial Award, 17 March 2006, para 263. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0740.pdf>

⁸⁷ Fortier and Drymer, supra n26, p327

international conventional and customary law, along with state practice will determine what constitutes a legitimate exercise of police powers or government regulation.⁸⁸

Thus it has been suggested by Newcombe that the employment of ‘police power’ regulation for the protection of the environment and human health might justify non-compensation.⁸⁹ Weiner writes that “...it is significant that both the developed and developing world have in recent decades accepted the importance of environmental protection as an important state interest”.⁹⁰ He also writes that this, when viewed alongside the International Court of Justice’s recognition of the importance of respect for the environment under international law, is likely to exempt state measures that aim to protect the environment from being deemed indirectly expropriatory.⁹¹ In the case of *Methanex v United States* mentioned above, the respondent state argued that the basis of its ban was for a public purpose – the avoidance of the harmful effects of MTBE - in view of scientific evidence that there were significant risks and costs associated with water contamination due to the use of MTBE.⁹² The tribunal took the view that the ban was “...motivated by the honest belief, held in good faith and on reasonable scientific grounds, that MTBE contaminated groundwater and was difficult to clean up”.⁹³

The suggestion that measures taken by a state for environmental protection are within the ‘police powers’ of State’s and non-compensable, has not been met with consistent support in investment disputes and was the subject of debate in *Tecmed v Mexico*.⁹⁴ Tecmed was a Spanish company with subsidiary companies in Mexico, which brought an expropriation claim against Mexico regarding its investment in a waste landfill it acquired in 1996. Tecmed claimed that the Mexican authorities failure to renew of a licence required to operate the landfill, removed any value of its investment, and amounted to an expropriation. The Mexican authorities argued that their refusal of the licence was, amongst other things, with a view to protect the environment, within the state’s police

⁸⁸ Weiner, supra n67, p174

⁸⁹ Newcombe, supra n5, p32

⁹⁰ Weiner, supra n67, p174

⁹¹ *ibid*

⁹² *Methanex v United States*, supra n71, para 9, Part III – Chapter A

⁹³ *Ibid*, para 102

⁹⁴ *Tecnicas Medioambientales Tecmed S.A. v The United Mexican States*, Award, May 2003. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0854.pdf>

powers, and was not an expropriation.⁹⁵ The Tribunal in dealing with the claim of expropriation went on to state that,

...no principle stating that regulatory administrative actions are per se excluded from the scope of the Agreement, even if they are beneficial to society as a whole—such as environmental protection—, particularly if the negative economic impact of such actions on the financial position of the investor is sufficient to neutralize in full the value, or economic or commercial use of its investment without receiving any compensation whatsoever.⁹⁶

This ruling confirms that state measures, taken with a view to protect the environment, will not always be accepted as a legitimate use of police powers and justify that investors are not compensated. While academics agree on the existence of a right of governments to regulate to protect the environment, they acknowledge that to date, there are no cases that provide guidance on addressing environmental harms in a modern regulatory context.⁹⁷

Another area where states could be exempt from the requirement to pay compensation to investors for regulatory interference, is Taxation.⁹⁸ It is suggested that taxation is generally considered to be inextricably bound to the practice of government. However it is possible that the exercise of this governmental power can result in economic effects that may not be dissimilar to indirect expropriation. Newcombe notes that a significant tax burden (50-60%) may be imposed on investments, without it being deemed expropriatory.⁹⁹ The viability of the ‘police power’ of taxation as a non-compensable exercise of governmental authority was the subject of debate in *Link-Trading v Moldova*.¹⁰⁰ The claimant was a US-Moldovan joint venture company created in 1996 under Moldovan law. It was created to sell products imported into Free Economic Zone of Chisinau (“the FEZ”), to retail customers.. In November 1996, Link-Trading registered as a resident of FEZ and, under Moldovan legislation at that time, was initially exempted from the import duties and value-added taxes on goods it brought into the FEZ. Link-

⁹⁵ Ibid, para 97

⁹⁶ Ibid, para 121

⁹⁷ Newcombe, supra n5, p32-33

⁹⁸ Ibid, p36

⁹⁹ Ibid

¹⁰⁰ *Link Trading Joint Stock Company v Department for Customs Control of the Republic of Moldova*, Final Award, 18 April 2002. Available at http://www.italaw.com/sites/default/files/case-documents/ita0468_0.pdf

Trading customers were exempt of up to US\$600 from the duties and taxes on goods imported from the claimant in the FEZ into the customs territory of Moldova.

The US \$600 limit was reduced in March 1997 to US\$400 and then again in December 1997 to US \$250. In July 1998, the exemption was revoked via an amendment to Moldovan law. Link-Trading protested and argued that this was in breach of a governmental guarantee of a ten-year period of stability in the tax and custom regime. Link-Trading asserted that the revocation of the tax exemption constituted an indirect expropriation. Moldova responded that the amendment of the tax and duties regime was carried out as part of a normal and proper exercise of the State's regulatory powers. In dealing with this dispute, the tribunal was not convinced that the Claimant's business had been expropriated, as a direct result of their tax exemption being revoked. The tribunal drew attention to, amongst other things, the fact that the language of the law governing the levels of exemptions explained that they would be set up "...annually".¹⁰¹ As a result of this the tribunal held that there were no grounds for believing that the exemption would not be subject to review and possible modification.¹⁰² The Tribunal went on to note however that fiscal measures will become expropriatory when they amount to an unfair, arbitrary or discriminatory taking or the violation of a state undertaking.¹⁰³

There is no evidence to date that supports the proposition that a particularly high level of taxation alone, by a State on foreign property, will be deemed to be an indirect expropriation.¹⁰⁴ However both investment tribunals¹⁰⁵ and commentators¹⁰⁶ appear to agree that international law protects against taxation that is confiscatory, that "takes too much away from the taxpayer".¹⁰⁷ The categorisation of a level of tax as being confiscatory, or expropriatory seems to centre on whether or not it causes a 'substantial

¹⁰¹ Ibid, para 83

¹⁰² Ibid

¹⁰³ Ibid, paras 64-91. See also *Occidental Exploration and Production Co v Ecuador*, LCIA No. UN 3467, Award, 1 July 2004, at para 85 where the tribunal confirmed that "... Taxes can result in expropriation as can other types of regulatory measures.". Available at <http://www.italaw.com/sites/default/files/case-documents/ita0571.pdf>

¹⁰⁴ In the recent case of *Burlington Resources, Inc v Republic of Ecuador* ICSID Case No ARB/08/5, Decision on Liability, 14 December 2012 at para 445 where the imposition of a 99 percent taxation on 'windfall profits' was not deemed to be, in and of itself, evidence of an expropriation. Available at http://www.italaw.com/sites/default/files/case-documents/italaw1094_0.pdf

¹⁰⁵ Ibid, para 393

¹⁰⁶ Newcombe, *supra* n5, p36

¹⁰⁷ A. Albrecht, 'The Taxation of Aliens Under International Law' (1952) Vol.29 Brit YB Intl L, p173.

deprivation' to the investor.¹⁰⁸ However Gildemeister does concede that while the use of such terminology is useful in the abstract, it is very difficult to define with any real degree of clarity and that much will depend on the approach taken by the tribunal in each particular case.¹⁰⁹ As a result, it has been noted that while taxation falls within the accepted definition of the sovereign 'police powers' of state's,¹¹⁰ Newcombe notes that its use will not always excuse state's of the need to compensate investors for its interference with investors property.¹¹¹

It has been suggested, as Vadi notes, that state measures that purport to protect or preserve cultural property may be exempt from the need to compensate, where they result in damage to a foreign investors property.¹¹² This matter was the subject of debate in what has become known as the *Pyramids case*.¹¹³ The dispute centered around the development of a tourist village at the pyramids of Giza. During the construction of the village, objects of archaeological significance were discovered. This prompted staunch opposition to the continuation of construction by the Egyptian parliament which was followed by a series of governmental measures that resulted in the cancellation of the project. The claimants eventually brought a claim before an ICSID tribunal claiming that the actions of the respondent constituted an expropriation of its investment. The respondent replied in a counterclaim where it argued that the cancellation of the project was a requirement of both Egyptian and international law, citing the 1972 UNESCO Convention for the Protection of the World Cultural and National Heritage. In dealing with the claim the tribunal stated:

Clearly, as a matter of international law, the Respondent was entitled to cancel a tourist development project situated on its own territory for the purpose of protecting antiquities...The decision to cancel the project constituted a lawful exercise of eminent domain.¹¹⁴

The tribunals meaning is quite plain from its comments. However it went on to hold that:

¹⁰⁸ *Burlington v Ecuador*, supra n104, para 396

¹⁰⁹ A. Gildemeister, Case Comment: *Burlington Resources, Inc v Republic of Ecuador 'How Much is Too Much: When is Taxation Tantamount to Expropriation?* (2014) ICSID Review, pp317-318

¹¹⁰ OECD, supra n12, p4

¹¹¹ Newcombe, supra n5, p36

¹¹² See a discussion in V. Vadi, 'Cultural Clash? World Heritage and Investors' Rights in International Investment Law and Arbitration', (2013) ICSID Review Vol.28 (1), pp123-143

¹¹³ *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, ICSID Case No ARB/84/3, Award on the Merits, 20 May 1992. Available at https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC671_En&caseId=C135

¹¹⁴ *Ibid*, para 158

The rules of Egyptian law and international law governing the exercise of the right of eminent domain impose an obligation to indemnify parties whose legitimate rights are affected by such exercise...The obligation to pay fair compensation in the event of expropriation applies equally where antiquities are involved.¹¹⁵

This ruling serves as yet another example of an instance where an investment tribunal, while recognising the legitimacy of a state's actions, nevertheless requires that compensation be issued to foreign investors. The evidence above does little to demonstrate any clarity on what 'public purposes' will remove the obligation of states to compensate investors for measures that have a negative impact on their property.

Another common theme that emerges from the literature regarding 'police power' regulatory expropriation, is that the doctrine of 'police powers' is not sufficiently clear.¹¹⁶ In *ADC v Hungary*,¹¹⁷ the tribunal considered the limits of state's regulatory powers. In 1994, ADC, a Canadian company, won the right to construct, renovate and operate two terminals at the Budapest-Ferihegy International Airport. In 1995, ADC concluded an agreement with the Air Traffic and Airport Administration (ATAA), a Hungarian State agency, which laid down the terms and conditions of the transaction. The Agreement provided that the term of the works would be twelve years from the date of the operations commencement, with a possible extension for another six years.

In 1998 ADC, successfully finished construction and renovation of the Terminals and operated them until the end of 2001. On 20 December 2001, the Hungarian Minister of Transport issued a decree for the transformation of ATAA. The statutory successor of ATAA, Joint Stock Co. Budapest Ferihegy International Airport Management Ltd., sent a letter to ADC notifying it of the decree and stating that it would take over operational control of the Airport from 1 January 2002. In 2003, ADC brought a claim before a tribunal alleging that their investments had been expropriated by Hungary as a result of its decree to transform the ATAA, depriving them of their rights to operate the airport terminals and to benefit from future opportunities. The tribunal accepted the claim that there was an indirect expropriation and rejected Hungary's argument that it was merely exercising its right to regulate in the following terms:

¹¹⁵ Ibid, para 159

¹¹⁶ A. Weiner, *supra* n67, p171

¹¹⁷ *ADC v Hungary*, Award, 2 October 2006. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0006.pdf>

The Tribunal cannot accept the Respondent's position that the action 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 the inherent right to regulate its domestic affairs, the exercise of such right is not unlimited and must have its boundaries. Therefore, when a State enters into a bilateral investment treaty like the one in this case, it becomes bound by it and the investment protection obligations it undertook therein must be honoured rather than be ignored by a later argument of the State's right to regulate.¹¹⁸

This ruling by the tribunal is useful in so far as it establishes that a state's right to regulate is subject to constraints. The tribunal went on to note that while investors must comply with a host state's laws and regulations, they would not be forced to submit to whatever demands the host state makes.¹¹⁹

The discussion above should demonstrate the lack of clarity as to what in fact will be deemed a bona fide exercise of state police powers. Investment tribunals have profound difficulties in applying the doctrine in investment disputes given that, as the discussion above demonstrates, the substance of the doctrine is contested by scholars and tribunals adjudicating on investment disputes. Furthermore the matter is made more complicated by the fact that tribunals expressly state that while states are entitled to regulate affairs within their territory, including foreign investment, this is subject to limitations.

¹¹⁸ Ibid, para 423

¹¹⁹ Ibid, para 424

Chapter 3

Distinguishing between Indirect and Regulatory Expropriation

There has not been any cohesive body of jurisprudence from investment tribunals that provides a set of criteria to draw a clear dividing line between indirect expropriation and regulatory expropriation in international investment law.¹²⁰ Instead, Schefer writes that tribunals will be less reliant on ‘rigorous theoretical analysis’ than on their own views on the limits of state power.¹²¹ She also suggests that there are certain issues which will be given attention by tribunals in making their decision,¹²² but that they will have to decide for themselves where to place emphasis when making a finding of expropriation or regulation.¹²³ It should be noted that there are competing arguments surrounding what factors will be determinate of a finding of indirect expropriation. However in identifying whether there has been an indirect expropriation, as Nikiema writes, tribunals have been found to have used three particular approaches: (i) look to establish a detrimental effect; (ii) consider the legitimacy of the public interest of a measure; or (iii) assess the proportionality of a measure.¹²⁴

1. Detrimental effect

In investment disputes, the detrimental effect criterion is sometimes known as the “sole effect doctrine”,¹²⁵ where the tribunals must be satisfied that a state measure has caused “...serious and irreversible damage to the investment”¹²⁶ before it will be deemed to be indirect expropriation. When tribunals use the sole effect doctrine, only the effects of a state measure on the investor’s control over the profits from its investment matter and not the intentions of the state.¹²⁷ In practice, the sole effect doctrine, is composed of two equally important facets – severity and irreversibility.¹²⁸ In establishing the seriousness of the damage to an investment, the traditional test that must be established is that “...the

¹²⁰ OECD, supra n12, p3

¹²¹ Schefer, supra n18, p208. It has also been noted that “...indirect expropriation jurisprudence and state practice reveal competing doctrinal strains, some that tend to favour the interests of foreign property owners, and others that favour the regulatory authority of states”, see A. Weiner, supra n67, p169

¹²² Ibid, pp205-208

¹²³ Ibid, p208

¹²⁴ Nikiema, supra n68, p13

¹²⁵ See R.Dolzer, ‘*Indirect Expropriation, New Developments?*’, (2002-2003) N.Y.U.Envntl.L. J, Vol.11, p79

¹²⁶ Nikiema, supra n68, p14

¹²⁷ Schefer, supra n18, pp208-9

¹²⁸ Nikiema, supra n68, p14. See also *Pope and Talbot Inc v Canada*, Interim Award, 26 June 2000, para 102. Available at <http://italaw.com/sites/default/files/case-documents/ita0674.pdf>

rights held over the investment have lost all economic interest for the investor”.¹²⁹ Nikiema notes that this will not be the case where an investor retains a free choice in company strategy and day-to-day management; has access to the profits generated from an investment; or has the freedom to come and go as they please.¹³⁰ In *Tokios Tokeles v Ukraine* the tribunal stated that:

A critical factor in the analysis of an expropriation claim is the extent of harm caused by the government’s actions. For any expropriation – direct or indirect – to occur, the state must deprive the investor of a “substantial” part of the value of the investment. Although neither the relevant treaty text nor existing jurisprudence have clarified the precise degree of deprivation that will qualify as “substantial, 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.¹³¹

In establishing the irreversible nature of a state measure under the sole effects doctrine, tribunals must have evidence that the damage caused is “...not merely ephemeral”¹³² or is a “...deprivation [...]enduring”.¹³³ As noted by the tribunal in the case of *LG&E v Argentina*:

The expropriation must be permanent, that is to say, it cannot have a temporary nature.¹³⁴

This approach was followed in the case of *Tippetts v Iran*.¹³⁵ The claimant, Tippetts, Abbot, McCarthy, Stratton (TAMS) was an American engineering and architectural consulting partnership. TAMS and an Iranian engineering firm, Aziz Farmanfarmanian and Associates (AFFA), created and held 50% ownership interest each in TAMS-AFFA,

¹²⁹ Ibid. See also *Starrett Housing Corporation, Starrett Systems, Inc., Starrett Housing International, Inv., v Iran, Bank Oman, Bank Meilat, Bank Markazi*, Award, 19 December 1983, p154 as cited in Nikiema, supra n68, p14

¹³⁰ Nikiema, supra n68, p15

¹³¹ *Tokios Tokeles v Ukraine*, ICSID Case No ARB/-2/18 at para 120. Available at <http://italaw.com/documents/TokiosAward.pdf>

¹³² *Tippetts, Abbet, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran*, Award, 29 June 1984, Iran-US CTR, 6, 1986, p225

¹³³ *LG&E Energy Corp. and LG&E International Inc. v Argentina* (ARB/02/1), Decision on Liability, 3 October 2006, para 193. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0460.pdf>

¹³⁴ Ibid, para 193

¹³⁵ *Tippetts v Iran*, supra n132

an Iranian organisation created to perform engineering and architectural services on the Tehran International Airport (TIA) project. TAMS-AFFA operated on the principle of joint control until 1979 and any decisions that were made required the consent of at least one member appointed by each organisation. The TIA project was based on a contract entered into on 19 March 1975 between TAMS and AFFA and the Civil Aviation Organization (CAO). However, as a result of the Iranian Revolution, work the airport stopped from December 1978 to January 1979. The Iranian Government in attempting to protect domestic industries, appointed a temporary manager for TAMS-AFFA, who was granted power to make decisions without the need to consult with TAMS. Furthermore as a result of political instability, TAMS representatives were forced to leave the country and attempt to maintain their operation in respects of the TIA from the United States. However despite several attempts of TAMS officials to contact TAMS-AFFA regarding these commitments, no reply was given. The claimant then brought a claim before an Iran-US Claims tribunal alleging expropriation. The tribunal, in finding that an indirect expropriation had taken place, provided the following as bases for its reasoning:

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 has been deprived of fundamental rights of ownership...The intent of the government is less important than the effects of the measure on the owner, and the form of the measures of control or interference is less important than the reality of their impact.¹³⁶

This ruling only reaffirms the rationale of the ‘sole effects’ doctrine. The tribunal makes clear that a state measure that is sufficiently severe to deprive an investor of ownership rights will attract the need for compensation. Regardless as to the intentions of the state in taking the action that it did, the damage suffered by the investors was deemed to be of such severity that there was a need for compensation to be provided.

¹³⁶ Ibid, pp225-226

Another example of the sole effect doctrine's application, was the case of *AES v Hungary*.¹³⁷ The dispute arose out of AES' US \$130 million investment in Tisza II and other Hungarian power stations in 1996, at a time when Hungary was privatising parts of its energy sector. A Power Purchase Agreement (PPA) between AES and Hungary established a pricing formula to be applied when Hungary ceased to oversee energy generation prices. However, in reaction to public outrage over the allegedly high profits of public utility companies, Hungary enacted price decrees in 2006 and 2007, restoring the administrative pricing regime. The return of administered prices caused AES significant losses of revenue, prompting the company to seek compensation through ICSID arbitration under the Energy Charter Treaty (ECT).¹³⁸ AES argued, amongst other things, that Hungary had violated its obligation not to expropriate the property of AES. In dealing with the claim that an indirect expropriation had taken place, the tribunal said:

It is evident that many of the state's acts or measures can affect investments and a modification to an existing law or regulation is probably one of the most common of such acts or measures. Nevertheless, a state's act that has a negative effect on an investment cannot automatically be considered an expropriation. For an expropriation to occur, it is necessary for an investor to be deprived, in whole or in significant part, of the property or in effective control of its investment: or for its investment to be deprived, in whole or in significant part, of its investment. But in this case, the amendment of the 2001 Electricity Act and the issuance of the Price Decrees did not interfere with the ownership or use of the Claimants' property.¹³⁹

This finding is helpful in demonstrating the severity and duration with which a government measure, under the sole effect doctrine, must be before there will be a finding of expropriation.

A final example of support in case-law for use of the 'sole effects' doctrine in deciding on a dispute was in the case of *BG Group Plc v Argentina*.¹⁴⁰ BG Group was a UK firm that

¹³⁷ *AES Summit Generation Limited and AES-Tisza Erömü Kft v. The Republic of Hungary*, ICSID Case No. ARB/07/22, Award, 23 September 2010. Available at http://www.italaw.com/sites/default/files/case-documents/ita0014_0.pdf

¹³⁸ Investment Treaty News, 'Tribunal dismisses claims against Hungary in ECT dispute over power stations', www.iisd.org/itn/2010/12/16/awards-and-decisions-3/, site visited 22 May 2014

¹³⁹ *AES v Hungary*, supra n137, paras 14.3.1-14.3.2

¹⁴⁰ *BG Group Plc v The Republic of Argentina*, UNCITRAL, 24 December 2007, Final Award. Available at <http://italaw.com/sites/default/files/case-documents/ita0081.pdf>

was part of a consortium which held a majority stake in MetroGas. MetroGas was an Argentinian business that held exclusive rights to distribute natural gas in Buenos Aires. At the time of BG Groups investment in the operation, Argentinian law provided that “tariffs” would be calculated in US dollars and would be set at levels to ensure a reasonable rate of return. However Argentina later changed this law providing that the tariffs be measured in pesos. This had a negative impact in MetroGas’ profits. The case was eventually brought before an international tribunal where BG Group claimed that there investment had been expropriated. In deciding on the dispute and that no expropriation had taken place the tribunal stated:

The Tribunal notes that a State may exercise its sovereign power in issuing regulatory measures affecting private property for the benefit of public welfare. Compensation for expropriation is required if the measure adopted by the State is irreversible and permanent and if the assets or rights subject to such measure have been affected in such a way that...any form of exploitation thereof...has disappeared.¹⁴¹

The tribunal ruled that based on the facts of the dispute, there was no such evidence that the claimant had been so deprived of its investment. This ruling simply reiterates the approach taken by other tribunals, identifying that “...irreversible and permanent...” harm must be suffered by an investment, before an indirect expropriation is deemed to have taken place. While there is clear evidence of the popularity of the use of the sole effects doctrine, there were some that questioned its utility.

2. Legitimacy of the public interest

The usefulness of the ‘sole effects’ doctrine has been criticised as being insufficient to identify instances of indirect expropriation when “legitimate” public regulations are the subject of a dispute and could result in any state measure that has a detrimental effect on an investor being deemed indirect expropriation.¹⁴² As a result, as an alternative, it has been

¹⁴¹ Ibid, para 268

¹⁴² Nikiema, supra n68, p15. See also Kriebaum, supra n75, p725

noted that tribunals have applied the ‘legitimate objective’ criterion in distinguishing between indirect expropriation and regulatory expropriation by state’s.¹⁴³

The assessment of the legitimacy of state action in claims of indirect expropriation is also known as the ‘purpose’ doctrine.¹⁴⁴ It has been acknowledged that this test has multiple applications.¹⁴⁵ However, all of these applications are said to revolve around the idea that “...certain legitimate host State measures with specific characteristics cannot be considered as indirect expropriations, even where they are seriously and irreversibly detrimental to an investment”.¹⁴⁶ These measures are commonly referred to as ‘police powers’.¹⁴⁷ Fortier *et al* suggest that the frequent use of the ‘purpose’ doctrine by tribunals indicates the need for a contextual analysis to be undertaken in determining claims of expropriation.¹⁴⁸

There is no definitive listing of what state measures will always be held to be ‘police powers’ or sufficiently legitimate and non-compensable.¹⁴⁹ This has caused some tribunals to take the view that, “...a blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation”.¹⁵⁰ Furthermore some tribunals have explicitly questioned the viability of the non-compensable status of state regulations, as in *Azurix v Argentina*.¹⁵¹ Azurix Corporation, was a US organisation, that took part in the privatisation of water services in the Argentinian Province of Buenos Aires. In July 1999, Azurix Buenos Aires (ABA), an Argentinian indirect subsidiary of Azurix, won a privatization tender and was granted a 30-year concession for the distribution of portable water, and the treatment and disposal of sewerage in the Province. ABA made a “canon payment” of 438.5 million Argentine pesos for the Concession. A new regulatory authority (“ORAB”) was established to oversee and regulate the Concession.

¹⁴³ Ibid, p17. See also Dolzer and Schreuer, supra n1, p300 where the authors discuss how the ‘purpose’ that a state measure is designed to serve, is assessed by tribunals. Despite the difference in terminology, tribunals are in effect using the same criterion.

¹⁴⁴ Fortier and Drymer, supra n26, p313

¹⁴⁵ Nikiema, supra n68, p17

¹⁴⁶ Ibid

¹⁴⁷ Ibid

¹⁴⁸ Fortier and Drymer, supra n26, p314

¹⁴⁹ Nikiema, supra n68, p19

¹⁵⁰ *Pope v Talbot Inc. v Canada*, supra n128, para 99

¹⁵¹ *Azurix Corp v the Argentina Republic*, Award, 14 July 2006, ICSID Case No ARB/01/12. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0061.pdf>

Under the Concession agreement, the Province was obliged to complete certain infrastructure repairs before Azurix would take over the water concession. However, the Province never completed the necessary repairs. As a result, in April 2000 an algae outbreak occurred, damaging Azurix's investment as a water provider. Azurix claimed that provincial health authorities bore responsibility for this and for encouraging the public not to pay their water bills, damaging Azurix's investment. Azurix brought an arbitral dispute before the International Centre for the Settlement of Investment Disputes, alleging amongst other things, that Argentina's actions resulted in an expropriation of its investment. Whilst the tribunal did not rule that Argentina's action resulted in an expropriation, it did state that it found the criterion of the purpose of a regulatory measure insufficient to excuse a State from the needs to compensate an investor¹⁵² and contradictory:

According to it, the BIT would require that investments not be expropriated for a public purpose and that there be compensation if such expropriation takes place and, at the same time, regulatory measures that may be tantamount to expropriation would not give rise to a claim for compensation if taken for a public purpose.¹⁵³

The tribunal also referred to the work of Rosalyn Higgins, subsequently a judge and President of the International Court of Justice, who voiced concerns regarding whether the difference between indirect expropriation and regulatory expropriation based on public purpose alone, was intellectually viable:

Is this distinction intellectually valid? Is not the State in both cases (that is, either by taking for a public purpose, or by regulating) purporting to act in the common good? And in each case has the owner of the property not suffered loss? Under international law standards, a regulation that amounted (by virtue of its scope and effect) to a taking, would need to be 'for a public purpose' (in the sense of the general, rather than for the private interest). And just compensation would be due.¹⁵⁴

Despite these concerns as to the rigour of the 'purpose' test in distinguishing indirect expropriation from regulatory expropriation, as Fortier *et al* note, the 'purpose' doctrine

¹⁵² Ibid, para 310

¹⁵³ Ibid, para 311

¹⁵⁴ Higgins *supra* n7, p331

has been incorporated into several international trade and investment agreements, all of which preserve the non-compensable pursuance of *legitimate* public welfare objectives from being deemed as expropriation.¹⁵⁵

The tribunal in *Azurix v Argentina* commented that, “...the public purpose criterion as an additional criterion to the effect of the measures under consideration needs to be complemented”.¹⁵⁶ The discussion above demonstrates that the purpose of a state measure has not been universally accepted as a criterion to excuse state’s from compensation. As in *Azurix*, there has been a call for a more contextual analysis of the nature of the measures taken by state’s against investors in pursuing a public purpose, and for proportionality to play a greater role in decisions taken when investment tribunals are reviewing regulatory measures taken by the host state.¹⁵⁷

3. Proportionality

The principle of proportionality is a relatively recent addition to the calculus of international investment dispute resolution.¹⁵⁸ It has been described as consisting of, “...the weighing [of] both the purpose and effect of a measure in a sort of regulation/expropriation balance”.¹⁵⁹ This approach is said to require that,

The higher the purpose of a measure and the greater its practical benefit to the public welfare, the greater is the level of investment interference that must be demonstrated in order to tip the scale towards a characterization of the measure as an expropriation.¹⁶⁰

A useful example of the use of proportionality in deciding an investment dispute was in the case of *Tecmed v Mexico*.¹⁶¹ Tecnicas Medioambientales Tecmed was incorporated in Spain. In 1996, its Mexican subsidiary Cytrar bought property, buildings, facilities, and other assets for a controlled landfill for hazardous industrial waste.

¹⁵⁵ Drymer and Fortier, *supra* n26, pp317-318

¹⁵⁶ *Azurix v Argentina*, *supra* n151, para 311

¹⁵⁷ *James and Others v United Kingdom*, 21 February 1986, Series A, No.98. 4, paras 50 and 63 cited in Henckels, *supra* n13, p231, and *Tecmed v Mexico*, *supra* n94

¹⁵⁸ Nikiema, *supra* n68, p15

¹⁵⁹ Drymer and Fortier, *supra* n26, p300

¹⁶⁰ *Ibid*

¹⁶¹ *Tecmed v Mexico*, *supra* n94

In the following years, the municipal administration was hostile to the landfill project. The federal government also refused to renew Tecmed's operating licence, citing breaches in the operational aspects of the landfill. Tecmed, convinced that the new local government's ideology, rather than legal issues, were the cause of the withdrawal of the licence, brought a claim to arbitration for compensation for indirect expropriations and measures 'tantamount to nationalization or expropriation'. Tecmed claimed that the local population had been incited to protest against the landfill and to close it down. In assessing Tecmed's claim, the Tribunal stated that it will consider:

...in order to determine if they are to be characterized as expropriatory [if regulatory actions and measures] are to be characterised as expropriatory, 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 [a measure's negative financial impact on the investment] has a key role upon deciding the proportionality...¹⁶²

The tribunal considered three things in its decision making; whether or not the damage suffered was substantial; whether there was a public interest in existence; and whether the state's response was necessary to achieve the public interest.¹⁶³ In assessing whether the damage suffered was substantial, the tribunal in *Tecmed* found that the Resolution provided for the non-renewal of the permit in question and the closing of the landfill – destroying Cyrtars interests in the landfill.¹⁶⁴ The tribunal did note that there was a degree of community or political pressure against the Landfill, establishing some measure of a public interest.¹⁶⁵ However, the tribunal found that the "...absence of any evidence that the operation of the Landfill was a real or potential threat to the environment or public health, coupled with an absence of massive opposition"¹⁶⁶ did not constitute justification enough to expropriate Tecmed's property, and its being excused from the need to compensate.

¹⁶² Ibid, para 122

¹⁶³ Nikiema, supra n68, p16

¹⁶⁴ *Tecmed v Mexico*, supra n94, para 117

¹⁶⁵ Ibid, para 133

¹⁶⁶ Ibid, para 144

The proportionality approach has been praised as being more balanced than the sole effect doctrine,¹⁶⁷ and is also arguably more so than the ‘purpose’ doctrine,¹⁶⁸ in that it contributes to a more robust decision making process.¹⁶⁹ It is suggested that in attempting to replace the ‘sole effect’ and ‘purpose’ doctrine in investment disputes, the proportionality approach actually incorporates and employs them in its use. As Olynyk writes on the merit of a ‘balanced approach’ to adjudicating investment disputes:

While both of these doctrines [‘sole effect’ and ‘purpose’] would incidentally provide a surer method of predicting the outcome of an investor-State dispute over a potential regulatory expropriation, both of these doctrines leave either the investor or the State in a superior position. A better approach is to adopt neither doctrine, but incorporate the principles from both into a balanced...analysis determined by all the relevant factors.¹⁷⁰

The proportionality approach focuses the examination of the adjudicators on the effect and purpose of a State measure, and employs them as component parts to be included in a wider analysis, allowing for a “...complete analysis of a potential expropriation ...”.¹⁷¹ However, some voiced concerns over its being used to resolve investment disputes.¹⁷² As traditionally understood, the proportionality approach was developed outwith the field of international investment law,¹⁷³ and was built around a system of legal processes which provided for certain frameworks. However these frameworks are not easily transposable within international investment law as it is made up of a complex network of BITs.¹⁷⁴ Moreover, its suitability has been said to be even more questionable the context of modern international investment law where, unlike in other regimes, there is no right to appeal to a decision of private individuals.¹⁷⁵

¹⁶⁷ Nikiema, supra n68, p16

¹⁶⁸ It has been noted that tribunals increasingly appear reluctant to adhere to ‘extreme versions’ of either the ‘sole effect’ or ‘purpose’ doctrines, and are more inclined to have regard for both the character and effect of a governmental measure on investment, Drymer and Fortier, supra n26, p326

¹⁶⁹ Henckels, supra n13, pp228-229

¹⁷⁰ Olynyk, supra n30, p280

¹⁷¹ Ibid, p279

¹⁷² Nikiema, supra n68, p16

¹⁷³ Ibid, p16-17

¹⁷⁴ Ibid, p17

¹⁷⁵ Ibid

As has been discussed, there is no universally accepted set of guidelines, distinguishing indirect expropriation from state regulatory expropriation. It appears that investment tribunal decisions will be more reliant on individuals than on doctrinal theories. From the discussion above it is clear that three competing approaches have arisen in terms of dealing with claims of indirect expropriation. The 'sole effect' and 'purpose' doctrines require investment tribunals to conduct their inquiries in a relatively simplistic manner: focus either on the effect of a state measure on an investment, or focus on the purpose that a measure is alleged to serve. The third approach based on proportionality, is multi-faceted and requires tribunals to conduct a balancing exercise between investors and states' rights. Given that the proportionality based approach is deemed to have overcome the flaws held by the two earlier approaches used by tribunals in investment law disputes, a more detailed discussion on its contents and use is called for.

Chapter 4

Exploring Proportionality in International Investment law

The utility of the employment of the proportionality approach has been the subject of increased debate in international investment law.¹⁷⁶ Its use has been advocated by a number of investment tribunals. As in the case of *LG&E v Argentina*, the tribunal stated that:

In order to establish whether State measures constitute expropriation...the Tribunal must balance two competing interests: the degree of the measure's interference with the right of ownership and the power of the State to adopt its policies...With 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 the imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed.¹⁷⁷

Similarly in the case of *Azurix v Argentina*, the Tribunal stated that there had to be:

a reasonable relationship of proportionality between the means employed and the aim sought to be realized". This proportionality will not be found if the person concerned bears "an individual and excessive burden... such a measure must be both appropriate for achieving its aim and not disproportionate thereto."¹⁷⁸

Furthermore many commentators write favourably of the use of the proportionality approach in adjudicating international investment disputes. Han writes that the principle of proportionality is a "...neutral concept"¹⁷⁹ which is designed to "...deal with the

¹⁷⁶ Henckels, supra n13, p224. See also X. Han, 'The Application of the Principle of Proportionality in *Tecmed v Mexico*', (2007) Chinese Journal of International Law, Vol.6 (3), pp635-652, E. Leonhardsen, 'Looking for Legitimacy: Exploring Proportionality Analysis in Investment Treaty Arbitration' (2011), Available at SSRN: <http://ssrn.com/abstract=2255804>, A. Sweet, 'Investor-State Arbitration: Proportionality's New Frontier' (2010), Law and Ethics of Human Rights, Vol.4, p4, B. Kingsbury and S. Schill, "Public Law Concepts to Balance Investors' Rights with State Regulatory Actions in the Public Interest – The Concept of Proportionality" in *International Investment Law and Comparative Public Law*, ed. S. Schill (2010, Oxford), p75

¹⁷⁷ *LG&E v Argentina*, supra n133, paras 189 and 195

¹⁷⁸ *Azurix v Argentina*, supra n151, para 311

¹⁷⁹ X. Han, supra n176, p635

relationship between end and means, and demands an appropriate relationship between them”.¹⁸⁰ Henckels notes that the use of proportionality in deciding on international investment law disputes provides “...greater policy space for host states to take measures in the public interest, yet would provide sufficient scrutiny to control misuse of public power”.¹⁸¹ Essentially the principle of proportionality involves a bringing together of the two approaches mentioned above: Detrimental Effect and Legitimacy, which are then weighed against one another so to establish whether the end result justifies the means employed.

*Tecmed v Mexico*¹⁸² is sometimes identified as the first dispute which saw a proportionality based approach used by an investment tribunal in deciding on a claim of indirect expropriation.¹⁸³ (Henckels writes that *Tecmed v Mexico* is the only case to have elaborated on what a proportionality analysis by investment tribunals actually involves.¹⁸⁴) The facts of the case were discussed earlier, and do not merit reproduction here. Turning to the ruling of the tribunal, following its analysis of the facts surrounding the dispute, the tribunal set out the first step in applying the proportionality approach to the case:

it is understood that the measures adopted by a State, whether regulatory or not, are an indirect de facto expropriation if they are irreversible and permanent and if the assets or rights subject to such measure have been affected in such a way that “...any form of exploitation thereof...” has disappeared; i.e. the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed. Under international law, the owner is also deprived of property where the use or enjoyment of benefits related thereto is exacted or interfered with to a similar extent, even where legal ownership over the assets in question is not affected, and so long as the deprivation is not temporary.¹⁸⁵

¹⁸⁰ Ibid, p636

¹⁸¹ Henckels, supra n13, pp224-225. See also S. Spears, “*The Quest for Policy Space in a New Generation of International Investment Agreements*”, J Intl Econ L, Vol.13 (4), pp1037-1075

¹⁸² *Tecmed v Mexico*, supra n94

¹⁸³ Nikiema, supra n68, p16

¹⁸⁴ Henckels, supra n13, pp230

¹⁸⁵ *Tecmed v Mexico*, supra n94, para 116

At first glance it seems the tribunal is applying what would ordinarily have been considered the ‘sole effects’ approach.¹⁸⁶ It states that the test that must be satisfied is that the harm suffered by a foreign investor be sufficiently substantial to result in the economic value of an investment being removed.

On closer inspection, however, things are not as simple as that. In *Tecmed v Mexico* the tribunal also invokes the idea of a *bona fide* public interest. It states:

[the purpose of this judgement is to]...examine whether the Resolution violates the Agreement in lights of its provisions and of international law. The Arbitral Tribunal will not review the grounds or motives of the Resolution in order to determine whether it could be or was legally issued. However it must consider such matters to determine if the Agreement was violated. That the actions of the Respondent are legitimate or lawful or in compliance with the law of the Respondent’s domestic laws does not mean that they conform to the Agreement or to international law.¹⁸⁷

In conducting its analysis of the legitimacy of state actions the tribunal thus reaffirms that the ‘wrong’ in question must be committed on the international plane. This is very similar to what would have been considered the ‘legitimacy approach’ discussed earlier. The key difference, however, is that after reviewing this question the tribunal immediately moves on to consider whether the state measures were necessary to achieve the respective public interest in question, or in other words, whether they were proportionate:

Although the analysis starts at the due deference owing to the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of those who suffered such deprivation. There must be a reasonable relationship of

¹⁸⁶ Nikiema, supra n68, p16

¹⁸⁷ *Tecmed v Mexico*, supra n94, para 120

proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.¹⁸⁸

It is true that the proportionality approach could be regarded as a more sophisticated test in distinguishing indirect expropriation from regulatory expropriation. Its use by tribunals involves a multifaceted analysis of the facts of a case before it can decide on whether or not state action is expropriatory or not.

Nikiema notes that at this point the tribunal essentially suggests that the applicable test ought to be that:

[for]...the authorities response [to] be necessary to achieve the intended public interest[,]...the measure taken by the State has to be the only measure available, to achieve the objective, or the least detrimental if a number of effective solutions exist.¹⁸⁹

Put differently, to determine whether or not the examined scenario falls under the rubric of indirect expropriation or regulatory expropriation the *Tecmed* approach proposes to examine (i) the severity of the damage done to an investment, (ii) the legitimacy of the public interest which a State claims to be protecting, and (iii) whether the measures pursued by the State were ‘reasonably proportionate’ vis-a-vis that end, in the sense that the charge or weight imposed on the foreign investor must correlate appropriately with the motivating purpose.

Henckels writes that while the use of this approach is becoming increasingly common in investment disputes, the popularity of the use of a proportionality based approach by investment tribunals should not be overstated.¹⁹⁰ She goes on to note that:

The use of the technique remains patchy and inconsistently applied, both within the context of a particular tribunal decision (tribunals employing the technique in

¹⁸⁸ Ibid, para 122

¹⁸⁹ Nikiema, supra n68, p16

¹⁹⁰ Henckels, supra n13, p237

relation to the same measures but not others), and in relation to different cases decided on the same facts.¹⁹¹

This view is shared by other commentators in the field. Thus Fan for example writes that the principle of proportionality has no substantial content in and of itself.¹⁹² Furthermore, Han goes on to note, “...the principle has different applications in different fields, and its content depends on the context”.¹⁹³

A similar observation is also made by Tarcisio Gazzini:

If the introduction of the proportionality test must be welcome, the application of the test remains rudimental and inaccurate...[I]t is difficult to compare the aim of the measure(s) with the charge imposed on the foreign investor. This may work in the field of human rights where tribunals are used and allowed to strike a balance between the general interest and the protection of the individual while recognizing a wide margin of discretion to States. The transposition to foreign investment of this approach seems rather problematic.¹⁹⁴

The same skeptical note can also be found in the writings of Simon Baughen, who similarly questions the usefulness of proportionality in deciding on claims of expropriation.¹⁹⁵ Commenting on *Tecmed* and its claim that the concept of proportionality adopted in the jurisprudence of the European Court of Human Rights could be useful in adjudicating investment disputes Baughen writes:

...under the ECHR jurisprudence...a deprivation of possessions, which equates to an expropriation under customary international law, will rarely, if at all, be proportional in the absence of compensation. In contrast, a measure that affects a control of use will often be proportional in the absence of compensation, but such

¹⁹¹ Ibid

¹⁹² J. Fan, ‘Regional Judicial Assistance of the Commercial Affairs in Macao and China: Origin, Present Situation, Framework and Perspectives’ (2004) Journal of Macao Studies, 40. Available at www.macaudata.com/macauweb/pdf_books/pdf_book_pm_0002.pdf

¹⁹³ X. Han, supra n176, p644

¹⁹⁴ T. Gazzini, ‘Drawing the Line between Non-Compensable Regulatory Powers and Indirect Expropriation of Foreign Investment – An Economic Analysis of Law Perspective’ (2010) Manchester J. Int’l Econ.L., Vol.36 (7), p43

¹⁹⁵ S. Baughen, ‘Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven’, (2006) J. Env’tl. L., Vol.18 (2), pp207-228

claims would not constitute expropriations under customary international law, because of the absence of the requisite severity of the impact on the investment. It must therefore be doubted whether the concept has any role to play in developing the jurisprudence of customary international law as to what State conduct constitutes an expropriation.¹⁹⁶

A profound substantive discontent, in other words, exists between the theories of proportionality developed under the ECHR system and the traditional assumptions of international investment law. To transplant the former into an investigate framework structured by the latter is while novel, a dubious proposition.

Nor is this all. As Gazzini points out:

The proportionality test as elaborated by the ECHR, moreover seems inappropriate in respect of measures affecting a plurality of subjects. In this case, proportionality must be applied taking into account inter alia the global impact of the measures for two reasons. First, the test will not only produce a partial and misleading result, but also make it extremely difficult – if not impossible – to prove a case of indirect expropriation. Second, since the impact of regulatory measures on different investors may be different, the individual application of the proportionality test is likely to lead to inconsistent outcomes.¹⁹⁷

The apparent appetite for the use of proportionality in modern practice seems to be in-keeping with, as Kennedy notes, “...a global trend in legal thought” to incorporate proportionality into legal decision making.¹⁹⁸ However doubts concerning the applicability of proportionality to the adjudication of investment disputes are not without merit. Taking into consideration the work of scholars mentioned, it would be appropriate to note the observation made by Kennedy in his discussion of the evolution of the proportionality discourse in legal reasoning that:

¹⁹⁶ Ibid, p213

¹⁹⁷ T. Gazzini, supra n194, p43

¹⁹⁸ D. Kennedy, ‘A Transnational Genealogy of Proportionality in Private Law’ in *The Foundations of European Private Law*, ed. B.Brownsword, H. Micklitz, L.Niglia and S. Weatherill (2011, Oxford), p187. See also D. Kennedy, ‘Three Globalizations of Law and Legal Thought:1850-2000’ in *The New Law and Economic Development. A Critical Appraisal*, ed. D. Trubek and A. Santos (2006, Cambridge)

...the move to proportionality represents the simultaneous de-rationalisation and politicisation of legal technique...[and] is open to radically different interpretations.¹⁹⁹

Kennedy notes the attractiveness of the ideal of proportionality in legal decision making by tracing its close relationship with the idea of balancing exercises:

...We balance when there is a gap, or conflict or ambiguity in legal materials, so that it is at least arguable that there is neither a definitive 'concept' nor a definitive teleological nor a definitive precedential answer to the interpretative question posed...In balancing, we understand ourselves to be choosing a norm (not choosing a winning party) among a number of permissible alternatives on the ground that it best balances or combines normative conflicting considerations...²⁰⁰

When they apply the principle of proportionality in international investment law, tribunals engage typically in a balancing exercise aimed to resolve a conflict in legal materials or rights: the rights of investors to the protection of their property against the rights of the host state to exercise its regulatory sovereignty within its territory. The problem with this setup, however, is that balancing is a notoriously open-ended exercise: there is nothing in the idea of proportionality that helps either the investor or the host state gain a clearer understanding of how exactly any given dispute is going to turn out. The logic of balancing in other words, does not allow for any greater degree of certainty in the determination of the legal boundary between indirect and regulatory expropriation.

From the foregoing discussion, it seems clear that there are conflicting views on how suitable the approach will be in distinguishing between indirect expropriation and regulatory expropriation. Ultimately, in addressing claims of indirect expropriation by states, one would hope that the tests used by tribunals to distinguish between the two practices are sufficiently clear and precise. A close examination of the matter, however, indicates that such hopes may be rather misplaced.

¹⁹⁹ Ibid

²⁰⁰ Ibid, p190

i. Severity of damage to an investment

As demonstrated in *Tecmed v Mexico*, a tribunal that seeks to apply the proportionality approach to an investment dispute, must first consider the level of damage that has been done to an investment.²⁰¹

Demonstrating the level of seriousness of damage that an investment has suffered before it is deemed as having been indirectly expropriated is difficult. In the first instance it is quite clear that the categorisation of a state measure as ‘harmful’ to an investment is indeterminate, and says little of the meaning of this criterion in practice. Tribunals have long recognised this fact and have attempted to provide clarity on the substance of this criterion of the proportionality approach to dealing with investment disputes. However their success has been limited. In his review of the decisions of many investment tribunals on the level of harm that must be done to an investment before it is identified as having been expropriated, Gazzini notes that “...Tribunals have adopted similar but by no means equivalent tests...”²⁰² A review of international investment law jurisprudence demonstrates the variety of tests that the tribunals have employed in addressing the harm done to an investment.

Thus in *CMS Gas Transmission Company v Argentina*,²⁰³ the tribunal stated that the test was whether or not there is evidence that “...substantial deprivation”²⁰⁴ has been suffered by investors. The difficulty is that this test is not sufficient in and of itself, in that the tribunal does not demonstrate what a ‘substantial deprivation’ involves. Rather the tribunal must involve other criteria to give meaning to this test in that a ‘substantial deprivation’ will only have occurred where (i) the investor is not in control of the investment, (ii) the Government controls the day-to-day operations of the company, (iii) company employees are under arrest, (iv) the payment of dividends by the company is

²⁰¹ *Tecmed v Mexico*, supra n94, para 116.

²⁰² Gazzini, supra n194, p39. See also M. Porterfield, ‘State Practice and the (Purported) Obligations under Customary International Law to Provide Compensation for Regulatory Expropriations’, (2011-2012), N.C.J Int’l L. & Com. Reg Vol.37, pp163-164

²⁰³ *CMS Gas Transmission Company v Argentina*, Award, 12 May 2005, ICSID Case No ARB/01/8.

Available at <http://www.italaw.com/sites/default/files/case-documents/ita0184.pdf>

²⁰⁴ *Ibid*, para 262

interfered with, (vii) directors or the senior management are not appointed by the company, or (viii) the investor does not have full control or ownership of their investment.²⁰⁵

A different test was followed in the case of *Pope & Talbot Inc. v Canada*.²⁰⁶ There the tribunal ruled that inasmuch as there was no evidence to demonstrate that there had been an interference “...substantial enough” the impact of the government measure in question could not be deemed as expropriatory.²⁰⁷ The tribunal did not clarify what the concept of ‘substantial enough’ interference actually means in practice, other than to agree that based on the arguments of the Respondent that this level of interference had not been proven in the present case.

By contrast in the case of *Tippets v Iran*²⁰⁸ the threshold argument was articulated in terms of ownership rights. The tribunal held that expropriation will occur:

...whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral.²⁰⁹

The difficulty with this ruling is that this test does not specify which particular rights have to be affected for the threshold to be crossed. Furthermore it also fails to explain what timeframe has to be borne in mind for when government interference would, or would not be “...merely ephemeral”. The fact of the matter is that both of these two components of the test are vague and there is considerable scope for interpretative contestation.

In *Starrett Housing v Iran*²¹⁰ a different test was employed altogether: in determining whether the damage suffered by the investor should be considered severe enough the tribunal stated that an expropriation will only have occurred where property rights “...are rendered so useless that they must be deemed to have been expropriated”.²¹¹ Arguably this test is somewhat more definitive than that which has been formulated by other tribunals in that it requires adjudicators to look for what would be typical of a case of direct

²⁰⁵ Ibid, para 259. The tribunal agrees with the Respondent in this case at paras 263-264, who argues that none of these criteria have been demonstrated by the Claimant.

²⁰⁶ *Pope & Talbot Inc. v Canada*, supra n128

²⁰⁷ Ibid, para 96

²⁰⁸ *Tippets v Iran*, supra n132

²⁰⁹ Ibid, p225

²¹⁰ *Starrett Housing Corp v Islamic Republic of Iran*, supra n61

²¹¹ Ibid, para 154

expropriation. However it is perhaps too severe a test in attempting to negotiate the apparent differences between indirect expropriation and regulatory expropriation. Furthermore the term “...so useless” is not particularly helpful in that it invites one to form a view depending on whether or not they view this aspect of the test as an absolute or a matter of degree, and begs the question as to when investors rights are robbed of any utility. This question is also subject to competing but equally valid answers.

In an even more bizarre turn of reasoning, in *LG&E v Argentina*²¹² the deciding factor in determining the severity of the damage suffered by the protected investment was defined in even more circular terms:

...[for] the economic impact unleashed by the measure adopted by the host State [to be] sufficiently severe as to generate the need for compensation due to expropriation...the impact must be substantial in order that that compensation may be claimed for the expropriation.²¹³

The lack of clarity with regard to what precisely constitutes the test for determining whether the severity of damage to an investment should be considered expropriatory or regulatory, is not limited international investment law jurisprudence, but can also be found in the writings of scholars and publicists. In his analysis of the scholarly literature in international investment law, Mostafa notes that there are various descriptions of the threshold that must be reached before a state measures impact on an investment is deemed to be expropriatory.²¹⁴ Gudofsky writes that a state measure must result in foreign investor suffering “...a significant loss over the use and/or enjoyment of his or her property” before it can be deemed as expropriatory.²¹⁵ Mapp on the other hand writes that a measure must be such that it “...renders property “virtually valueless”” before it could be vulnerable to a finding of being expropriatory.²¹⁶ Wortley offers a completely different idea of how severe

²¹² *LG&E v Argentina*, supra n133

²¹³ Ibid, para 191

²¹⁴ B. Mostafa, ‘*The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law*’ (2008) *Austl. Int’l L. J.*, Vol.15, pp279-280

²¹⁵ J. Gudofsky, “*Shedding Light on Article 1110 of the North American Free Trade Agreement (NAFTA) Concerning Expropriations: An Environmental Case Study*” (2000-2001) *Northwestern Journal of International Law and Business*, Vol.21, p258.

²¹⁶ W. Mapp, *The Iran-US Claims Tribunal : The First Ten Years* (1993) p155, cited in J. Wagner, “*International Investment, Expropriation and Environmental Protection*” (1999) *Golden Gate University Law Review*, Vol.29, pp522-523. Available at <http://digitalcommons.law.ggu.edu/ggulrev/vol29/iss3/6>

damage to an investment must be before it can be deemed expropriatory in that it “...become[s] equivalent to the [direct] expropriation of a property right”.²¹⁷

A modest foray into international investment law jurisprudence demonstrates the variety of tests that tribunals have employed in establishing the severity of damage suffered by investors. However attempts by investment tribunals and scholars to clarify the level of damage that must be suffered by an investment have so far had limited success. Their efforts have resulted in an incoherent body of case law, which has resulted in this criterion of the proportionality approach to be no less indeterminate than when it was created. A lacking in certainty on the requisite level of damage that is required before an investment is deemed as having been expropriated represents a significant problem for both investors and tribunals. Investors may be faced with the prospect of having to argue a claim of indirect expropriation but not knowing the relevant threshold they have to demonstrate to the tribunal. Furthermore tribunal members will not know how to apply their minds to the facts that are presented to them - they will not be equipped with the necessary tools to establish whether or not an expropriation has occurred. Wortley goes on to note that the “...uncertainty concerning the threshold of seriousness of the adverse effect of the measure(s) upon the foreign investor represents a serious problem”.²¹⁸

ii. Legitimacy of the Public Interest

Establishing the legitimacy of a public interest which is claimed to be the motivating factor for a state’s actions, is difficult.²¹⁹ Historically some scholars have questioned whether an international court or tribunal should have any part to play in determining the legitimacy of state regulatory conduct. As Sornarajah notes :

²¹⁷ B. Wortley, *Expropriation in Public International Law* (1959, New York) p110

²¹⁸ Ibid

²¹⁹ Nikiema, *supra* n68, p19

[T]he inquiry into the motives behind the taking of foreign property, especially by a foreign court or tribunal, would be a task that would not only involve an affront to the sovereignty of the nationalizing state but would lead to charges of prejudice against a tribunal which makes the decision.²²⁰

In adjudicating on investment disputes tribunals have been reluctant to engage in any analysis on the motivations behind state regulatory measures.²²¹ However the only reason that a tribunal will question the legitimacy of the purpose of a state's regulatory measure is to ensure that it is acceptable under international, not national law. In most investment disputes where a state claims that it was pursuing bona fide regulation, arguments about the use of regulatory or 'police powers' tend to arise. Many tribunals have ruled that in principle state actions that are regulatory in nature are exempt from the need to compensate investors. What exactly should be included under this rubric, however, remains unclear. As the tribunal in *SD Myers v Canada*²²² noted:

The general body of precedent usually does not treat regulatory action as amounting to expropriation. Regulatory conduct by public authorities is unlikely to be the subject of legitimate complaint under Article 1110 of the NAFTA although the Tribunal does not rule out the possibility.²²³

The tribunal in *Saluka v Czech Republic*²²⁴ made similar comments:

In the opinion of the Tribunal, the principle that a State does not commit an expropriation and is thus not liable to pay compensation to a dispossessed alien investor when it adopts general regulations that are 'commonly accepted as within

²²⁰ M. Sornarajah, *The Pursuit of Nationalised Property*, (1986), p175 cited in J. Stanley, 'Keeping Big Brother Out of Our Backyard: Regulatory Takings as Defined in International Law and Compared to American Fifth Amendment Jurisprudence' (2001) *Emory Int'l L. Rev.*, Vol.15, pp374-375

²²¹ This has been the approach of some tribunals when dealing with state measures that were claimed to have been taken with the purpose of protecting the environment. See B. Choudhury, 'Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to a Democratic Deficit?', (2008) *Vanderbilt J Transnat'l L* Vol.41, p794

²²² *SD Myers v Canada*, Partial Award, 13 November 2000, UNCITRAL. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0747.pdf>

²²³ *Ibid*, para 281

²²⁴ *Saluka v Czech Republic*, supra n86

the police power of States' forms part of customary international law today. There is ample case law in support of this proposition.²²⁵

This principle was also reiterated in the case of *Continental Casualty v Argentina*:²²⁶

Limitations to the use of property in the public interest that fall within typical government regulations of property entailing mostly inevitable limitations imposed in order to ensure the rights of others or of the general public (being ultimately beneficial also to the property affected). These restrictions do not impede the basic, typical use of a given asset and do not impose an unreasonable burden on the owner as compared with other similar situated property owners. These restrictions are not therefore considered a form of expropriation and do not require indemnification, provided however that they do not affect property in an intolerable, discriminatory or disproportionate manner.²²⁷

The criterion of 'legitimacy' in the context of investment law does not suffer from the same indeterminacy as the severity component of the proportionality approach. As evidenced above, the question for a tribunal dealing with an investment dispute is whether or not a State has committed a wrong under international law: it must establish whether the purpose pursued by a state is acceptable under international law, and therefore in effect determine its legitimacy. However the difficulty in using the 'police powers' of states as a criterion, as Atwood and Trebilcock note, that will either condemn or save a state's actions and deem them as indirectly expropriatory or regulatory, is that there is conflicting evidence as to their substantive content.²²⁸ Tribunals appear to have been inconsistent in applying this doctrine in practice.

A brief reiteration of the findings of investment tribunals on the content of the 'police powers' doctrine, as was discussed earlier in this thesis, is merited. Some tribunals notably *Methanex v United States* recognised environmental measures as being within the limits of

²²⁵ *ibid*, para 262

²²⁶ *Continental Casualty v Argentina*, Award, 5 September 2008, ICSID Case No. ARB/03/9. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0228.pdf>

²²⁷ *Ibid*, para 276

²²⁸ E. Atwood and M. Trebilcock, 'Public Accountability in an Age of Contracting Out', (1996) C.B.L.J. Vol.27, p45

the ‘police powers’ doctrine,²²⁹ but failed to substantiate the ruling in discussing the parameters of the public purpose pursued. Furthermore in cases like *Santa Elena v Costa Rica*,²³⁰ the tribunals showed little regard for the alleged purposes put forward by the host, and made clear that regardless of the motivating purpose of state measures the investor still required to be compensated. This ruling was similar to that in *Tecmed v Mexico*²³¹ where there was little doubt that measures taken with a view to protecting societal interests are not immediately excluded from the rule requiring investors to be compensated following their investments being damaged as a result. Moreover in *Metalclad v Mexico* the tribunal stated that the motivation for the states employing environmental protection measures was irrelevant to its finding of an indirect expropriation.²³² The tribunal in *Link-Trading v Moldova* held that the impact of a state’s taxation powers would not, in the circumstances merit compensation.²³³ However, the same tribunal did acknowledge that taxation can be of such severity that it would constitute expropriation.²³⁴ Furthermore while in cases like *SD Myers v Canada* the tribunal deemed state regulatory practices to be exempt from categorisation as expropriatory, in the case of *Pope and Talbot v Canada*²³⁵ the tribunal was very critical of the claim that regulatory ‘police power’ measures cannot be expropriatory.²³⁶ What is more, some tribunals have even gone so far as to say that there has never been any agreed definition of ‘police powers’ in international law.²³⁷

It is clear from case-law that there are contradictory decisions being made by investment tribunals, and a lack of consensus on the substance of the ‘police power’ doctrine and regulatory expropriation. The differing views expressed by tribunals on this topic do little more than present an incoherent body of decisions from which one cannot discern, with

²²⁹ *Methanex v The United States*, supra n71

²³⁰ *Compania del Desarrollo de Santa Elena, S.A. v Republic of Costa Rica* ICSID Case No ARB/96/1, Final Award, 17 February 2000, para 72. Available at http://italaw.com/documents/santaelena_award.pdf

²³¹ *Tecmed v Mexico*, supra n94

²³² *Metalclad v Mexico*, supra n55, para 111

²³³ *Link Trading v Moldova*, supra n100, para 83,

²³⁴ *Ibid*, paras 64-91

²³⁵ *Pope and Talbot v Canada*, supra n128

²³⁶ *Ibid*, para 99 where the Tribunal states “Canada appears to claim that, because the measures under consideration are cast in the form of regulation, they constitute an exercise of ‘police powers’, which, if non-discriminatory, are supposedly beyond the reach of the NAFTA rules regarding expropriations. While the exercise of ‘police powers’ must be analysed with special care, the Tribunal believes that Canada’s formulation goes too far. Regulations can indeed be exercised in a way that would constitute creeping expropriation.”

²³⁷ See *American International Group, Inc. and American Life Insurance Company v Islamic Republic of Iran and Central Insurance of Iran*, Iran-US CT Award No 93-2-3, 19 December 1983 at para 145 where the tribunal states that a “...precise definition of the ‘public purpose’ for which an expropriation may be lawfully decided had neither been agreed upon in international law nor even suggested.”

any degree of certainty what the content of the ‘police powers’ doctrine is. This view is held also by the scholarly authorities. Thus Mostafa writes “...the precise scope and meaning of the rule is notoriously uncertain”²³⁸ and has “...multiple formulations”.²³⁹ In their discussion on government regulation and expropriation, both Atwood and Trebilcock share the view that there does not “...appear to be any universally agreed set of principles as to when one government action should fall into one category and another in the other”.²⁴⁰ Mostafa goes on to note that:

It should be accepted that the current state of customary international law, and indeed treaty law, in the field of foreign investment, is that States are free to determine what is in their public interest. International investment law does not contain a hierarchy under which public purposes that are recognised by all States are legitimate, whilst only those invoked by some States are not.²⁴¹

From the discussion above it is clear that what is deemed to be in the public interest of states in pursuing regulatory measures, or exercising their ‘police powers’ is a fundamentally unsettled question. Tribunals’ approach to dealing with the issue has been highly inconsistent, and scholarly opinion seems to be in keeping with this view.

While there are concerns regarding the certainty of the substance of the doctrine of ‘police power’ in international investment law, some also question the very language used to create it. Weston discusses the terminology of lawyers, both municipal and international, and is critical of the use of ambiguous descriptors of state actions as “regulatory” or “an exercise of the police power”.²⁴² As he goes on to note:

To aggrieved parties it is a small comfort that the action is “regulatory” or “an exercise of the police power.” They have all lost in the same way. As Edwin Borchard is reputed to have said, “[e]very man whose property rights are diminished thinks that there has been a ‘confiscation’”²⁴³

²³⁸ Mostafa, supra n214, p272

²³⁹ Ibid, p267. See also Kriebaum, supra n75, pp726-728

²⁴⁰ Atwood and Trebilcock, supra n228. See also A. Mouri, ‘*The International Law of Expropriation as Reflected in the Work of the Iran-US Claims Tribunal*’, (1994, The Netherlands), p326

²⁴¹ Mostafa, supra n214, pp277-278

²⁴² B. Weston, “‘*Constructive Takings*’ under International Law: A Modest Foray into the problem of ‘*Creeping Expropriation*’” (1975-1976) *Va.J.Int’l L.*, Vol.16, p111

²⁴³ Ibid, p112

An alternative to speaking about measures that are accepted as a bona fide use of ‘police powers’, is of state measures taken in the ‘public interest’. However this alternative taxonomy provides little guidance for tribunals in attempting to resolve investment disputes when, as Choudhury writes, ‘public interest’ issues can be formulated in one of two ways

First the public interest can be thought of in terms of the interest of the state and its constituents. Thus for example, under takings jurisprudence, state takings may be exempt from liability if effectuated for a public purpose. For the most part the state is given broad discretion to self-define its “public purpose” so long as it is rational and reasonable. The discretion given to states to act for a public purpose is premised on the idea that the state will act in the best interests of the state and its citizens...The public interest can also implicate issues which encapsulate the common interest of mankind. Examples of this include issues such as those raised by human rights or environmental concerns. In this context, public interest may implicate the economists’ notion of public goods. Economists define a public good as being non-rival and non-excludable. Thus, the environment, drinking water, and many public services are all considered public goods.²⁴⁴

Both of these competing, but equally valid, interpretations of the idea of public purposes are available to tribunals in deciding on investment disputes. The availability of multiple meanings does not fit well with the task of finding an exclusionary criterion.

iii. Necessity of the measure

The last component of the proportionality analysis requires tribunals to consider whether or not the actions of the State were necessary in the circumstances giving rise to an investment dispute. This is arguably the most difficult aspect of the proportionality approach for tribunals to deal with. As has been noted in scholarly literature this component of the proportionality approach, where a tribunal will determine whether state’s actions are indirectly or regulatory expropriatory will consider“...by way of a

²⁴⁴ Choudhury, *supra* n221, p791. See also K. Baslar, *The Concept of the Common Heritage of Mankind in International Law*, (1998), pp40-41 and T. Waelde and A. Kolo, ‘*Environmental Regulation, Investment Protection and ‘Regulatory Taking’ in International Law*’, (2001), *Int’l & Comp. L. Q.*, Vol.50, p817.

balancing process, all relevant circumstances”,²⁴⁵ has been applied in a contradictory manner by tribunals.

Henckels notes that “...there is no single coherent approach to proportionality” but points out that in the context of investment disputes one approach does seem to have become popular where tribunals are required to employ “...a nested sequence of successively more stringent tests” in determining whether or not an impugned state measure will be deemed proportionate to its aim.²⁴⁶ Leonhardsen also notes this and speaks in greater detail on the substance of the necessity criterion:

I mean here a judicial analysis consisting of three different elements: suitability, necessity and proportionality *stricto sensu*, which must be assessed cumulatively. The first of these implies ‘whether the measure at issue is suitable or appropriate to achieve the objective it pursues.’ For a measure to be suitable the existence of ‘a causal relationship between the measure and its object’ is required. For a measure to be necessary there must exist no alternative measure that is both less restrictive than the measure being reviewed and equally effective in achieving the objective pursued. This stage of the analysis exists in a somewhat uneasy relationship with the notion of a wide margin of appreciation left to State parties by international adjudicators, which sometimes seems to cause them to skip this stage altogether, as appears to have been the case in the award in the *Tecmed* case discussed below.²⁴⁷

In terms of determining a measures’ proportionality *stricto sensu*, Leonhardsen refers to the work of Van den Bossche who, in a somewhat different though related context, states that this “...involves an assessment of whether the effects of a measure are disproportionate or excessive in relation to the interests involved”.²⁴⁸ Leonhardsen also notes the works of Adenas and Zepling in this respect, who write that in the context of resolving WTO disputes:

²⁴⁵ Henckels, *Supra* n13, p226

²⁴⁶ *Ibid*, p227

²⁴⁷ E. Leonhardsen, ‘*Looking for Legitimacy: Exploring Proportionality Analysis in Investment Treaty Arbitration*’ (2011), Available at SSRN: <http://ssrn.com/abstract=2255804>, pp20-21

²⁴⁸ *Ibid*; see also P. Van den Bossche, “*Looking for Proportionality in WTO Law*” (2008) *Legal Issues of Economic Integration* Vol.35, p285

It is at this stage that a true weighing and balancing of competing objectives takes place. The more intense the restriction of a particular interest, the more important the justification for the countervailing objective needs to be.²⁴⁹

Despite the admirable efforts of scholars to point out the constituent parts of the necessity criterion to allow for its consistent application, tribunals appear to have adopted conflicting approaches to its application. Despite being the leading case on the test, the tribunal in *Tecmed v Mexico* has been heavily criticised by scholars for failing to administer the full necessity criterion. As Leonhardsen notes, the tribunal in *Tecmed* seemed to skip the analysis of the states measure's necessity altogether.²⁵⁰ As Henckels goes on to note:

Proceeding directly to assess a measure's strict proportionality entails arriving at a normative judgement about whether the importance of achieving the objective outweighs the objective of preventing harm to the investor's interests without first evaluating suitability (likely effectiveness) of the measure to achieve its objective nor whether alternative measures are open to the host state to achieve its objective.²⁵¹

The tribunal in *Tecmed* was not alone in being selective of how to apply the necessity criterion to the facts. The tribunal in *Saluka v Czech Republic* followed the approach of *Tecmed*:

The determination of a breach ... requires a weighing of the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other. A foreign investor protected by the Treaty may in any case properly expect that the Czech Republic implements its policies bona fide by conduct that is, as far as it affects the investors' investment, reasonably justifiable by public policies and that such conduct does not manifestly violate the requirements of consistency, transparency, even-handedness and non discrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by

²⁴⁹ Ibid; see also M. Adenas and S. Zleptnig, 'Proportionality: WTO Law: In Comparative Perspective' (2006-2007) Vol.42 (3) Tex.Int'l L.J. p390

²⁵⁰ Leonhardsen, supra n247, p20.

²⁵¹ Henckels, supra n13, p233

showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment.²⁵²

This approach was followed in other investment law disputes regarding indirect expropriation. In the case of *EDF Limited v Romania*²⁵³ the tribunal, in applying the proportionality approach to the dispute, also applied a strict necessity analysis.²⁵⁴ It failed to undertake "...a full analysis of the preliminary stages of assessment of regulatory objective, suitability and necessity".²⁵⁵

As evidenced from the discussion above, there are multiple formulations emerging on how the necessity criterion is to be applied. Furthermore as noted by Leonhardsen there is evidence of differing approaches to proportionality in different fields and settings.²⁵⁶ The difficulty therefore is deciding on which of these approaches to applying the necessity criterion is correct in the context of resolving investment disputes. While scholars do criticise the approach of the tribunal in *Tecmed v Mexico*, there is no evidence from other tribunals to suggest that any ruling is per se wrong. The implication therefore is that most if not all of these differing interpretations and applications of the necessity criterion are valid. However this does not bode well for the use of the criterion in attempting to distinguish between indirect and regulatory expropriation. The substance of the criterion has been proven to have become porous, in that it invites tribunals to consider competing approaches. This variety of approaches, all of which may well be valid, prevent the criterion from operating as an exclusionary tool in the resolution of investment disputes which greatly reduces its utility as a legal doctrine.

Each of the component parts of the proportionality approach seem to suffer from significant flaws in that they are either the subject of various different interpretations, or are so vague that they require adjudicators to involve other considerations before they can come to a decision. The concepts, or rather the ways that tribunals have applied them, do not allow for any degree of predictability in deciding on claims of indirect or regulatory expropriation. As has been observed by one tribunal:

²⁵² *Saluka v Czech Republic*, supra n86, paras 304-307

²⁵³ *EDF (Services) Limited v Romania*, ICSID Case No. ARB/05/13, Award, 8 October 2009, ICSID Case No. ARB/05/13. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0267.pdf>

²⁵⁴ *Ibid*, paras 45-64 and 293-94

²⁵⁵ Henckels, supra n13, p236

²⁵⁶ Leonhardsen, supra n247, p23

[p]redictability 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 ‘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 at grievance, but also on the way the evidence is presented, and the legal bases pleaded. The outcome is judgement, i.e. the product of discernment, and not the printout of a computer program.²⁵⁷

It is suggested that the proportionality approach is not sufficient to maintain the distinction between indirect expropriation and regulatory expropriation in international investment law. Having identified weaknesses in the analytical framework that tribunals employ in attempting to distinguish between indirect and regulatory expropriation the issue is whether or not indirect and regulatory expropriation as concepts, are dealt with in a more consistent and predictable manner, which allows for their labelling as distinctive practices to be credibly maintained.

²⁵⁷ *Generation Ukraine v Ukraine*, Award, 16 December 2003, ICSID Case No. ARB/00/9, para 20.29. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0358.pdf>

Chapter 5

Questioning conceptual distinctions

To recap, in international investment law state measures that leave the legal title to property intact, but have some other negative impact on, or restricts the value of an investment may amount to indirect expropriation. This requires that investors be compensated for their loss. However international tribunals and academics also recognise that state actions that are taken in exercise of police powers, regulatory expropriation, in principle should not require foreign investors to be compensated.²⁵⁸ The reason for this is found in the concept of state sovereignty which is thus seen to act as a restriction on the investors' right to compensation. What this chapter intends to demonstrate is how the proposition that indirect and regulatory expropriation are distinct legal phenomena can be brought into question. This chapter will evidence how tribunals in presenting the two doctrines as theoretically distinct nevertheless seem to focus on the same conceptual structures.²⁵⁹ In all of the cases that shall be discussed, the tribunals return to deal with the same analytical elements. Furthermore this chapter will demonstrate how in arriving at their decisions, tribunals are inconsistent in their reasoning as to what aspects of a dispute are important in distinguishing indirect expropriation from regulatory expropriation.

The available literature on the indirect/ regulatory expropriation distinction is both wide and dense. The tribunal decisions that are discussed below, it is suggested, are particularly useful in demonstrating the confusion that seems prevalent in international investment law in treating indirect expropriation and regulatory expropriation by a state as wholly distinct legal phenomena.

The claim of an indirect expropriation of foreign investors property was the subject of debate in the case of *Biloune v Ghana Investment Centre*.²⁶⁰ Mr Antoine Biloune, a Syrian national held 60% equity interest in MCDL, a corporation incorporated in Ghana. MCDL was initially granted a lease in November 1985 by GTDC (a corporation owned and formed by the Ghanaian Government to operate tourist facilities) to renovate and manage a restaurant at the Marine Drive Complex in Accra, Ghana. In 1986, MCDL formed a joint venture with GTDC for the construction of a 4-star hotel resort complex. The project was

²⁵⁸ Mostafa, supra n214. p273

²⁵⁹ See Nikiema, supra n68 at p18 where it is noted that what may be deemed as lawful regulations "...cannot be...considered indirect expropriations, regardless of the adverse effects on the investment"

²⁶⁰ *Biloune and Marine Drive Complex Ltd v Ghana Investments Centre and the Government of Ghana*, 95 I.L.R (1989)

approved by the Ghana Investments Centre in the “GIC Agreement”. MCDL completed a great deal of remodelling and construction, when the Accra City Council issued an order for operations to cease owing to the lack of a building permit. The City Council then demolished part of the project, and Mr. Biloune, and others were subjected to financial scrutiny by the authorities, after which Mr Biloune was arrested, held in custody for 13 days without charge, and subsequently deported from Ghana to Togo. The Government then closed the site of the project. Mr Biloune was not permitted to return to Ghana and MCDL was not allowed to carry out any further work on the project, which remained uncompleted.

The Government claimed that its actions were due to a failure by GTDC to obtain a permit for the works it had carried out.²⁶¹ The tribunal was puzzled by the motivations of the Ghanaian government for acting in the way that it did:

The motivations for the actions and omissions of the Ghanaian governmental authorities are unclear.²⁶²

However the tribunal ruled that this constituted an instance of ‘constructive’ or indirect expropriation and said the following on the motivations of the Ghanaian Government:

...the Tribunal need not establish those motivations to come to a conclusion in this case. 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 with 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.²⁶³

The tribunal makes very clear that while none of the individual measures pursued by the state could be wholly determinate, the combination of state measures taken against MCDL and Mr Biloune were sufficient to cause the investment significant harm, in preventing its purpose from being realised in the completion of the project. The Tribunal goes on to note:

²⁶¹ Ibid, p208

²⁶² Ibid

²⁶³ Ibid, p209

Given the central role of Mr Biloune in promoting, financing and managing MDCL, his expulsion from the country effectively prevented MCDL from further pursuing the project. In view of the Tribunal, such prevention of MCDL from pursuing its approved project would constitute constructive expropriation of MCDL's contractual rights in the project and, accordingly, the expropriation of the value of MR Biloune's interest in MDCL, unless the Respondents can establish by persuasive evidence justification for these events.²⁶⁴

Based on the ruling by the tribunal in this case, the purpose of the respondent for pursuing the action that became the subject of the dispute was irrelevant to its being classified as an indirect or regulatory expropriation. Rather what appears to have been the deciding factor in deeming this to be an instance of indirect expropriation, was the level of damage suffered by the investor.

The tribunal identifies a state measure that was taken with a public purpose, which in this case the tribunal cannot identify, that has a negative effect on an investment. These three facets are clearly identifiable as the concepts which the tribunal points out in identifying the dispute as an instance of indirect expropriation. Therefore it seems reasonable to infer that regulatory expropriation would be conceptually quite different from an instance of indirect expropriation, given that its occurrence will not attract the requirement of compensation for investors.

However a counterpoint to the idea that regulation by a state is not expropriatory is that, as Newcombe writes, "by definition, almost any government regulation restricts property rights".²⁶⁵ Furthermore as Dolzer and Schreuer write, instances of state regulation are dealt with by investment tribunals under the same rules as cases of indirect expropriation.²⁶⁶ Moreover in discussing the impact of a States regulatory practices on foreign investments, tribunals have acknowledged that it is "...undisputable" that the exercise of police powers can cause economic damage to a foreign investment.²⁶⁷ Therefor as has been noted by Barklem et al:

In practice, protection against indirect appropriation means a foreign investor is entitled to file a claim against a host state on the grounds that the state when

²⁶⁴ Ibid

²⁶⁵ Newcombe, supra n5, p24

²⁶⁶ Dolzer and Schreuer, supra n1, p120

²⁶⁷ *Teemed v Mexico*, supra n94, para 119. See also Choudhury, supra n221, p794

exercising its regulatory powers (e.g. a law, decree, decision or other interference) is depriving him, wholly or partially, of his property, even if the state has not physically seized the asset. Under such protection, an investor can sue for economic loss caused by a state's action which affects his property.²⁶⁸

The regulatory practices of government were discussed in the landmark case of *Saluka v Czech Republic*²⁶⁹ which arose out of a failed privatisation of the Czech Republic's third largest bank, IPB. In 1998, the government sold a controlling block of IPB shares to Nomura Europe, which in turn transferred them to its subsidiary, Saluka Investments BC, a Nomura special-purpose company that was incorporated in the Netherlands. While the bank's performance was considerably improved under its new owner and management, the IPB still lacked sufficient operating capital and was burdened by a large amount of non-performing loans. In 1999 and 2000, the Czech government continued to privatise state owned banks and began to supervise the sector more closely. After repeatedly failing to comply with new and more stringent regulatory requirements, in June 2000 the IPB was put under forced administration by the Czech National Bank and then sold to another banking group. Nomura lost managerial control over the IPB bank and the IPB shares held through Saluka were rendered worthless. Saluka brought a claim before an investment tribunal alleging, amongst other things, that the actions of the Czech Government had expropriated its investment in IPB.

The tribunal set about establishing whether or not Saluka's shares were an investment under international law:

Saluka's shares in IPB were assets entitled to protection under the Treaty. Pursuant to Article 5 of the Treaty, the Czech Republic was prohibited from taking any measures depriving, directly or indirectly, Saluka of its investment in IPB unless one or more of the cumulative conditions set out in that Article were complied with. If the Tribunal finds that the Czech Republic has adopted such measures

²⁶⁸ C. Barklem and E. Prieto-Rios, 'The Concept of "Indirect Expropriation", its appearance in the international system and its effects in the regulatory activity of governments' *Civilizar* 11, (2011) Vol.21, p78. Available at <http://www.usergioarboleda.edu.co/civilizar/civilizar-21/the%20concept%20of%20indirect%20expropriation.pdf>. Accessed 18 August 2014

²⁶⁹ *Saluka v Czech Republic*, supra n86

without having complied with one or more of these conditions, the conclusion will inevitably follow that the Respondent has breached Article 5 of the Treaty.²⁷⁰

It is clear from the tribunal's formulation that the investment was subject to protection under the Treaty, and therefore under international law. As such investors were entitled to expect that their investment would not become the subject of an expropriation claim. The tribunal then went on to consider what had happened to the investment made by Saluka in the Czech Republic. It noted that Saluka had been deprived of its investment as a result of the forced administration by the Czech National Bank:

There can be no doubt, and the Tribunal so finds, that Saluka has been deprived of its investment in IPB as a result of the imposition of the forced administration of the bank by the CNB on 16 June 2000.²⁷¹

The process which the tribunal follows appears to be relatively linear. It has identified that the property of a foreign investor, Saluka, was the subject of protection by an investment treaty with the Czech Republic, and that the investment had been damaged as a result of the action taken by the Central Czech National Bank as state regulator for the industry.

Nevertheless the tribunal recited the position of state regulation in international investment law:

[i]t is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.²⁷²

The tribunal acknowledges that in international law state regulation, in pursuance of accepted goals or objectives, would not be deemed expropriatory. The tribunal then made a comment on the application of the doctrines of indirect and regulatory expropriation in the adjudication of investment disputes:

²⁷⁰ Ibid, para 266

²⁷¹ Ibid, para 267

²⁷² Ibid, para 255

...international law...has yet to draw a bright and easily distinguishable line between non-compensable regulations on the one hand and, on the other, measures that have the effect of depriving foreign investors of their investment and are thus unlawful and compensable in international law.²⁷³

This comment is significant in that the tribunal directly addresses the difficulties in labelling state conduct as being either indirect expropriation or regulatory expropriation. It points out that the rules which it must apply in deciding on investment disputes are unclear. Despite this the tribunal attributed a great deal of attention to the ability under domestic Czech law for the National Bank, as industry regulator, to force banks into administration where their shareholders have not taken measures to correct deficiencies in a banks performance with a view to protect the stability of the Czech banking system.²⁷⁴ The Tribunal attached importance to this, and held that the National Banks forced administration of IPB was:

...a lawful and permissible regulatory action by the Czech Republic aimed at the general welfare of the State, and does not fall within the ambit of any of the exceptions to the permissibility of regulatory action which are recognised by customary international law. Accordingly, the CNB's decision did not, fall within the notion of a "deprivation" referred to in Article 5 of the Treaty, and thus did not involve a breach of the Respondent's obligations under that Article.²⁷⁵

The tribunal in this case was motivated by the public utility that the state measure was alleged to serve, and felt that the end was sufficiently legitimate to justify the means where it held the action of the Czech Government regulatory and not to be expropriatory,²⁷⁶ "...notwithstanding that the measure had the effect of eviscerating Saluka's investment in IPB".²⁷⁷

The tribunal's arguments and ultimate ruling in this case is consistent with the idea of a framework where a state's actions, or that of state regulatory bodies, taken in pursuance of what is bona fide regulation or the exercise of police powers in international law will not

²⁷³ Ibid, para 263

²⁷⁴ Ibid, Decision of the Czech National Bank

²⁷⁵ Ibid, para 275

²⁷⁶ The Tribunal held that the measures pursued by the Czech National Bank "...can be justified as permissible regulatory actions", *ibid* para 265

²⁷⁷ Ibid, para 276

be expropriation. Interestingly however, in dealing with what it deemed to be an entirely separate situation, that of bona fide state regulation, the tribunal in this case returned to the same formula as that used in *Biloune*. Discussion was centred around how a state measure, taken with a public purpose, had the negative impact on the investment. This leads one to question how distinct the doctrines of indirect expropriation and regulation are when discussion on two theoretically different practices involve the same conceptual tropes: that of a state measure taken with a view to protect some kind of public or state interest which has the same identifiable effect on an investors property i.e. an investment is harmed by a states actions. In *Saluka* the state measure, aimed at protecting banking stability, resulted in the investment being “eviscerated”, and in *Biloune* the states actions resulted in the “irreparable cessation of work”. The tribunal in *Saluka* leads the observer away from this point, in holding that the facts of the case are indicative of *bona fide* state regulatory practices. Therefore while the investor does suffer damage, it is deemed to be ‘legitimate’ damage in the circumstances. Moreover there appears to be a conflict in these two cases as to what the deciding factor has been in arriving at their respective rulings. This will be explored in greater detail throughout this chapter.

This same difficulty of distinguishing indirect expropriation from regulatory expropriation is apparent in other cases. A clear example of this was in the case of *CME v Czech Republic*.²⁷⁸ Operating under the United Nations Commission on International Trade (UNCITRAL) rules, the tribunal in this case had to decide on whether the interference by the Czech Media Council, with the contract rights of the claimant’s subsidiary CNTS, constituted an indirect expropriation. In January 1993, the Czech Media Council issued a broadcasting licence to CET 21, a Czech company that the claimant in the dispute had agreed to finance. This decision, in allowing foreign capital to have control over the Licence, was the subject of intense criticism locally. To resolve the dispute CME and CET 21 agreed to form a new Czech company called CNTS. In exchange for ownership in the company, CET 21 provided CNTS with “irrevocable and exclusive” rights to the Licence. After a period of time, the Media Council expressed concerns that CNTS was improperly broadcasting without a licence. CNTS and CET 21 attempted to address these concerns by clarifying that CET held the Licence and was in operational control of broadcasting, and CNTS only arranged services for CET 21’s activities. In 1999 disputes arose between CET 21 and CNTS because CET 21 no longer wanted to contract exclusively with CNTS for

²⁷⁸ *CME v Czech Republic*, Partial Award, 13 September 2001, UNCITRAL. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0178.pdf>

broadcasting services related to the Licence. The Media Council also provided a letter that stated that CNTS did not have exclusive rights related to the Licence. CME argued that amongst other things, the action of the Czech Republic through the Media Council amounted to an expropriation. The Czech Republic defended the actions of the Media Council in many ways, including that the Council was merely monitoring and enforcing domestic law as industry regulator.

The tribunal noted that the practice of states or state regulators making changes to basis of an investment agreement is not uncommon in international investment law. However it did note that such practices are subject to limitations:

The Czech Republic and/ or the Media Council are as a matter of principle not debarred from amending or altering the basis for CME's investment, subject to the acquired rights and treaty obligations. This is a question of the Czech Republic's national sovereignty. However any such action must have been done under due process of law, providing just compensation (Art.5 of the Treaty).²⁷⁹

This comment is useful in that it sheds light on the reasoning of the tribunal in this instance. In deciding on the dispute, it seems clear that the tribunal was being guided by the necessity for "...due process of law..." to be observed, in deciding on whether indirect expropriation or regulatory expropriation had taken place. The tribunal then turned its attention to the facts of the case as it saw them:

The silent and coerced vitiation of CME's basis for its investment does not fulfil such a requirement and is, therefore, under the standards of the Treaty, and the rules of international law, a breach of treaty obligations.²⁸⁰

The meaning of the tribunal's argument is unmistakable. The state regulators interference with the investment had resulted in a breach of international law. The tribunal in deciding whether or not the actions of the state constituted the indirect expropriation of CME's investment, adopted very familiar language to that of cases of supposed regulatory expropriation by states in describing the situation:

²⁷⁹ Ibid, para 533

²⁸⁰ Ibid

The Media Council's actions and omissions...caused the destructions of CNTS' operations, leaving CNTS as a company with assets, but without business...What was touched and indeed destroyed was the Claimant's and its predecessor's investment as protected by the Treaty. What was destroyed was the commercial value of the investment...by reason of coercion exerted by the Media Council.²⁸¹

The tribunal identifies that while the assets are still within CNTS' control, its relationship with CET 21 was ultimately destroyed following the interference by the state regulator. The tribunal went on to note that:

The expropriation claim is sustained despite the fact that the Media Council did not expropriate CME by express measures of expropriation. De facto expropriation or indirect expropriations, i.e. measures that do not involve overt taking but that effectively neutralize the benefit of the property of the foreign owner, are subject to expropriation claims.²⁸²

The tribunal goes on to reiterate the doctrinal understanding of indirect expropriation in international investment law. The actions of the state regulator are deemed by the tribunal to be typical of this practice, and it goes on to hold that:

Expropriation of CME's investment is found as a consequence of the Media Council's actions and inactions as there is no immediate prospect at hand that CNTS will be reinstated in a position to enjoy an exclusive use of the licence...There is no immediate prospect at hand that CNTS can resume its broadcasting operations, as they were in 1996 before the legal protection of the use of the licence was eliminated.²⁸³

The tribunal ruled that the Media Council, as an organ of the Czech state had indirectly expropriated CME's investment, owing to the fact that the Council had not observed due process in its dealings with CET 21 and CNTS. The tribunal points out that while states are entitled to pursue activities that are in line with national sovereignty, this must be done

²⁸¹ Ibid, para 591

²⁸² Ibid, para 604

²⁸³ Ibid, para 607

in observance of *due process of law*. It found that this was not the case in this dispute. This ruling is demonstrative of how yet again the tribunal draws on the same set of conceptual tropes - a *state measure*, that has been taken for a *public purpose*, which has a *negative impact on an investment* - that could have otherwise been used to justify arriving at the entirely opposite finding of regulatory expropriation. Furthermore the case demonstrates the inconsistency in how tribunals decide on claims of indirect and regulatory expropriation. Unlike in the case of *Saluka* where the ‘public purpose’ was the deciding factor in the tribunals decision, or in *Biloune* where the damage to the investment was deemed crucial to the tribunals finding, CME saw the tribunal attach particular importance to ‘due process of law’ in arriving at its decision.

Another topical case on the distinction between indirect expropriation and regulatory expropriation, and arguably one of the most controversial investment law decisions to have been decided was that of *Santa Elena v Costa Rica*.²⁸⁴ Compañía del Desarrollo de Santa Elena, S.A. (“CDSE”) was a Costa Rican corporation, whose majority shareholders were US nationals. In 1970 CDSE purchased the property known as “Santa Elena”. This property was situated within Costa Rica and was composed of Pacific coastline, rivers and springs and several mountains, forests and valleys. CDSE bought Santa Elena for US\$395,000 with the intention of developing it as a tourist resort and residential community. CDSE began to design a land development program and undertook a variety of financial and technical analyses of the property with a view to its development. In 1978 Costa Rica issued a decree of expropriation in respect of Santa Elena (the “1978 Decree”), so to add it to the Santa Rosa National Park and contribute to the preservation of rare species. Although the property remained in the de facto possession of CDSE, it could no longer pursue its plans to develop the area into a tourist resort. To compensate CDSE for expropriation, Costa Rica proposed to pay CDSE approximately US\$ 1,900,000. CDSE did not object to expropriation per se but questioned the price fixed by Costa Rica. CDSE organised its own evaluation of the property (also in 1978) and claimed that US\$ 6,400,000 as compensation was merited. During the subsequent twenty-year period the parties were involved in litigation before Costa Rican courts, with the amount of compensation remaining unresolved. Under political pressure from the US Government, in 1995 Costa Rica consented to turn this matter over to the ICSID for arbitration.

²⁸⁴ *Santa Elena v Costa Rica*, supra n230

This case was arguably unique among the majority of claims to be brought to international arbitration. The parties in this case did not disagree on whether expropriation had occurred:

International law permits the Government of Costa Rica to expropriate foreign-owned property within its territory for a public purpose and against the prompt payment of adequate and effective compensation. This is not in dispute between the parties.²⁸⁵

Rather the issue at hand was on the level of compensation to be paid to the investors. However the Tribunal, in fixing the level of compensation to be paid, made the following observations of Costa Rica's conduct in attempting to preserve its natural environment:

While an expropriation or taking for environmental reasons may be classified as a taking for a public purpose, and thus may be legitimate, the fact that the Property was taken for this reason does not affect either the nature or the measure of the compensation to be paid for the taking. That is, the purpose of protecting the environment for which the Property was taken does not alter the legal character of the taking for which adequate compensation must be paid. The international source of the obligation to protect the environment makes no difference.²⁸⁶

The tribunal then went on to state that:

Expropriatory environmental measures—no matter how laudable and beneficial to society as a whole—are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains.²⁸⁷

The point made by the tribunal at this point became the subject of some contention. As noted by Kulick the reasoning of the court is rather appealing:

²⁸⁵ Ibid, para 71

²⁸⁶ Ibid

²⁸⁷ Ibid para 72

...Every expropriation requires a public purpose, thus public interest concerns such as preventing the natural diversity of flora and fauna may well serve as a public purpose but do not affect the host State's obligation to pay compensation. Indeed, if a host State was able to allege public interest concerns in general as a basis for justification of expropriation, the investor's protection in this regard would simply render void given the myriad of public purposes possible.²⁸⁸

It should be noted however that this ruling has not been received favourably in international investment law. The tribunal took a relatively blunt approach to the indirect expropriation/ regulatory expropriation distinction that had become prevalent in investment disputes, and held that there is no such thing as regulatory expropriation in international investment law: each and every expropriation by a state of a foreign investors property would require compensation.

Another widely reported decision on the question of indirect and regulatory expropriation was that of *Tecmed v Mexico*²⁸⁹. The tribunal in this case employed remarkably similar language to that used in *Saluka* in describing the impact of a state measure on a foreign investment that was ultimately characterised as indirectly expropriatory. The details of this case were briefly mentioned in Chapter 1, but merits more detailed analysis. The dispute concerned the decision by the state of Mexico, via an environmental agency of the Mexican Federal Government known as INE, not to renew a licence for Tecmed to operate a landfill and the accompanying impact on Tecmed. It was claimed that this was an act of expropriation by the state of Mexico, which was defended as a "...control measure in a highly regulated sector and which is very closely linked to public interests".²⁹⁰ The tribunal submitted the factual circumstances to extensive review.

In answering the question as to whether or not Tecmed's investment had been expropriated, the tribunal first turned its attention to whether or not it had been deprived of its investment following the decision of INE not to renew the permit licence. The tribunal made the following comments in this regard:

²⁸⁸ A. Kulick, *Global Public Interest in International Investment Law*, (2012, Cambridge), p236

²⁸⁹ *Tecmed v Mexico*, supra n94

²⁹⁰ *Ibid*, para 46

Undoubtedly it has provided for the non-renewal of the Permit and the closing of the Landfill permanently and irrevocably, not only due to the imperative affirmative and irrevocable terms under which the INE's decision included in the resolution is formulated, which constitutes an action – and not a mere omission – attributable to the Respondent, with negative effects on the Claimant's investment and its rights to obtain the benefits arising therefrom, but also because after the non-renewal of the Permit, the Mexican regulations issued by INE became fully applicable. ...When the Resolution put an end to such operations and activities at the Las Viboras site, the economic or commercial value directly or indirectly associated with those operations and activities and with the assets earmarked for such operations and activities was irremediably destroyed.²⁹¹

The tribunal was in little doubt that the measure taken by INE were attributable to the state. Furthermore the tribunal had no difficulty in finding that the investors had lost the entirety of their investment. As in other cases of indirect expropriation, the tribunal did however consider it necessary to evaluate whether the decision not to renew the licence could be expropriatory, in light of the underpinning purpose. The tribunal adopted a rather different approach to dealing with investment disputes that concerned the arguments over the use of police powers than that which had been seen in previous tribunals. In dealing with the dispute the tribunal was very conscious that its role was not to review the motivating purpose of a state measure to determine whether or not it was legally issued.²⁹² Furthermore the tribunal did acknowledge the position of the doctrine of 'police power' regulation in international investment law:

The principle that the State's exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to compensation is undisputable.²⁹³

However it then went on to make the following comments:

After reading Article 5(1) of the Agreement and interpreting its terms according to the ordinary meaning given to them (Article 31(1) of the Vienna Convention), we

²⁹¹ Ibid, para 117

²⁹² Ibid, para 120

²⁹³ Ibid, para 119

find no principle stating that regulatory administrative actions are per se excluded from the scope of Agreement, even if they are beneficial to society as a whole – such as environmental protection – particularly if the negative economic impact of such actions on the financial position of the investor is sufficient to neutralize in full the value, or economic or commercial use of its investment without receiving any compensation whatsoever.²⁹⁴

These comments are significant, but are not uncommon in investment disputes. The tribunal disagreed with the argument, as was mentioned in *Saluka*, that regulatory powers by a state are non-compensable. Moreover the tribunal was not convinced that the measures pursued by the state in failing to renew the licence were motivated by a desire to protect “...the environment or public health”.²⁹⁵ The tribunal then went on to state that it must:

for the purpose of establishing whether the Respondent breached Article 5(1) of the Agreement, to evaluate such reasons as a whole to determine whether the Resolution is proportional to the deprivation of rights sustained by [Tecmed] and with the negative economic impact on the Claimant arising from such deprivation.²⁹⁶

The tribunal went on to acknowledge that, as the Respondent had suggested, there were “socio-political circumstances” which motivated the decision not to renew the licence, by way of local opposition to the operation and location of the landfill.²⁹⁷ However the tribunal went on to state in holding that Mexico had indirectly expropriated the investment:

the Respondent has not presented any evidence that community opposition to the Landfill —however intense, aggressive and sustained— was in any way massive ... Even after having gained substantial momentum, community opposition, although it had been sustained by its advocates through an insistent, active and continuous public campaign in the mass media, could gather on two occasions a crowd of only two hundred people the first time and of four hundred people, the second time out

²⁹⁴ Ibid, para 121

²⁹⁵ Ibid, para 124

²⁹⁶ Ibid, para 132

²⁹⁷ Ibid, paras 129 and 133

of a community with a population of almost one million inhabitants... Additionally, the “blockage” of the Landfill was carried out by small groups of no more than forty people [footnote omitted]. The absence of any evidence that the operation of the Landfill was a real or potential threat to the environment or to the public health, coupled with the absence of massive opposition, limits “community pressure” to a series of events, which, although they amount to significant pressure on the Mexican authorities, do not constitute a real crisis or disaster of great proportions, triggered by acts or omissions committed by the foreign investor or its affiliates.²⁹⁸

Once again the same conceptual tropes of a state measure, taken for a public purpose that has a negative impact on an investment are readily identifiable. This is simply another example of how readily identifiable these traits are when tribunals are dealing with claims of alleged expropriation of investments. The difficulty however is that these same tropes are being engaged by tribunals when they discuss, what is understood to be a completely distinct practice of police power regulation. This only serves to confuse the distinction, and bring its existence in dispute resolution into question. Furthermore as can be gleaned from the discussion above the tribunal employs a wholly new criterion for deciding that an indirect expropriation has occurred. Unlike in previous cases where due process or a public purpose has been the deciding factor, the tribunal utilises the concept of proportionality to make its decision. This demonstrates the continuing inconsistency with which tribunals adjudicate on investment disputes.

Another notable case on the indirect expropriation/ regulation distinction was that of *Pope and Talbot v Canada*.²⁹⁹ The case concerned a dispute regarding Canada’s actions in the implementation of the 5-year Softwood Lumber Agreement (“SLA”) concluded by Canada and the U.S. in 1996. The Investor claimed that certain aspects of Canada’s implementation of the SLA via its Export Control Regime constituted a breach by Canada of, among other things, the provisions under NAFTA Chapter 1 that it not expropriate the investment. The tribunal in dealing with the expropriation claim was very clear of the position of Pope and Talbot’s investment:

²⁹⁸ Ibid para 144

²⁹⁹ *Pope and Talbot v Government of Canada*, supra n128

The Tribunal concludes that the Investment's access to the US market is a property interest subject to protection under Article 1110.³⁰⁰

In making this statement the tribunal set out very clearly that Pope and Talbot's investment was covered by the terms of NAFTA. The tribunal went on to deal with the claim by Canada that "...the ability to sell lumber to the U.S. market is not an investment within the meaning of NAFTA"³⁰¹. The tribunal was not convinced of Canada's claim that Pope and Talbot's investment did not fall within the definition of the trade agreement:

While Canada suggests that the ability to sell softwood lumber from British Columbia to the U.S. is an abstraction, it is, in fact, a very important part of the "business" of the Investment. Interference with that business would necessarily have an adverse effect on the property that the Investor has acquired in Canada, which, of course, constitutes the Investment. While Canada's focus on the "access to the U.S. market" may reflect only the Investor's own terminology, that terminology should not mask the fact that the true interests at stake are the Investment's asset base, the value of which is largely dependent on its export business. The Tribunal concludes that the Investor properly asserts that Canada has taken measures affecting its "investment," as that term is defined in Article 1139 and used in Article 1110.³⁰²

The framework that the tribunal appears to be following looks to be similar to that that has been employed by many other tribunals. The investment has been recognised as being protected under the terms of an investment treaty from state interference, unless otherwise compensated. However the Tribunal diverts from its otherwise linear path in holding that the actions of Canada are not expropriatory, notwithstanding that Canada's actions had "...resulted in reduced profits for the investment."³⁰³ As the tribunal goes on to state:

Even accepting (for the purpose of this analysis) the allegations of the Investor concerning diminished profits, the Tribunal concludes that the degree of interference with the Investment's operations due to the Export Control Regime

³⁰⁰ Ibid, para 96

³⁰¹ Ibid, para 97

³⁰² Ibid, para 98

³⁰³ Ibid, para 101

does not rise to an expropriation (creeping or otherwise) within the meaning of Article 1110.³⁰⁴

While the tribunal in this case did not find the Canadian Government to have expropriated the investment, it did note Canada's argument that because the measures that it took were cast as regulations exercised under its 'police powers' they could not be regarded as expropriatory.³⁰⁵ The Tribunal rejected this line of argument and states that:

Canada appears to claim that, because the measures under consideration are cast in the form of regulation, they constitute an exercise of 'police powers', which, if non-discriminatory, are supposedly beyond the reach of the NAFTA rules regarding expropriations. While the exercise of 'police powers' must be analysed with special care, the Tribunal believes that Canada's formulation goes too far. Regulations can indeed be exercised in a way that would constitute [indirect] expropriation.³⁰⁶

Other than the tribunals comments mentioned above, there was no other discussion on the purpose of the measures taken by Canada. The tribunal shied away from any comment on legitimacy of Canada's implementation of the SLA. By inference from the wording of the tribunals ruling, it appears to be the case that while again, the tribunal separates the doctrines of indirect expropriation and regulation on a conscious level, it does recognise the reality that a regulatory purpose can still in effect be expropriatory, regardless of the purpose pursued. The difficulty however is that, as evidenced above, despite tribunals discussion of what appear to be identical concepts in two apparently distinct state practices the separation is still maintained. The confusion as to why this is the case is even more profound when multiple tribunals, including in *Pope & Talbot* expressly recognise the ability of state regulatory measures to be expropriatory. Furthermore the tribunal deems the level of harm (not) suffered by the investment to be indicative of its not being an instance of expropriation. While there is some evidence that at least one tribunal has used this criterion in adjudicating a dispute this does not grant any greater level of consistency to the debate as there is no framework from which one is able to discern what factor will be

³⁰⁴ Ibid, para 102

³⁰⁵ Ibid, para 99

³⁰⁶ Ibid

determinate in a given set of circumstances which are subject to an international arbitration.

The confusion over the distinction between regulatory and indirectly expropriatory measures was again evident in the case of *Marvin Roy Feldman Karpa v The United Mexican States*.³⁰⁷ The case centred on a dispute regarding the impact of Mexican tax laws on the export of tobacco products by CEMSA. CEMSA was a Mexican company, owned and controlled by Mr. Marvin Feldman, a US citizen. Mr Feldman claimed that through the conduct of its Ministry of Finance and Public Credit, the state of Mexico's refusal to rebate excise taxes applied to cigarettes exported by CEMSA and Mexico's continuing refusal to recognize CEMSA's right to a rebate of such taxes regarding prospective cigarette exports constituted a breach of NAFTA Articles 1102 (National Treatment), 1105 (Minimum Level of Treatment), and crucially, 1110 (Expropriation and Compensation). Mr Feldman brought his claim before an ICSID tribunal for over \$50 million. The tribunal found little difficulty in holding that CEMA as an organisation, owned and controlled by Mr Feldman, was an investment and was protected under the terms of the NAFTA.³⁰⁸ In dealing with the claim that the investment had been indirectly expropriated, the tribunal considered the facts of the complaint and made the following comment:

The facts presented here might, depending on their interpretation, appear to support a finding of an indirect or creeping expropriation. The Claimant, through the Respondent's actions, is no longer able to engage in his business of purchasing Mexican cigarettes and exporting them, and has thus been deprived completely and permanently of any potential economic benefits from that particular activity.³⁰⁹

The tribunal here expressly points out that because of the actions of the state of Mexico, through the application of its taxation laws, has "...completely and permanently" removed any profits or other benefit, that could have been enjoyed from the investment. This seems to be territory that is all too familiar in investment disputes. Actions of a state taken either directly or in this case indirectly have a negative, and in this case, disastrous impact on the property of an investor.

³⁰⁷ *Marvin Roy Feldman Karpa v The United Mexican States*, Award, 16 December 2002, ICSID Case No. ARB(AF)/99/1. Available at <http://www.italaw.com/sites/default/files/case-documents/ita0319.pdf>

³⁰⁸ Ibid, para 96

³⁰⁹ Ibid, para 109

Furthermore in dealing with the fact that it was the impact of taxation laws which were the subject of the dispute the tribunal did note that there are instances where taxation could be deemed to be expropriatory.³¹⁰ The tribunal goes on to state:

The Tribunal notes that the ways in which governmental authorities may force a company out of business, or significantly reduce the economic benefit of its business, are many. In the past, confiscatory taxation, denial of access to infrastructure or necessary raw materials, imposition of unreasonable regulatory regimes, among others, have been considered to be expropriatory actions.³¹¹

This comment from the tribunal is significant in that it points out that regulatory actions by a state can, in certain instances result in expropriation of an investors property. The tribunal went on to note that in dealing with the complaint brought before it under NAFTA, "...No one can seriously question that in some circumstances government regulatory activity can be a violation of Article 1110".³¹² This admission is one of the clearest instances where an investment tribunal has recognised that the doctrines of indirect expropriation and regulatory expropriation may not be as distinct as would have traditionally been understood. Furthermore the tribunal went on to note, in citing the ruling of the tribunal in *Pope & Talbot v Canada* that:

Regulations can indeed be characterized in a way that would constitute creeping expropriation...Indeed, much creeping expropriation could be conducted by regulation, and a blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation.³¹³

Despite the admission that governmental regulatory measures could be so severe as to amount to expropriation, the tribunal went on to rule that the actions of the state did not constitute expropriation. The tribunal provided several reasons for its holding which can be summarised as follows:

³¹⁰ Ibid, para 106. See also at para 109 where the tribunal recognises that State Parties under NAFTA expressly confirm that tax regulatory powers can be expropriatory.

³¹¹ Ibid, para 103

³¹² Ibid, para 110

³¹³ Ibid

(1) ... not every business problem experienced by a foreign investor is an expropriation under Article 1110; (2) NAFTA and principles of customary international law do not require a state to permit “gray market” exports of cigarettes; (3) at no relevant time has the IEPS law, as written, afforded Mexican cigarette resellers such as CEMSA a “right” to export cigarettes (due primarily to technical/legal requirements for invoices stating tax amounts separately and to their status as non-taxpayers); and (4) the Claimant’s “investment,” the exporting business known as CEMSA, as far as this Tribunal can determine, remains under the complete control of the Claimant, in business with the apparent right to engage in the exportation of alcoholic beverages, photographic supplies, contact lenses, powdered milk and other Mexican products--any product that it can purchase upon receipt of invoices stating the tax amounts-- and to receive rebates of any applicable taxes under the IEPS law.³¹⁴

However in describing the impact of Mexico’s measures on Mr Feldmans investment, the tribunal stated that:

The Claimant, through the Respondent’s actions, is no longer able to engage in his business of purchasing Mexican cigarettes and exporting them, and has thus been deprived completely and permanently of any potential economic benefits from that particular activity.³¹⁵

The problem with this ruling of the tribunal, in not holding the conduct of the state of Mexico to amount to indirect expropriation, is that it nevertheless makes use of the same language in discussing what has taken place. Yet again as in other cases mentioned above, the actions of Mexico were such that they had a disastrous impact on the property of the foreign investor. Furthermore the tribunal appears to employ the same conceptual tropes of a state measure that is motivated by some kind of public purpose and has a negative impact on the investment. The ruling in this case however is more significant than those of other cases, as it expressly recognises the expropriatory trait that regulatory measures can demonstrate. Moreover it provides further evidence that the frameworks of indirect expropriation and regulation used by tribunals are not so distinct.

³¹⁴ Ibid, para 111

³¹⁵ Ibid, para 109

The ruling of the tribunal is also useful in that it not only demonstrates the shared characteristics of indirect and regulatory expropriation, but is also demonstrative of the continuing inconsistency in how tribunals decide on claims of expropriation. As the tribunal goes on to note, having listed the motivating factors for its decision:

While none of these factors alone is necessarily conclusive, in the Tribunal's view taken together they tip the expropriation / regulation balance away from a finding of expropriation³¹⁶

This does little to instil confidence in how investment tribunals arrive at their decisions. The language of the tribunal, it is suggested, is not demonstrative of a robust or coherent approach to its decision. Rather it demonstrates an inconsistent approach to the indirect expropriation/ regulatory expropriation distinction that could have yielded a different decision depending on what the tribunal chooses to focus its attention on in the dispute.

The difficulty in maintaining the indirect / regulatory expropriation distinction was again evident in the case of *Phelps Dodge Corp v Iran*.³¹⁷ The Claimant, a New York corporation, sought compensation for the alleged expropriation of its shareholders interest in an Iranian company established for the purpose of manufacturing and selling various wire and cable products in Iran. In November 1980, Iran transferred the management of the Iranian company and its factory to two agencies of the government. Pursuant to the transfer, managers were appointed by the government to operate the factory; no meetings of the company's board of directors or shareholders were held; and no information concerning the business activities and financial affairs of the Iranian company was provided to the Claimant. The Iranian government claimed that the transfer measure was taken for the public welfare, so to prevent the closure of the factory and to ensure the payment of wages owed to workers and debts owed to the government. The tribunal in this case stated:

³¹⁶ Ibid, para 111

³¹⁷ *Phelps Dodge Corp v Iran*, Iran-US CT Award No, 217.99.2 (Mar 19, 1986)

The facts of this case...show a progressive erosion...of Phelps Dodge's ability to exercise its ownership rights in SICAB.³¹⁸

Having reviewed the facts of the case, and the actions of the Iranian government the tribunal went on to state that:

The conclusion is unavoidable that as of 15 November 1980, control of the SICAB factory was taken by the Respondent, thereby depriving Phelps Dodge of virtually all of the value of its property rights. It is undisputed that such deprivation has lasted for five years, and it seems clear to the Tribunal that it is likely to continue indefinitely.³¹⁹

Once again the framework common to both claims of indirect expropriation and regulation is engaged by the tribunal. There is an identifiable negative impact to an investment, that is protected under an international treaty, that is attributable to the state. The tribunal, in finding that an indirect expropriation had taken place, did however dedicate some thought to the purpose that the Iranian government claimed it was protecting in pursuing the measures that it did. The tribunal went on to note that:

The Tribunal fully understands the reasons why the Respondent felt compelled to protect its interests through this transfer of management, and the Tribunal understands the financial, economic and social concerns that inspired the law pursuant to which it acted, but those reasons and concerns cannot relieve the Respondent of the obligation to compensate Phelps Dodge for its loss.³²⁰

Despite the tribunals holding that the measures taken by Iran amounted to an indirect expropriation, it did note the existence of a public purpose. One may even go so far as to say that the Tribunal recognised the compelling reasons that motivated this particular purpose, while avoiding any comment as to its 'legitimacy', but could not view it as having so special a status to class Iran's actions as regulatory. Even in this case while the Tribunal did understand the States intentions behind its measures, as having a legitimate purpose as

³¹⁸ American Society of International Law, *Iran-United States Claims Tribunal: Award in Case Concerning Phelps Dodge Corp. and Overseas Private Investment Corp. and Iran* (1986) International Legal Materials, Vol. 25, No. 3 p624

³¹⁹ Ibid, p625, para 22

³²⁰ Ibid

their aim,³²¹ Iran was still found to have pursued a measure that while regulatory in nature, possessed an expropriatory dimension while still pursuing a public purpose. The tribunal relied on the ruling in *Tippetts* when it stated that:

In the present case, the Respondent has taken control of the SICAB factory, it is running it for its own benefit and seems likely to continue to do so indefinitely. Consequently, it has effectively taken Phelps Dodge's property and is liable to the Claimants for the value of that property.³²²

Yet again the tribunal juggles the same readily identifiable concepts of (i) a state measure; (ii) taken with a public purpose; and (iii) a negative impact on the investment in arriving at its decision that the states actions are indirectly expropriatory. This serves as further evidence that the doctrines of indirect and regulatory expropriation are insufficiently distinct. The tribunal in this case also seems to base its decision on where control of the investment lies. This is evidence of further inconsistency in how the tribunals base their decisions. Furthermore and perhaps more worrisome in this ruling is that like that given in *Santa Elena v Costa Rica*, the tribunal recognises the motivations for governmental actions but nevertheless holds them to be indirectly expropriatory.

The discussion above demonstrates how tribunals have, in attempting to distinguish one kind of state practice from another, unintentionally demonstrated their use of the same conceptual tropes. The frameworks used to maintain these distinctions are not sufficiently distinct. It is suggested that having reviewed the decisions of investment tribunals that there is a deep flaw in the belief that indirect and regulatory expropriation by states are so dissimilar. In each case that has been decided, there has always been a state measure that has a negative impact on an investment that is claimed to serve a public purpose. However the question for the tribunal will be whether or not the purpose served, is sufficiently legitimate in their eyes to sway their decision. In deciding on this question different tribunals have, as has been demonstrated, used different criteria on which to base their decisions. This suggests that the boundary between indirect expropriation and regulatory expropriation is not sufficiently stable to be deployed by adjudicators in investment disputes.

³²¹ Ibid

³²² Ibid, p626, para 23

Chapter 6

Conclusion

This thesis has examined the established wisdom regarding a significant distinction that exists in international investment law: indirect and regulatory expropriation. The aim has been to subject this distinction to critical review. In order to have carried out this objective, this thesis has had to employ a deconstructive analysis of the current position in international investment law, to expose conceptual ambiguities, contradictions and weaknesses that exist within the legal framework on which this distinction is based and which is meant to be understood in terms of.

What has been the result of this exercise? Is the distinction between these two practices to be taken seriously?

There are several insights that this thesis has yielded. However before these insights are discussed, a few preliminary remarks are necessary. It is suggested that the creation of the doctrines of indirect and regulatory expropriation was an attempt to deal with a problem: holding states responsible for underhanded expropriations of foreign investors property while still recognizing the prerogatives of self-governance. While this solution may have been acceptable to many, there are questions surrounding its rigour.

As the discussion above has demonstrated, in international investment law literature, case-law and state practice – in the context of drafting investment treaties – there are multiple conflicting definitions of indirect expropriation.³²³ While it is true that there are some common strands which are identifiable, the presence of multiple ideas about how indirect expropriation by states is defined or recognised inspires little confidence as to its credibility. Moreover the mere fact that multiple definitions exist is demonstrative of the fact that there is a degree of dissatisfaction with what has been proposed. For the concept of indirect expropriation to be taken seriously, it must be more clearly defined. Unfortunately this has not proved possible. It is suggested that whilst unhelpful, the practice of actors in international investment law is to attempt to deal with instances of indirect expropriation on the basis of, as Fortier and Drymer write, *‘I Know it When I See*

³²³ See a discussion in Chapter 1

It’ as none of the existing definitions provide sufficient guidance for tribunals to be able to identify indirect expropriation in the context of investment disputes.

The current position regarding state regulation of foreign investments, or regulatory expropriation, in international law is also unsatisfactory. There is a significant volume of evidence to be found in both scholarly and judicial sources, that supports the proposition that states are entitled to regulate domestic affairs in international law through use of their ‘police powers’. However there is considerable disagreement as to what the substance of ‘police power’ regulation actually means³²⁴. As before it is suggested that before the doctrine can be taken seriously and applied consistently, there must be clarity on its meaning. Not only do tribunals and scholars, as evidenced, disagree on the substance of the ‘police powers’ doctrine. Some tribunals have even gone so far as to suggest that there has never been any consensus on this point, while others suggest that there is little merit in clinging to the idea that states should be excused from the requirement to compensate investors for regulatory expropriation.³²⁵

It appears that despite the evidence as to the many weaknesses that the distinction between regulatory and indirect expropriation suffers from, many of these have been overlooked. The distinction is maintained and over the course of time, tribunals have employed new tools with which to recognise the distinction. Historically some tribunals utilised single criteria on which to base their distinction, either through use of the ‘sole effect’ or ‘public purpose’ doctrine. Both of these approaches however have been identified to suffer from many inadequacies in the context of investment disputes.³²⁶ As a result the new trend in investment law saw the use of a more multifaceted analysis, via the introduction of the so-called proportionality approach.³²⁷ While there are many reasons to support the use of a proportionality approach in investment disputes, like its predecessors it also remains subject to criticism.

The proportionality approach as it currently stands, is insufficiently clear and precise to lend itself well to effective use in legal disputes.³²⁸ It invites those sitting on arbitration panels to advance their own subjective views regarding the meaning of various criteria in

³²⁴ See Chapter 1, pp22-29

³²⁵ *ibid*

³²⁶ See Chapter 2, pp30-37

³²⁷ See Chapter 3, pp37-40

³²⁸ See Chapter 3, pp48-60

applying proportionality. The situation is complicated even further by the fact that, not only do competing interpretations exist, but all of these are also equally valid in their own way. There is no logical reason to doubt any of the competing approaches to applying the proportionality approach. Therefore one must question its utility as a legal doctrine: each of its components is vague, imprecise and invites competing interpretations. It cannot be used to provide clear, authoritative and consistent decision making in investment law.

Despite the evidence as to the vagueness of the distinction between indirect and regulatory expropriation, and the weaknesses suffered by the proportionality approach to recognise the distinction, tribunals continue to recognise their utility. However indirect and regulatory expropriation suffer a fatal flaw in their construction as distinctive state practices. As has been evidenced in this thesis, tribunals continually speak of each practice by reference to the same shared conceptual tropes: a *state measure*, that has been taken for a *public purpose*, which has a *negative impact on an investment*.³²⁹

The findings of this thesis are that the distinction between indirect and regulatory expropriation is not based on a theoretical framework that is coherent, precise and identifiable. The tools through which international investment law identifies indirect and regulatory expropriation are not suited to the task they are employed to tackle. They allow tribunals to form their own view as to the meaning of a legal approach to decision making: they invite political decision making in legal disputes. As a result the underlying doctrinal structure is insufficiently clear and conceptually stable to be credibly used in the context of legal adjudication.

³²⁹ See Chapter 4, pp61-84

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