

BONA FIDE REGULATORY EXPROPRIATION
IN INTERNATIONAL LAW: IDENTIFICATION
AND JUSTIFICATIONS

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

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Abstract

The primary objectives of this thesis are to clarify and distinguish the existence of regulatory expropriation from other types of indirect expropriation and to propose alternative ways to rescrutinise regulatory expropriation in light of its establishment and justification in international law. In pursuing the first objective, the research delves into certain national, regional, and international contexts, identifying the key features of regulatory expropriation – for instance, regulatory autonomy and regulatory interference – and conducts an extensive exploration of the relevant principles of international law. This exploration concentrates especially on the doctrine of police power and on principles that can contribute to an elaborated application of the doctrine for the identification of regulatory expropriation. With regard to the second objective, the research examines the principle of necessity in international law that functions to preclude the wrongfulness of a state's act and also takes into account the interacting relationship between customary international law and bilateral investment agreements. In addition, the research goes a step further by means of its analysis of the necessity exception in WTO law. This thesis puts forward the conclusion that an arbitral approach to *bona fide* regulatory expropriation that can be justified in international law, if it is based on the elaborated application of the doctrine of police power and on the application of the principle of proportionality within the framework of the ends-means and the cause-effect, will be more desirable for investment treaty arbitration given that arbitration is a type of public law adjudication.

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List of Abbreviations

ACIA	ASEAN Comprehensive Investment Agreement
ADM	Archer Daniels Midland
ASEAN	Association of Southeast Asian Nations
BITs	Bilateral Investment Treaties
CIEL	Centre for International Environmental Law
CME	CME Czech Republic
CMS	CMS Gas Transmission Company
ECHR	European Convention on Human Rights
ECT	Energy Charter Treaty
ECtHR	European Court of Human Rights
EEC	European Energy Charter
EU	European Union
FCN	Friendship, Commerce and Navigation
FET	Fair and Equitable Treatment
FTA	Free Trade Agreement
FSC	Financial Supervisory Commission
FTC	Free Trade Commission
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
ICC	International Chamber of Commerce
ICJ	International Court of Justice
ICSID	International Centre for Settlement of Investment Disputes
ILC	International Law Commission
IMF	International Monetary Fund
KEB	Korea Exchange Bank
KEBCS	Korea Exchange Bank Credit Service Co Ltd
LCIA	London Court of International Arbitration
MAI	Multilateral Agreement on Investment
MEC	Middle East Cement

MFN	Most-Favoured-Nation
MIGA	Multilateral Investment Guarantee Agency
MST	Minimum Standard of Treatment
NAFTA	North American Free Trade Agreement
NPM	Non-Precluded Measures
NTS	National Tax Service
OECD	Organisation for Economic Co-operation and Development
PCIJ	Permanent Court of International Justice
PPI	Producer Price Index
RCEP	Regional Comprehensive Economic Partnership
RTAs	Regional Free Trade Agreements
SEP	Strategic Economic Partnership
SPA	Share Purchase Agreement
TPP	Trans-Pacific Partnership
TRIPS	Trade-Related Aspects of Intellectual Property Rights
TTIP	Transatlantic Trade and Investment Partnership
UNCTAD	UN Conference on Trade and Investment
VCLT	Vienna Convention on the Law of Treaties
WTO	World Trade Organisation

Introduction

The outstanding and long-disputed question in international investment law concerning expropriation asks how one distinguishes compensable expropriation from that of an ordinary regulation that incurs no obligation to pay compensation, and vice versa. The notion of ‘regulatory expropriation’ takes a central place in the context of this question. Regulatory expropriation, which arises as a legal issue on the ‘boundaries of state responsibility’, fundamentally leads to an inquiry into the appropriate allocation of risk in the modern state that exercises regulatory power.¹ The allocation of risk entails balancing the interests of sovereign powers and the interests of investor rights by conducting due evaluation.² This task can be characterised as ‘fact driven’ and a ‘case-based method’.³ It is widely recognised that the occurrence of an expropriation is to be considered on a case-by-case basis,⁴ despite the difficulties involved in such a balancing task, which considers all circumstances.⁵ The principal risk of such an analysis is demonstrated by circumstances where different arbitral tribunals, confronted with the same set of facts, have reached different conclusions concerning expropriation claims. Campbell McLachlan QC has highlighted this risk and notes the cases of *Lauder v Czech Republic*⁶ and *CME v Czech Republic*⁷ by way of example. Both cases arose out of two expropriation claims, submitted by two different claimants in similar factual circumstances. The two claimants were ‘Lauder’, a US national, and ‘CME’, a Dutch company. The facts were that the government of the Czech Republic issued a television broadcasting licence to a domestic company, which then entered into an

¹ Andrew Newcombe, ‘The Boundaries of Regulatory Expropriation in International Law’ (2005) 20(1) ICSID Review 1, 7.

² *ibid.*

³ *ibid.* 6.

⁴ Campbell McLachlan and others, *International Investment Arbitration: Substantive Principles* (OUP 2010) 298.

⁵ *ibid.*

⁶ *Ronald S Lauder v The Czech Republic* (Final Award) 3 September 2001 UNCITRAL Arbitration.

⁷ *CME Czech Republic BV v The Czech Republic* (Partial Award) 3 September 2001 UNCITRAL Arbitration.

agreement with a subsidiary of CME. The actions of the government caused some revision of the agreement and thus it was disputed whether, as a result of the revision, expropriation had occurred. The Lauder tribunal found no such expropriation, whereas the CME tribunal did. Besides expropriation claims, arbitral tribunals have also dealt with the same set of facts and reached different conclusions in relation to investment claims. The Argentine emergency measures cases demonstrate such differing conclusions in investment claims; for example, *CMS*, *Enron*, and *Sempra* on the one hand, and the *LG&E* case on the other. These cases arose out of investment disputes, which contended that Argentine emergency measures, taken in response to the economic crisis, resulted in a violation of investment treaty obligations.

This research paper proceeds on the basic premise that the regulatory expropriation issue, in international investment law, should be handled by a case-by-case based analysis. On this basis, the research will proceed by reformulating the dominant question concerning regulatory expropriation and with an exploration of this question; seeking viable methods to address the challenged credibility of the investment treaty regime. Prior to explaining the research methodology and specific approaches used, the selected questions and research aims will be introduced.

The central question of this research is: ‘Under what conditions can *bona fide* regulatory expropriation be justified in international law?’ This central question is divided into two further specific questions. Firstly, when is a regulatory expropriation to be found or established? Secondly, under what conditions is a *bona fide* regulatory expropriation lawfully justified? In consideration of the absence of sufficient guiding rules that govern regulatory expropriation and the standard of compensation, Surya P Subedi has pointed out that it is desirable to discern some regulatory expropriations, permissible under evolving and extant international law, which may call for less than full compensation and permissible but compensable

types of regulatory expropriation that entail the Hull formula-based full compensation.⁸

In relation to the first question, it should be noted that conditions or criteria that direct the determination of the finding of regulatory expropriation are different from conditions that determine the lawfulness of expropriation in international investment law. Careful attention should be paid and efforts should be made to articulate the former conditions in order for the nature or characteristics of regulatory expropriation to be closely observed. Regulatory expropriation is classified as a type of indirect expropriation. In an attempt to address the central question of this research, endeavours will be made to articulate certain distinctive characteristics of regulatory expropriation so that these can be distinguished in consideration of the functionality of regulatory expropriation. In so doing, the doctrine of police power will be subjected to a close analysis. The doctrine of police power is invoked to circumscribe the boundaries within which an ordinary regulation does not constitute an expropriation. The second question is premised on the idea that a state is essentially entitled to expropriate in the exercise of its right. The issue of lawfulness only arises as international law places some legal restraints on the aforementioned right. A broad view to look into relevant rules of international law will be necessary to examine how international law may constrain the state's right to expropriate.

There are several aims that this research intends to pursue. One aim is to seek to identify the elaborated ways in which the doctrine of police power can be applied. This doctrine is usually relied upon in order to discern a normal regulation from an alleged indirect expropriation. This research seeks to find ways to use the doctrine of police power for the purpose of identifying the existence of regulatory expropriation. Additionally, this research aims to shed light on the legitimate characteristic of regulatory expropriation from the perspective of international law, given that it originates from the exercise of regulatory autonomous power. The

⁸ Surya P Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing 2012) 153.

research will try to identify useful and viable rules and principles of international law for their use within international investment law on regulatory expropriation. In this way, the research also aims to provide investment treaty arbitration tribunals with guidelines on which to rely when setting appropriate standards of deference to a state's regulatory autonomy. Further, it aims to offer a challenge to the barrier between trade and investment, showing that both fields of international trade law and international investment law share a common concern over a state's regulatory autonomy. In this way, the research, by using a range of rules and principles of law, will demonstrate when *bona fide* regulatory expropriation can be established and justified in international law.

This research adopts a doctrinal methodology. This methodology is basically aimed at analysing legal doctrines on the basis of the reading of primary and secondary sources of literature. In conducting this methodology, the research concentrates on setting out applicable rules and principles and comparatively analysing them in order to derive available rules or principles of international law or of international investment law from the different works. This method or approach is selected in consideration of the concerns about the doubted credibility of the investment treaty regime. In this research, two sources of challenge to the credibility of the investment treaty regime are to be noted. First is the autonomous effect of bilateral investment treaties (BITs) on investment treaty arbitration. Second is the nature of investment treaty arbitration, as this public law dispute resolution should be sufficiently taken into account in the process of arbitral award-making.

Among the sources of international law,⁹ customary international law and international agreements or conventions mainly shape the substance of international law. These two sources of law are very different in terms of nature, formation, and ways of changing, and so on. BITs tend to prevail in the field of international investment law. In comparison with customary international law, that needs state practice and *opinio juris*, BITs stand out in terms of clarity, concreteness,

⁹ Article 38 of the Statute of the International Court of Justice (ICJ).

availability for invocation, speedy formation, and so on. BITs have proliferated in a simple way whereby they can be formed merely based on bilateral negotiations and a consensus on investment protection. It is now no exaggeration to call it the era of BITs. It is noteworthy that BITs have a considerable potential to expand the international minimum standard of treatment, which has been formed based on customary international law, into the international maximum standard of treatment.¹⁰ BITs can function as a mechanism through which states can codify their own *lex specialis*, applicable to investment disputes that arise in relations within those states.¹¹ In addition, before BITs and regional trade agreements were actively concluded, it was less convenient to establish an internationally wrongful act from the scrutiny of a state's particular act that interfered with a foreign owner's property interest.¹² BITs and regional trade agreements can contain specific provisions of protections, extra privileges, and concessions, which may all allow a foreign investor to claim that a state has committed an internationally wrongful act.¹³ On the other hand, as generally recognised, customary international law, the other main source of international law, is not static, but evolving. These two main sources of international law do not exist in isolation, but interact with each other, which may cause uncertainty in relation to international investment law concerning standards of treatment. There are diverging opinions connected to the relationship and interaction between these two sources of law. This problem sometimes makes a practical difference to the determination of arbitral awards in investment disputes. In an effort to address this problem, it is desirable to seek appropriate viable rules and principles of international law that can guide the interpretations and the applications of customary international law and BITs.

Traditionally, arbitration was recognised as a mechanism through which commercial disputes between private parties were to be resolved, as well as a means to promote

¹⁰ Subedi (n 8) 137–39.

¹¹ *ibid* 91.

¹² *ibid* 141.

¹³ *ibid*.

international commerce.¹⁴ Under the regime of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) of 1958, which implemented the recognition and the enforcement of foreign arbitral awards, the function of international arbitration was limited to addressing claims by private parties over commercial matters, leaving the authority to resolve public disputes to the domestic courts.¹⁵ Investment treaty arbitration took shape by incorporating the traditional arbitration model, as investment treaties imported the procedural framework including employing privately selected arbitrators, and the enforcement form from arbitration treaties.¹⁶ As a result, traditional commercial arbitrations and investment treaty arbitrations display similarities. Even so, it must be acknowledged that investment treaty arbitration is a mechanism that resolves a matter of public law. This is not only because the arbitration regime is established by sovereign acts of states parties to an international investment agreement, but also because the subject matter is a dispute concerning a state's regulatory act and a foreign private person who is subject to the state's public authority.¹⁷ In this respect, the nature of investment treaty arbitration makes it necessary to contemplate applicable rules and principles of international law that may govern states' acts in general. It is accepted that this is more relevant in investment cases that dispute a state's regulatory autonomy and its right to expropriate.

The discussions of this thesis are structured as follows. In Chapter 1, the research takes a wide view over international investment law with the intention of making foundational preparations on which to develop expositions and arguments about indirect and regulatory expropriations in international law. Firstly, the origin and development of international investment law is identified and articulated. Subsequent to the codification by UN Draft Articles of state responsibility and the

¹⁴ Gus Van Harten and Martin Loughlin, 'Investment Treaty Arbitration as a Species of Global Administrative Law' (2006) 17 EJIL No 1 121, 125.

¹⁵ *ibid.*

¹⁶ *ibid* 126.

¹⁷ *ibid* 148–49.

state taking of property, the establishment of the customary international law standard of treatment, the emergence of international investment treaties such as BITs and FTAs, the relationship between customary and treaty laws, issues and cases regarding expropriation and other standards of treatment in the context of BITs and FTAs are to be observed. Chapter 1 will provide the opportunity to examine and understand the issues of the protection of foreign-owned property and expropriation in the context of the development of international investment law. It is worthwhile to note the importance of the relationship between customary international law and international investment agreements, and the development of international investment law on expropriation. Thereafter, the mechanisms of investment treaty arbitration and the standard of treatment will be explained in detail. It will be shown how international investment agreements function in a manner that consequently expands the scope of protection. The linkage between a foreign owner and his or her property can be legally characterised by two concepts: ownership and control. These two concepts are related to the scope of the notion of a foreign investor. The notion of investment is also extended to cover indirect investment. International investment agreements have enabled these changes. Judgments by investment treaty tribunals of a state's act or measure cannot be unlimited. With appropriate deference to a state's sovereignty and its right to regulate within its territory, the international legal supervision of a state's regulatory interference with a foreign owner's property should follow a proper standard of review. In consideration of this, the standard of review will be carefully examined. Also, standards of treatment (or investment protection) will be expounded, such as expropriation, fair and equitable treatment, national treatment, most-favoured-nation treatment, full protection and security, the prohibition of arbitrary and discriminatory measures, and the free transfer of funds. In the end, the mechanisms of investment treaty arbitration will be considered. As touched upon above, in Chapter 1 the research covers investment treaty arbitration and standards of treatment in detail. It intends to establish a concrete understanding of how the arbitration mechanism works and to help identify how expropriation disputes can arise and be handled within the mechanism. It will also aid in the understanding of

how the expropriation standard is unique in comparison with other standards of treatment.

In Chapter 2, the research is aimed at exploring international law on expropriation in order to proceed with the analysis of regulatory expropriation in Chapter 3. The focus in Chapter 2 shifts from the typical form of expropriation, namely, direct expropriation, to indirect expropriation. As mentioned briefly, this research draws upon a state's right to expropriate when dealing with issues of indirect and regulatory expropriations. It is necessary to bear this in mind when considering international law on expropriation, focusing on the concept of expropriation and the lawfulness of expropriation. In Chapter 2, the discussion starts with an explanation of the premise that a state has the right to expropriate. Thereafter, the discussion develops into an analysis of the basic aspects of indirect expropriation.

Indirect expropriation contains an essential element that also constitutes a critical part of direct expropriation from the conventional perspective of international investment law. It is the consequential effect of an alleged indirect expropriation on investment. Conventional arbitral jurisprudence shows a strong propensity for relying on the effect that a state's measure has on an investment in order to identify an expropriation. The effect is typically described as deprivation. Based on the notion of deprivation, a close analysis of arbitral jurisprudence will be conducted. Specifically, deprivation that represents the consequential effect of an alleged indirect expropriation will be grouped into two types: the deprivation of the economic value of a right or an investment and the deprivation of effective control. Also, it will be shown that not all deprivations are regarded as indirect expropriation in arbitral jurisprudence. Next, as a subjective aspect of a state's measure, the intent of indirect expropriation will be examined. In addition, a rather new type of indirect expropriation will be explained, this being 'creeping expropriation'. In a broad sense, indirect expropriation merely means a non-direct form of expropriation. On the other hand, creeping expropriation connotes more than a non-direct form. In finalising the analysis of the establishment of indirect expropriation, the question of

how to distinguish expropriation from an ordinary regulation is approached, using certain doctrines. In the following part of this chapter, the lawfulness of expropriation and the four conditions for lawful expropriation will be dealt with.

In the final part of this chapter, a comparative analysis will be conducted concerning the principles of international law that determine the lawfulness of a state's act under international law. For this analysis, three principles of necessity types will be selected, as they are considered closely relevant to expropriation as well as international investment law. These three types will be grouped into two, owing to the fact that two of the principles are usually regarded as interconnected. The first group is the principle of necessity, the application of which precludes the wrongfulness of a state's act that violates international obligation and is derived from the non-preclusion measure (NPM) clause. The second is the necessity exception test that comes from the WTO General Exceptions. Even though these principles are different, they convey a high degree of similarity. Furthermore, the traditional convergence and divergence between international trade law and investment law may indicate that the two different systems have developed complementary relationships.¹⁸ The principles of the first group can apply when a state violates international obligations in pursuit of certain purposes and the legal effect of their application exempts a state from international responsibility. The necessity exception test, although originally applicable to trade issues, can also prove its potential in the field of international investment law. The goal of the examination of these principles in this chapter is to suggest that in addition to certain conditions that must be met for lawful expropriation, there are other available principles requiring consideration that are applicable in the justification of indirect or regulatory expropriation.

¹⁸ Mavluda Sattorova, 'Defining Investment Under the ICSID Convention and BITs: Of Ordinary Meaning, Telos, and Beyond' (2012) 2 Asian Journal of International Law 267, 286.

All research efforts that are made in this chapter aim to demonstrate general aspects of international law relating to indirect expropriation, in preparation for dealing with more specific aspects, particularly those concerning regulatory expropriation.

In Chapter 3, the research explores regulatory expropriation. Initially, it undertakes a comparative analysis of the 5th Amendment of the US Constitution, the so-called US Takings Clause, the NAFTA rules on expropriation, and the jurisprudence of the European Convention on Human Rights (the European Convention) regarding expropriation. Relying on the review of relevant expropriation provisions and cases, the comparative analysis of significant rules of law on expropriation will reveal that there are certain similarities and common elements between them. Deriving from these similarities and elements, it is aimed at identifying viable rules, principles, and even guidance applicable to regulatory expropriation.

The principal question for international investment law on expropriation is: ‘at what point can a state’s sovereign regulation justifiably interfere with private property?’ Said differently, it may be asked as: ‘how can a normatively desirable balance be struck between sovereign regulatory interests and property interests in the consideration of policy and principles of international investment law?’ It will be noted that the US Takings Clause doctrine, the NAFTA expropriation rule, and the EU expropriation rule all seek to answer this question. These rules will be contemplated in the later part of the chapter, in connection to regulatory expropriation.

Thereafter, an intensive analysis, identifying key constituent elements of regulatory expropriation, will be conducted. In addition, certain conditions for establishing regulatory expropriation will be scrutinised. The state’s exercise of police power takes a central place in contemplating these conditions. In view of these elements and the conditions, it will be possible to re-evaluate the relationship between regulatory expropriation and police power.

Compensation is one of four conditions which have been firmly recognised as required in international law for lawful expropriation. There have been many scholarly discussions on the standard of compensation. In Chapter 4, the research does not delve into the details surrounding the standard of compensation, but concentrates solely on the consideration of compensation as a conditional aspect of lawful expropriation; in particular, regulatory expropriation. The main goal in this section is to see whether the Hull doctrine, which requires full fair market value compensation, should be an absolute rule that governs compensation for expropriation.

At the start of this chapter, the research suggests that there have been differing views relating to the standard of compensation, which have attempted to cast doubt on the status of the Hull doctrine. Both the Hull doctrine and the Calvo doctrine, strongly supported by developing countries, are compared. Efforts are made to seek and identify exceptions to the Hull doctrine. So-called ‘evidence’ indicating exceptions to the Hull doctrine is located and reviewed. In contemplating viable principles, applicable as exceptions to the Hull doctrine, ECtHR jurisprudence is also scrutinised.

In Chapter 5, the *Lone Star* case is explored. This case is the first investor-state arbitration case under ICSID involving an expropriation claim, in which the Republic of Korea was confronted. The case involves a taxation-based expropriation claim. Even though the award has not yet been determined, the analysis of this case will be conducted with a view to gaining an understanding of regulatory expropriation. The brief facts of the case are that Lone Star filed an arbitration claim on behalf of six Belgian investors against the government of the Republic of Korea (Korea). It is claimed that Korea violated several standards of treatment provided for by the BIT between Korea and Belgium, in particular, fair and equitable treatment, the prohibition of arbitrary and discriminatory measures, non-discriminatory treatment, uncompensated expropriation, and the free transfer of funds. It was argued by Lone Star that Korea committed a violation of

uncompensated expropriation, in that the financial supervisory body of Korea delayed the approval process and caused Lone Star to lose share transaction agreements with Korean companies, and tax authorities imposed undue taxes on and conducted an improper tax assessment of Lone Star's sales of shares to Korean companies. Proceedings were commenced on 15 May 2015, and the case is still ongoing. Even though the dispute has not yet been resolved, it is still meaningful to examine the claims by Lone Star, which provide an opportunity to address a taxation-based expropriation claim and to analyse taxation in the context of regulatory expropriation.

Even though taxation could be considered as a state's normal right to tax, it may also be regarded as indirect expropriation, given that it constitutes a measure that directly confiscates a portion of property. Nonetheless, there is a concept that indicates a type of regulatory expropriation which allows a broader perspective to see taxation in the context of regulatory expropriation, this being 'creeping expropriation'. Creeping expropriation is unique in comparison with general indirect expropriation because it involves a series of regulatory measures at issue, whether related or unrelated, rather than a single measure. From the perspective of creeping expropriation, a range of taxation measures, including measures for tax enforcement, not a single tax measure, becomes an issue.

In this chapter, the research seeks to demonstrate how taxation issues may form the subject matter in investment treaty arbitration. Additionally, it seeks to analyse cases relating to taxation-based expropriation claims; the analysis sets out when such claims were accepted or otherwise rejected.

Chapter 1: Overview of International Investment Law on the Protection of Foreign-Owned Property and Expropriation

1.0 Introduction

Currently, international investment law is represented by Bilateral Investment Treaties (BITs), Regional Free Trade Agreements (RTAs) that contain provisions dealing with investment as well as trade, and investment treaty arbitration that provides for an investor-state dispute resolution mechanism. International investment law appears to be moving to its next phase, as geographical scopes are expanded in new types of regional trade agreements, such as the Trans-Pacific Partnership (TPP) agreement, the Transatlantic Trade and Investment Partnership (TTIP) agreement, and the Regional Comprehensive Economic Partnership (RCEP) agreement. Additionally, the previous landscape of international investment law is very different. The history of international investment law will be expounded in the following sections. In summary, prior to the advent of international investment agreements, international investment was regulated by customary international law, the principle of state responsibility, and diplomatic protection. Since the conclusion of the first BIT between Germany and Pakistan, on 25 November 1959, the growth of BITs and RTAs has been swift, and they have formed an extensive global network.

Prior to the advent of the BIT and RTA era, conflicting positions arose over the extent of alien treatment between capital-importing states and capital-exporting states. On the other hand, after the era commenced, the appropriate level of treatment, namely the standards of treatment, has reconciled conflicting interests between a private foreign investor and a host state. During these periods, the remaining issue as to how much autonomy a state can enjoy in exercising its

regulatory power has remained unchanged. To be more specific, from the perspective of investment protection, how much a state can justifiably interfere with a foreign-owned investment within legitimate boundaries of the standards of treatment of international investment law has remained static. In this context, this thesis focuses on a state's right to expropriate. Furthermore, the credibility of investment treaty arbitration has been doubted. There is concern that under the resolution mechanism of a dispute between a private foreign investor and a state, a state's sovereignty will be seriously challenged. In this first chapter, the major goal is to examine the growth and development of international investment law and gain a degree of background knowledge. It will prove useful to understand the flow of debates concerning the state's regulatory power, in terms of the treatment of foreigners, and to obtain some clues that will enable the exploration of a state's right to expropriate, and furthermore, a state's regulatory expropriation.

1.1 The Beginning and Growth of International Investment Law on the Protection of Foreign-Owned Property and Expropriation

1.1.1 The Codification of Rules of International Law on State Responsibility and the Taking of Foreign-Owned Property

In international law, state responsibility refers to the legal consequences of an internationally wrongful act of a state.¹⁹ State responsibility was originally envisaged as rules of international law that address violations of states' international obligations based on customary international law.²⁰ The concept of state responsibility for injuries to aliens first emerged in the middle of the eighteenth century. Its central idea was manifested by Emmerich Vattel in 1758: '[W]hoever uses a citizen ill, indirectly offends the state, which is bound to protect this

¹⁹ Antonio Cassese, *International Law* (2nd edn, OUP 2005) 241.

²⁰ Sompong Sucharitkul, 'State Responsibility and International Liability under International Law' (1996) 18 *Loyola of Los Angeles International and Comparative Law Review* 821, 823.

citizen’.²¹ This concept developed as concern for the protection of the property of aliens and was recognised.²² A state is obliged to pay compensation or make reparation for injuries sustained by nationals of other states.²³

The League of Nations made efforts to codify state responsibility since 1924. Firstly, it did this by instituting a Committee of Experts for the Progressive Codification of International Law, which made recommendations in 1927 for seven subjects for codification. On 27 September 1927, the Eighth Assembly of the League of Nations decided to put forward three topics to the First Conference for the Codification of International Law, including the ‘Responsibility of States for Damage done in their Territory to the Person or Property of Foreigners’.²⁴ Harvard Law School, in preparing a draft international convention on the three topics to be dealt with at the 1930 Codification Conference, proposed a ‘Draft Convention on Responsibility of States for Damage done in their Territory to the Person or Property of Foreigners’ (1929 Harvard Draft).²⁵ According to the 1929 Harvard Draft, ‘a state is responsible, when it has a duty to make reparation to another state for the injury sustained by the latter state as a consequence of an injury to its national’.²⁶ A following Draft Convention on the International Responsibility of States for Injuries to Aliens (1961 Draft Convention) revised the 1929 Draft Convention.²⁷

Article 10 of the 1961 Draft Convention prescribes the concepts of the ‘taking of property’ and the ‘taking of the use of property’, and the conditions to be met for those takings not to be wrongful; such as the pursuit of public purpose, the non-

²¹ Jonathan Gimblett and O Thomas Johnson Jr, *From Gunboats to BITs: The Evolution of Modern International Investment Law* (Covington & Burling LLP 2011) 649.

²² *ibid.*

²³ *ibid.*

²⁴ Newcombe (n 1) 15. Two topics are set out in the reference section to Newcombe’s book, in addition to ‘State Responsibility’; these are ‘Nationality’ and ‘Territorial Waters’.

²⁵ *ibid.*

²⁶ Harvard Law School, ‘Research in International Law – Responsibility of States for Damage done in Their Territory to the Person or Property of Foreigners’, Article 1, reprinted in 23 AJIL 133. See Sucharitkul (n 20) 825.

²⁷ *ibid.*

violation of a treaty, and just compensation.²⁸ It defines the ‘taking of property’ and the ‘taking of the use of property’ as follows:

- (a) A ‘taking of property’ includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after the inception of such interferences.

- (b) A ‘taking of the use of property’ includes not only an outright taking of use but also any unreasonable interference with the use or enjoyment of property for a limited period of time.²⁹

In the ‘Explanatory Note’ to Article 10, it was acknowledged that a ‘taking’ could take place through, *inter alia*, the ‘enforcement of legislation or an executive decree’, the ‘taking of an administrative measure’, or a ‘failure to take an administrative measure’.³⁰ According to the ‘Explanatory Note’, a state is legitimately entitled to take property as the exercise of its right, subject to some conditions. As can be observed domestically, all legal systems allow a state to forcefully acquire its citizens’ private property, through specific processes, such as eminent domain, requisition, preemption, expropriation, or nationalisation, upon the payment of compensation.³¹ Thus, a state can exercise its right to take property without committing any wrongdoing, provided that it conducts itself in accordance with the governing rules of municipal law, and pays compensation.³² Likewise, international law permits a state to take foreign-owned property, but is subject to certain limitations, such as the payment of compensation, there being a public

²⁸ Paragraph 1 to Article 10 of the Draft Convention on the International Responsibility of States for Injuries to Aliens.

²⁹ Paragraph 3 to Article 10 of the Draft Convention on the International Responsibility of States for Injuries to Aliens.

³⁰ *ibid* 554.

³¹ *ibid* 555.

³² *ibid*.

purpose, and the non-violation of a treaty.³³ It can be noted that a state's right to take a private property is recognised in a similar manner in both municipal law and international law.

In December 1974, the Charter of Economic Rights and Duties of States (the Charter) was adopted by the UN General Assembly by a vote of 120 to 6 with 10 abstentions. Article 2 of the Charter recognises that a state has the right to regulate foreign-owned property within its national jurisdiction in conformity to its laws and regulations and also provides for a state's right to expropriate:

Each state has the right to nationalise, expropriate or transfer ownership of foreign property in which case appropriate compensation should be paid by the state adopting such measures, taking into account its relevant laws and regulations and all circumstances that the state considers pertinent.³⁴

Although the Charter reflects the views of a great majority of developing countries that strongly advocate sovereignty, being a UN General Assembly resolution, it is only a political and programmatic announcement, and is not legally binding.³⁵ In addition, it does not contribute to the formation of state practice concerning the protection of foreign-owned property, as developing countries have joined international investment agreements, competing for the inflow of foreign investments.³⁶ Even so, from a comparison of the Charter and the previous Draft Conventions, it can be concluded that under international law, a state has the legitimate but limited right to expropriate foreign-owned property. Additionally, the prevailing view is that the state's right to expropriate is subject to certain conditions imposed by customary international law.

³³ *ibid* 555–56.

³⁴ Article 2(2)(c) of the Charter of Economic Rights and Duties of States.

³⁵ Newcombe (n 1) 32. The Charter, like the NIEO Declaration, was an assertion of national sovereignty by developing states. Although it was adopted by an overwhelming majority, most developed states either voted against its adoption or abstained from voting.

³⁶ *ibid*.

1.1.2 Disputes concerning the Level of Protection of Foreign Investors and Expropriation

1.1.2.1 The International Minimum Standard of Treatment versus National Treatment

Conflicting positions have existed in relation to the level of protection of aliens, advocating either the national treatment or the international minimum standard. In the nineteenth century, when investment flows expanded between imperial powers and colonised countries, investments were regulated by the municipal laws of the colonial powers. State practice in this period was mainly shaped by the Western viewpoint, which held that their nationals should not be treated by host states under a standard of treatment that fell below a certain international minimum standard, even though that minimum standard might connote treatment more favourable than that accorded to their own nationals.³⁷ However, when colonised territories became independent, a contrasting position emerged based on the doctrines of sovereignty and sovereign equality.³⁸ Latin America has substantially contributed to the development of rules and principles governing state responsibility in relation to the doctrine.³⁹ With the recognition that the reality of diplomatic protection in the nineteenth century involved the use of military self-help, in other words, ‘gunboat diplomacy’,⁴⁰ Latin America was opposed to diplomatic protection as well as to international minimum standards.⁴¹

Against this backdrop, the Calvo doctrine was adopted by some Latin American states. This maintained that the responsibility of governments towards foreigners could not be greater than that which governments would have owed to their own

³⁷ *ibid* 12.

³⁸ Subedi (n 8) 8.

³⁹ *ibid*.

⁴⁰ Santiago Montt, *State Liability in Investment Treaty Arbitration: Global Constitution and Administrative Law in the BIT Generation* (Hart Publishing 2009) 32.

⁴¹ *ibid* 38.

nationals.⁴² This doctrine was pursued in attempts to strike a balance between the goals of encouraging foreign investment and addressing the abuse of diplomatic protection.⁴³ According to Article 9 of the Convention on the Rights and Duties of States, which was signed at the Seventh Pan-American Conference, because the jurisdiction of a state within its territorial limit reaches all inhabitants, nationals and foreigners are under the same protection of the law and, accordingly, the national authorities and foreigners cannot claim rights beyond those provided for nationals.⁴⁴ The Calvo doctrine can be summarised as follows:

- (1) Foreign nationals are entitled to no better treatment than host state nationals;
- (2) The rights of foreign nationals are governed by host state law; and
- (3) Host state courts have exclusive jurisdiction over disputes involving foreign nationals.⁴⁵

At the beginning of the twentieth century, the diplomatic and arbitral practices that were shaped in the previous century gave rise to a rule governing the treatment of aliens and their property. This was deemed to be generally applicable under international law. The former US Secretary of State, Elihu Root, maintained the following:

There is a standard of justice, very simple, very fundamental, and of such general acceptance by all civilised countries as to form a part of the international law of the world ... If any country's system of law and administration does not conform to that standard, although the people of the country may be content or compelled to live under it, no other country can be

⁴² *ibid* 39.

⁴³ *ibid* 40.

⁴⁴ Article 9 of the Montevideo Convention on the Rights and Duties of States, signed at Montevideo on 23 December 1933 and entered into force on 23 December 1934.

⁴⁵ Newcombe (n 1) 13.

compelled to accept it as furnishing a satisfactory measure of treatment to its citizens.⁴⁶

Schwarzenberger also supported this position by claiming as follows:

The national standard cannot be used as a means of evading international obligations under the minimum standard of international law. Even if the standard of national treatment is laid down in a treaty, the presumption is that it has been the intention of the parties to secure to their nationals in this manner additional advantages, but not to deprive them of such rights as, in any case, they would be entitled to enjoy under international customary law or the general principles of law recognised by civilised nations.⁴⁷

These conflicting views concerning national treatment and the international minimum standard almost came to an end as the international minimum standard became predominant. The international minimum standard was strongly maintained during the 1920s in significant decisions of the US-Mexico General Claims Commission; for instance, in the cases of *Neer*, *Roberts*, and *Hopkins*. This standard was further reinforced by the judgments of the PCIJ in cases such as the *Case Concerning Certain German Interests in Polish Upper Silesia*, where the PCIJ held that a foreigner's vested rights must be protected, and in the *Case Concerning the Factory at Chorzów*, in which the PCIJ held that an illegal taking of property incurs the obligation of reparation.⁴⁸ This latter judgment connoted that a state is obliged to treat a foreigner and his or her property in accordance with a minimum standard of treatment.⁴⁹ Subsequently, Mexico, a loyal advocate of the Calvo doctrine, embraced Chapter XI of the North American Free Trade Agreements (NAFTA). Many other countries in Latin America have chosen to leave the Calvo doctrine by

⁴⁶ Address of Hon Elihu Root, President of the Society on 'The basis of protection to citizens residing abroad' 4 ASIL 517, cited in Subedi (n 8) 7, 9.

⁴⁷ G Schwarzenberger, *International Law as Applied by International Courts and Tribunals* (London, Stevens, 1957) 248 cited in Subedi (n 8) 9.

⁴⁸ *Chorzów Factory (Germany v Poland)* [1928] PCIJ Rep Series A No 17, 47.

⁴⁹ Newcombe (n 1) 15.

entering into bilateral investment treaties (BITs).⁵⁰ However, in 2002, the US Congress passed the Trade Promotion Authority Act, requiring that US trade negotiators ensure that foreign investors are not provided with greater substantive rights than US nationals.⁵¹

Early arbitral cases involving the international minimum standard usually addressed the ‘physical maltreatment’ of foreigners and their property by agents of the state or the state’s failure to punish those who committed physical injuries to foreigners or their property.⁵² The *Neer*, *Roberts*, and *Hopkins*⁵³ cases, decided by the Mexican-US General Claims Commission (‘the Commission’), are deemed to indicate the emergence of the international minimum standard in international law.⁵⁴

Although the *Neer* case demonstrates the standard of treatment for foreigners, it was not concerned with an investment dispute, but with the murder of an American national. The Commission concluded that the Mexican authorities’ failure to arrest or punish those who were responsible for Neer’s death did not *per se* violate the international minimum standard of treatment of a foreigner. The Commission described the minimum standard as follows:

The treatment of aliens, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognise its insufficiency.⁵⁵

⁵⁰ Centre for International Environmental Law (CIEL), ‘International Law on Investment: The Minimum Standard of Treatment (MST)’ (Issue Brief 2003) 2.

⁵¹ *ibid.*

⁵² Ioana Tudor, *The Fair and Equitable Treatment Standard in the International Law of Foreign Investment* (OUP 2008) 63.

⁵³ *USA (George W Hopkins) v United Mexican States* (Award) (1926) the Mexican-US General Claims Commission IV RIAA 41.

⁵⁴ *ibid.*

⁵⁵ *LFH Neer and Pauline Neer (USA) v United Mexican States* (Award) 15 October 1926 Mexico-US General Claims Commission.

The *Roberts* case is also regarded as reflecting the international minimum standard. In this case, the Commission concluded that the treatment of Roberts, who was confined in a small cell with no sanitary equipment, necessitated indemnity because it constituted cruel and inhumane imprisonment.⁵⁶ The Commission stated that the international minimum standard does not indicate the equality of treatment of a foreigner, but the treatment of a foreigner ‘in accordance with ordinary standards of civilisation’.⁵⁷ On the basis of the *Roberts* case, the international minimum standard is regarded as a norm of customary international law which governs states in their treatment of aliens, irrespective of their domestic legislation and practices, by providing for a minimum set of principles.⁵⁸

Paragraph 165.2 of the 1965 American Law Institute’s Restatement (Second) of Foreign Relations Law of the United States articulates the definition of the international minimum standard, as follows:

The international standard of justice ... is the standard required for the treatment of aliens by: (a) the applicable principles of international law as established by international custom, judicial and arbitral decisions, and other recognised sources or, in the absence of such applicable principles, (b) analogous principles of justice generally recognised by states that have reasonably developed legal systems.⁵⁹

There are several elements that constitute the international minimum standard and denial of justice has long been recognised as one such element. The denial of justice is considered to refer to both the narrow notion of judicial misconduct as well as a range of other injuries that would today be recognised as expropriation or as other

⁵⁶ *Harry Roberts (USA) v United Mexican States* (Award) 2 November 1926 Reports of International Arbitral Awards vol IV 77–81.

⁵⁷ *ibid* 104–05.

⁵⁸ *ibid* 81.

⁵⁹ The 1965 American Law Institute’s Restatement (Second) of Foreign Relations Law of the United States, para 165.2. See Tudor (n 52) 61.

claims.⁶⁰ Another element of the standard involves the obligation of host states to exercise due diligence to prevent injuries to aliens or to make reasonable efforts to bring the culprits to justice.⁶¹ The third element is the one of due process. It is required in the ‘administration of justice’.⁶² If a violation of due process is not rectified by the judicial mechanism, a denial of justice will occur.⁶³ Due process in customary international law concerns a host state’s conduct that may affect the right of a foreign investor or foreign-owned property.⁶⁴ For instance, a lack of transparency or unfairness in an administrative process, such as the revocation of a business license without notice or hearing, will result in a breach of the international minimum standard of treatment.⁶⁵ In addition, the international minimum standard protects a foreign investor and foreign-owned property from arbitrary host state acts.⁶⁶ §712 of the Restatement (Third) of the Foreign Relations Law of the United States provides that a state is responsible for its arbitrary acts that cause injury to the ‘property or other economic interests’ of a foreign national. The commentary to §712 describes ‘arbitrary’ as referring to an ‘act that is unfair and unreasonable, and inflicts serious injury to established rights of foreign nationals, though falling short of an act that would constitute an expropriation’.⁶⁷ Finally, non-discrimination is related to the international minimum standard. Discrimination in the context of international investment agreements connotes a form of illegitimate differentiation between persons or things that are in a similar circumstance.⁶⁸ For instance, in *Waste Management II*, the tribunal concluded that the conduct of a state which ‘is discriminatory and exposes the claimant to sectional or racial prejudice’ is prohibited by the international minimum standard of treatment.⁶⁹

⁶⁰ Gimblett and Johnson Jr (n 21) 655.

⁶¹ *ibid.*

⁶² Newcombe (n 1) 244.

⁶³ *ibid.*

⁶⁴ *ibid.*

⁶⁵ Newcombe (n 1) 245.

⁶⁶ *ibid.* 246.

⁶⁷ §712 of the Restatement (Third) of the Foreign Relations law of the United States (including the commentary).

⁶⁸ Newcombe (n 1) 251.

⁶⁹ *Waste Management v United Mexican States* (Final Award) (Dismissing on Jurisdiction) 2 June 2000 (ICSID Additional Facility Case No ARB(AF)/98/2).

A significant issue arises as to whether the notion of the international minimum standard remains to be interpreted as in the early arbitral cases, such as *Neer* and *Roberts*, or whether it refers to an evolving customary international law that has been formed under the influence of the extensive BITs.⁷⁰ According to the Free Trade Commission of NAFTA, the fair and equitable treatment of Article 1105(1) prescribes the international minimum standard of the treatment of foreigners and of their property.⁷¹ From this perspective, certain NAFTA tribunals such as *ADF* and *Mondev* have advocated that the international minimum standard has continued to evolve since 1926 and *Neer*. For instance, the *ADF* tribunal affirmed that the international minimum standard of treatment has developed as follows:

What customary international law projects is not a static photograph of the minimum standard of treatment of aliens as it stood in 1927 when the Award in the *Neer* case was rendered. For both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.⁷²

The *Mondev* tribunal indicated the development of the minimum standard, influenced by the increased numbers of BITs, when interpreting Article 1105(1) of NAFTA:

Both the substantive and procedural rights of the individual in international law have undergone considerable development. In the light of this development it is unconvincing to confine the meaning of ‘fair and equitable treatment’ and ‘full protection and security’ of foreign investments to what those terms – had they been current at the time – might have meant in the 1920s when applied to the

⁷⁰ OECD, ‘International Investment Law: A Changing Landscape’ (2005) 83.

⁷¹ The NAFTA Free Trade Commission adopted an interpretation of Article 1105(1) on 31 July 2001. ‘Notes of Interpretation of Certain Chapter 11 Provisions’ <www.sice.oas.org/tpd/nafta/Commission/CH11understanding_e.asp> accessed 1 May 2015.

⁷² *ADF v USA* ICISD Case No ARB (AF)/00/1 para 179.

physical security of an alien. To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious.⁷³

1.1.2.2 The Relationship between the International Minimum Standard and Expropriation

A state is obliged by customary international law to provide a foreign investor and foreign-owned property with the minimum standard of treatment.⁷⁴ Without an international investment agreement, the international minimum standard of treatment functions as the relevant standard of treatment for diplomatic protection.⁷⁵ In a dispute concerning an international investment agreement, the international minimum standard of treatment serves for the interpretation of the obligations of an international investment agreement as the minimum standard is equated with fair and equitable treatment and is required in some international investment agreements as ‘treatment in accordance with international law’.⁷⁶ On the other hand, the international minimum standard of treatment may assist in other ways in relation to the international law rules on expropriation.

As previously noted, in the competing race between national treatment and the international minimum standard of treatment, the latter became predominant. This implies that developing countries, which once advocated the former, have changed their position, choosing to endorse the international minimum standard of treatment as a more acceptable standard. Furthermore, the basic function of the international minimum standard is to set a minimum criterion with which any municipal law should comply. Elihu Root, who supports the application of the international minimum standard to the treatment of aliens, argued that there existed a standard of justice, forming a part of international law, which became a ‘general international

⁷³ *FA Mondev International Ltd v United States* (Award) 11 October 2002 (ICSID Case No ARB (AF) 99/2) para 116.

⁷⁴ Newcombe (n 1) 235.

⁷⁵ *ibid.*

⁷⁶ *ibid.*

standard' with which any municipal law regulating the treatment of aliens had to comply.⁷⁷

In this respect, the international minimum standard in itself can be a minimum criterion on which investment treaty arbitration tribunals can rely when addressing expropriation cases; in particular, in assessing the lawfulness of expropriation. It is noteworthy that the international minimum standard of treatment and the conditions required by customary international law for lawful expropriation share a few common elements, such as due process and non-discrimination. Considering the legal nature of the international minimum standard and these common elements, it is reasonable to contemplate that the international minimum standard of treatment can exert some influence on the evaluation of the lawfulness of expropriation. This potential will be explored in the subsequent chapter where the lawfulness of expropriation will be examined.

1.1.3 International Investment Treaty Law on the Protection of Foreign-Owned Property and Expropriation

1.1.3.1 BITs, the Standard of Treatment, and Expropriation

1.1.3.1.1 The Advent of the Era of BITs

International investment agreements have been negotiated or concluded at bilateral, regional, inter-regional and multilateral levels, in an attempt to address uncertainties and the paucity of customary international law on state responsibility for injuries to aliens and their property.⁷⁸ Also, capital exporting states have striven to secure enhanced market access commitments from capital importing states for their nationals, and to fulfil progressive development in the standard of investment

⁷⁷ E Root, 'The Basis of Protection to Citizens Residing Abroad' (1910) 4 AJIL 517, 521–22. See Subedi (n 8) 9.

⁷⁸ Newcombe (n 1) 41.

protection.⁷⁹ Prior to the advent of international investment agreements, the primitive form of the investment protection treaty was the treaty of ‘Friendship, Commerce and Navigation’ (FCN). For example, the 1956 Treaty of Friendship, Commerce and Navigation between Nicaragua and the United States is a type of general economic treaty which serves the same function as a BIT.⁸⁰ Since the first BIT was signed between Germany and Pakistan in 1959 and came into force in 1962,⁸¹ BITs have grown expansively. According to UNCTAD monitoring, there exist 2,923 BITs; 2,240 having come into force, along with 345 other international investment agreements.⁸² Today, the era of BITs has emerged in a background where the division between developed and developing countries over the customary norms regulating foreign direct investment has not reached a compromise.⁸³ In this situation, each country has conducted BIT negotiations based on bilaterally agreed terms.⁸⁴

1.1.3.1.2 The Relationship between BITs and Customary International Law in Connection to the Standard of Protection in International Investment Law

The expansion of an international network of BITs raises an important question in the relationship between BITs and customary international law. According to Article 38(1) of the Statute of the International Court of Justice, BITs, as international conventions, and customary international law, are the source of international law. The question is what the relationship between BITs and customary international law is when addressing the common subject of the

⁷⁹ *ibid.*

⁸⁰ *ibid.*

⁸¹ Treaty for Promotion and Protection of Investments between Pakistan and Federal Republic of Germany (with Protocol and exchange of notes), signed at Bonn on 25 November 1959.

⁸² UN UNCTAD Investment Policy Hub, International Investment Agreements Navigator <<http://investmentpolicyhub.unctad.org/IIA>> accessed 3 May 2015.

⁸³ Ahmad Ali Ghouri, ‘The Evolution of Bilateral Investment Treaties, Investment Treaty Arbitration and International Investment Law’ (2011) 14(6) International Arbitration Law Review 189, 195.

⁸⁴ *ibid.*

treatment of foreign-owned property. One view is that the extensive network of BITs embodies rules on the treatment of foreign investment, by re-establishing rules of customary international law on the treatment of foreign investment. It may not be immediately understood that BITs not only legally bind parties to the specific treaties, but can also constitute general international law that may exert a general binding force on the international community. The UN International Law Commission has admitted the possibility that treaties can generalise rules on the basis of similarity in treaty provisions, as follows:

An international convention admittedly establishes rules binding the contracting states only, and based on reciprocity; but it must be remembered that these rules become generalized through the conclusion of other similar conventions containing identical or similar provisions.⁸⁵

Mann argued that BITs would provide the evidentiary support for the existence of an international obligation, by contending that where BITs ‘express a duty which customary law imposes or is widely believed to impose, they give very strong support to the existence of such a duty and preclude the contracting states from denying its existence’.⁸⁶ The tribunal in the *Mondev* case also admitted the potential for BITs and RTAs to exert such an influence with regard to some treatment of foreign investment:

The vast majority of bilateral and regional investment treaties (more than 2000) almost uniformly provide for fair and equitable treatment of foreign investments, and largely provide for full security and protection of investments. ... On a remarkably widespread basis, states have repeatedly obliged themselves

⁸⁵ Report of the International Law Commission covering the work of its twelfth session, II Yearbook of the International Law Commission 145, UN Doc A/4425 (1960).

⁸⁶ FA Mann, ‘British Treaties For the Promotion and Protection of Investment’ (1981) 52(1) British Year Book of International Law 241, 249. Mann stated that the ICJ decision in the *North Sea Continental* case, ICJ Reports 4 (1969), to the effect that rules of international law cannot be derived from bilateral treaties, is not true of BITs for the reason that BITs form an extensive network. See Kishoiyian (n 88) 328.

to accord foreign investment such treatment. In the Tribunal's view, such a body of concordant practice will necessarily have influenced the content of rules governing the treatment of foreign investment in current international law.⁸⁷

Another view is that due to a lack of consistency, BITs fall short of exercising such an influence on the formation of customary international law. Even though a state may obtain a right on the basis of the consent of the other state parties concerned, a general rule of customary international law demands more than such consent.⁸⁸ There should be indications that states not party to the formation of the rule have in fact come to abide by it as part of their general law and have acted in accordance with this perception.⁸⁹ For all states concerned to accept a legal principle, there should be a 'general conviction' that states honour the rights based on the customary principle by endorsing it as a legal obligation.⁹⁰ In order to examine whether BITs can create customary international law concerning foreign investment, it is necessary to consider a few key aspects of the rules on foreign investment. It is evident that BITs exhibit varying scopes in relation to the definition of the property to be protected by treaties, require different combinations of conditions for lawful expropriation, show differences in terms of applicable law and the methods of investment dispute resolution, and also do not include a unified standard of compensation.⁹¹ In this respect, this opinion concludes that BITs fail to demonstrate consistency that is sufficient to support the possibility that any definite rules of customary international can form from them.⁹²

A third view suggests that even when admitting that the content of BITs and custom is different, and BITs as a whole may not indicate a new custom, BITs can exert a

⁸⁷ *Mondev* (n 73) para 117.

⁸⁸ Bernard Kishoiyian, 'The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law' (1993) 14(2) *Northwestern Journal of International Law & Business* 327, 337.

⁸⁹ *ibid.*

⁹⁰ *ibid.*

⁹¹ *ibid.* 341–71. Kishoiyian offers a detailed explanation in support of the inability of BITs to form rules of customary international law.

⁹² *ibid.*

‘marginal’ effect in reinforcing and materialising rules of customary international law.⁹³ This view acknowledges that because ‘cross-fertilisation’ between BITs and customary international law can happen, the extensive network of BITs can influence customary international law.⁹⁴ Firstly, certain standards of investment protection can result in the ‘consolidation’ of existing rules of customary international law, so-called ‘codification’.⁹⁵ Secondly, the ‘common law of investment protection’, which stems from BITs, will lead to the future materialisation of new rules of customary international law.⁹⁶ In addition, according to this view, customary international law can assist the provisions of BITs by filling the gaps when incompleteness, ambiguity or abstractness exists in the BITs’ provisions. For instance, the *ADC* tribunal supported such a role of customary international law when there is a gap in treaty provisions, as follows:

Since the BIT does not contain any *lex specialis* rules that govern the issue of the standard of assessing damages in the case of an unlawful expropriation, the Tribunal is required to apply the default standard contained in customary international law in the present case.⁹⁷

Based on their bilateral nature, it is conceivable that BITs can be relied on by negotiating states to extend the scope of the standard of treatment afforded by customary international law.⁹⁸ Also, it is possible that BITs, rather than simply codifying the rules of customary international law, can provide extended protection to foreign investors by endeavouring to reflect more favourable treatment in BIT provisions.⁹⁹ Although each BIT could be deemed as a *lex specialis*, it can be argued that the practice of states in concluding BITs is capable of reinforcing the alleged

⁹³ Patrick Dumberry, ‘Are BITs Representing the New Customary International Law in International Investment Law?’ (2010) 28 Penn State International Law Review 675, 676.

⁹⁴ *ibid* 694.

⁹⁵ *ibid* 695.

⁹⁶ *ibid*.

⁹⁷ *ADC v Hungary* (Award) 27 September 2006 (ICSID Case No ARB/03/16) para 483.

⁹⁸ Subedi (n 8) 90.

⁹⁹ *ibid*.

rules of customary international law of relevant subjects.¹⁰⁰ It is further admitted that there exist a great number of BITs that even contain provisions of high similarity. Nonetheless, it does not necessarily mean that such provisions materialise rules of customary international law,¹⁰¹ given that BITs cannot sufficiently meet the two constituent requirements of customary international law: i.e. consistent state practice and *opinio juris*. In addition, rules of customary international law can be relied upon in certain occasions for the interpretation of an investment treaty provision. For instance, in interpreting Article 1105 of NAFTA, reference should be made to principles of customary international law.¹⁰²

Even though it may be hard to accept that BITs are capable of modifying the meaning, nature and scope of general customary international law,¹⁰³ it may be admitted that customary international law can play a larger role than simply filling gaps in BITs. For instance, the international minimum standard of treatment, as a rule of customary international law, is regarded as a constituent element that forms part of fair and equitable treatment or full protection and security, which are provided for in treaty provisions. In this respect, customary international law is capable of shaping some BIT standards of treatment.

1.1.3.1.3 BITs and Expropriation

For the purpose of promoting foreign investment and thus protecting it from unjustifiable expropriation, BITs typically contain provisions codifying a *lex*

¹⁰⁰ Subedi (n 8) 85.

¹⁰¹ Subedi (n 8) 142.

¹⁰² In a statement that the Government of Canada provided for guidance for the interpretation of Article 1105 of NAFTA, it stated that ‘Article 1105, which provides for treatment in accordance with international law, is intended to assure a minimum standard of treatment ... this article provides for a minimum absolute standard of treatment, based on long-standing principles of customary international law.’ (*Canada Gazette* (Part I, 1 January 1994) 149.)

¹⁰³ Subedi (n 8) 143.

specialis to address expropriation claims.¹⁰⁴ Within the legitimate scope, circumscribed by BITs, states can directly exercise their right to expropriate foreign-owned property in pursuit of economic development and reform, environmental protection, and other public welfare interests; albeit that direct expropriation became rare with the end of socialism.¹⁰⁵ In an attempt to evade the perception that they could abuse their expropriation authority, capital-importing countries began to alternatively pursue indirect forms of expropriation.¹⁰⁶ BITs have since reflected that a foreign investor's investment can be expropriated 'indirectly through measures tantamount to expropriation or nationalisation'.¹⁰⁷ This substantive language is shared in almost all BITs (as well as in RTAs) and reflects various types of indirect expropriation.¹⁰⁸ The so-called 'tantamount clause' is capable of extending the scope of the notion of indirect expropriation for the purpose of establishing or sustaining favourable legal conditions in the host state.¹⁰⁹ It is a universal requirement, adopted by BITs as well as RTAs, which obliges a state to pay compensation when it expropriates foreign-owned property.

Along with this obligation of compensation, there are other conditions to be met for lawful expropriation, including public purpose, non-discrimination, and due process. These conditions are also required by customary international law. For instance, the Agreement between Korea and Russia¹¹⁰ for the Promotion and Reciprocal Protection of Investment stipulates:

Investment of investors of either Contracting Party shall not be nationalised, expropriated or subjected to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as 'expropriation') in the territory of the

¹⁰⁴ W Michael Reisman and Robert D Sloane, 'Indirect Expropriation and Its Valuation in the BIT Generation' BU Working Paper No 06-43, 118
<http://ssrn.com/abstract_id=943430> accessed 1 May 2015.

¹⁰⁵ *ibid.*

¹⁰⁶ *ibid.*

¹⁰⁷ US-Russia BIT (1992) art III(1).

¹⁰⁸ Reisman and Sloane (n 104) 118-19.

¹⁰⁹ *ibid.*

¹¹⁰ Formerly the Union of Soviet Socialist Republics.

other Contracting Party except for a public purpose. The expropriation shall be carried out under due process of law, on a non-discriminatory basis and shall be accompanied by prompt, adequate and effective compensation.¹¹¹

The Investment Agreement between Chile and China also provides a similar provision which allows a state to expropriate upon certain conditions:

Neither Contracting Party shall expropriate, nationalise or take similar measures (hereinafter referred to as ‘expropriation’) against investments of investors of the other Contracting party in its territory, unless the following conditions are met:

- (a) for the public or national interest;
- (b) under domestic legal procedure;
- (c) without discrimination;
- (d) against compensation.¹¹²

With regard to expropriation and the accompanying requirement of compensation, there are two critical issues. The first one is whether the tantamount clause can expand the scope of expropriation beyond the concept as recognised by customary international law. The second one is whether the so-called Hull formula, which requires ‘prompt, adequate, and effective’ compensation, should be universally accepted in all international investment agreements and relied on for the interpretation of the compensation requirement as such. These two issues will be explored in detail in later parts of this thesis.

¹¹¹ Article 5(1) of the Agreement between the Government of the Republic of Korea and the Government of the Union of Soviet Socialist Republics for the Promotion and Reciprocal Protection of Investments, signed on 14 December 1990 and came into force on 10 July 1991.

¹¹² Article 4 of the Agreement between the Government of the Republic of Chile and the Government of the People’s Republic of China Concerning the Encouragement and the Reciprocal Protection of Investment (1994).

1.1.3.2 Regional Trade Agreements (RTAs), Standards of Treatment, and Expropriation

In addition to BITs, there have appeared comprehensive regional agreements covering trade and investment, such as the Energy Charter Treaty, the North American Free Trade Agreements, and the ASEAN Investment Agreements. The first multilateral treaty that included investment provisions was the Energy Charter Treaty of 1994. The treaty was designed to create ‘a level playing field’ to promote Western investment in the development of energy resources in Eastern Europe and the former Soviet Union, and accordingly to produce a legal framework which would contribute to long-term coordination in the energy sector.¹¹³ The treaty covers trade, transit, the transfer of technology, the sovereignty over energy resources, and dispute settlement, as well as investment.¹¹⁴ Earlier, in December 1991, the European Energy Charter (EEC) had been adopted and signed.¹¹⁵ This was a non-binding treaty, but put forward guidelines for the negotiation of a subsequent binding treaty, which was to become the ECT, and a set of protocols.¹¹⁶ As of 2010, the ECT has been signed and ratified by 45 states and the European Union. The Russian Federation, while embracing the provisional application of the ECT, had signed it in 1991, but not ratified it.¹¹⁷ It later withdrew from the ECT by terminating provisional application in 2009.¹¹⁸

ECT ‘investment’ covers a broad concept of ‘every kind of asset’ owned or controlled directly or indirectly by an investor and enumerates specific asset

¹¹³ Gillian Turner, ‘Investment Protection Through Arbitration: the Dispute Resolution Provisions of the Energy Charter Treaty’ [1998] *International Arbitration Law Review* 166.

¹¹⁴ The Energy Charter Treaty, Part II (Commerce), Part III (Investment Promotion and Protection), Part IV (Miscellaneous Provisions), and Part V (Dispute Settlement).

¹¹⁵ Kaj Hober, ‘Investment Arbitration and the Energy Charter Treaty’ (2010) 1(1) *Journal of International Dispute Settlement* 153, 154.

¹¹⁶ *ibid.*

¹¹⁷ Irina Mironova, ‘Russia and the Energy Charter Treaty’ (Energy Charter, 7 August 2014) <www.energycharter.org/what-we-do/knowledge-centre/occasional-papers/russia-and-the-energy-charter-treaty> accessed 2 December 2015.

¹¹⁸ *ibid.*

types.¹¹⁹ The aim of the ECT provisions related to investment is to create a ‘level playing field’ for investments in the energy sector and to minimise the non-commercial risks that can be involved in such investments.¹²⁰ It is noteworthy that the ECT draws a distinctive line between the pre-investment phase of making an investment and the post-investment phase that comes after an investment is completed.¹²¹ While the provisions regarding the pre-investment phase establish a ‘soft regime of best endeavour’ obligations, a ‘hard regime’ is established for the post-investment phase on the basis of the standards of investment protection, the types being observed in the provisions of NAFTA and other BITs.¹²² The substantive protections under the ECT include fair and equitable treatment, constant protection and security, the protection from impairment by unreasonable or discriminatory measures of investment management or disposal, national treatment, most-favoured-nation treatment, and the observance of any obligations committed by treaty states.¹²³ The ECT dispute settlement procedure can commence after the lapse of a three-month cooling-off period. The procedure has a few more options than state-to-state or investor-state dispute resolutions. There are additionally: (i) the courts or administrative tribunals of the host state; (ii) any applicable, previously agreed dispute settlement procedure; and (iii) the Arbitration Institute of the Stockholm Chamber of Commerce.¹²⁴

A few cases can be used to exemplify the violations of the standards of treatment or investment protection. The case of *Petrobart Limited v The Kyrgyz Republic*¹²⁵ concerned a sales contract, wherein the Kyrgyz state-owned company KGM bought 200,000 tonnes of gas condensate from Petrobart. When Petrobart attempted to enforce its right regarding unpaid shipments, the Kyrgyz authorities took measures to privatise KGM and transferred its assets to new companies, plus directed the

¹¹⁹ ECT Article 1(6) Investment.

¹²⁰ Hober (n 115) 153, 155.

¹²¹ *ibid.*

¹²² *ibid.*

¹²³ *ibid* art 10 (1).

¹²⁴ *ibid* art 26.

¹²⁵ *Petrobart Limited v The Kyrgyz Republic* Award Arbitration No 126/2003 of the Arbitration Institute of Stockholm Chamber of Commerce (2005).

domestic court to accord a stay of enforcement, in which period KGM was declared bankrupt and could not be subjected to the enforcement of Petrobart's rights. The tribunal concluded the Kyrgyz government acted against the principle of fair and equitable treatment¹²⁶ by transferring KGM assets and impairing the benefits of KGM's creditors. Additionally, it also breached the obligation to ensure effective means of assertion and the enforcement of rights with respect to investment¹²⁷ by its intervention in court proceedings.

The arbitration case of *Nykomb Synergetics Technology Holding AB v The Republic of Latvia*¹²⁸ involved an expropriation claim. In 1997, Latvenergo, a state-owned Latvian company, and Windau, a subsidiary wholly owned by Nykomb, entered into an agreement for the construction of power plants in Latvia. In accordance with the agreement, Latvenergo was to purchase the surplus electric power by paying at a tariff which was twice the average tariff for electric power sanctioned by the Public Utilities Commission of Latvia (the Double Tariff). Latvenergo, however, refused to pay the Double Tariff, and instead purchased surplus electric power from Windau at 75 per cent of the average tariff under the new Energy Law, which came into force after the construction agreement was concluded. Nykomb argued that Latvenergo's reliance on the new Energy Law, and consequential refusal to pay the Double Tariff, deprived Windau of its right to the Double Tariff, which amounted to a regulatory taking that had an effect equivalent to expropriation and was discriminatory. The tribunal held that because there was no interference with the shareholder's rights or with the management's control over the business, the refusal to pay the Double Tariff did not constitute an expropriation under the ECT. However, it accepted Nykomb's discrimination claim for the reason that Latvenergo accorded double tariffs to other companies and failed to put forward evidence against its varying treatment.

¹²⁶ Article 10(1) of the ECT.

¹²⁷ Article 10(12) of the ECT.

¹²⁸ *Nykomb Synergetics Technology Holding AB v The Republic of Latvia* (Award) 16 December 2003 Arbitration Institute of the Stockholm Chamber of Commerce.

NAFTA is also a regional trade agreement signed by the United States, Canada and Mexico, which came into effect on 1 January 1994. Although NAFTA is a trade agreement, it contains provisions for foreign investment protection in Chapter 11, with the aim of establishing a ‘predictable commercial framework’ for investment.¹²⁹ NAFTA provides for several substantive obligations, which are: (i) national treatment (Article 1102); (ii) most-favoured-nation treatment (Article 1103); (iii) treatment in accordance with international law (Article 1105); (iv) the prohibition of imposition of performance requirements (Article 1106); (v) the prohibition of appointing individuals to senior management positions (Article 1107); (vi) freedom of currency transfers (Article 1109); and (vii) expropriation and compensation (Article 1110).

Among those obligations, Article 1105 (1) raises a particularly significant issue with regard to the level of protection accorded by the provision in comparison to customary international law. It stipulates that ‘Each Party shall accord to investment of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security’.¹³⁰

This provision is construed to connote that the protection of investment accorded under customary international law is as extensive as that provided in the NAFTA, based on the premise that the NAFTA provisions simply codify rules of customary international law.¹³¹ However, it may not be certain whether the protection of customary international law in practice extends as far as NAFTA protection does.¹³² Also, it is doubtful as to whether the new concepts introduced by NAFTA in Articles 1110(1) and 1105(1), such as the due process of law, fair and equitable treatment, and full protection and security, can be absorbed into the notion of the minimum international standard of treatment of foreign investment accepted in

¹²⁹ NAFTA preamble.

¹³⁰ NAFTA, art 1105(1).

¹³¹ Subedi (n 8) 108.

¹³² *ibid.*

traditional international law under the heading ‘Minimum Standard of Treatment’.¹³³

As BITs adopt a ‘tantamount’ clause in their expropriation provisions, the NAFTA also contains such a clause in its expropriation provision:

No Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalisation or expropriation of such investment (expropriation) except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1);
- (d) on payment of compensation in accordance with paragraph 2 through 6.¹³⁴

It can be noted that there has been a NAFTA case which concerned the relationship between the expropriation provision of Article 1110 of NAFTA and customary international law. In *Pope & Talbot Inc v Canada*,¹³⁵ Pope & Talbot Inc raised an expropriation claim. Pope & Talbot Inc is a Delaware company that owns a British Columbia wood-products company which manufactures and sells softwood lumber and exports its softwood lumber production to the United States. Canada instigated a Softwood Lumber Agreement (SLA) with the United States, which set a restriction on the export to the United States of softwood lumber originally manufactured in British Columbia. Pope & Talbot Inc argued that Canada’s Export Control Regime carrying out the SLA had undermined its company’s ability to conduct the business of exporting softwood lumber to the United States, thus expropriating Pope & Talbot Inc’s investment. The claimant based its argument on the fact that the measure at issue, though not falling within the ambit of customary

¹³³ *ibid.*

¹³⁴ NAFTA, art 1110(1).

¹³⁵ *Pope & Talbot, Inc v The Government of Canada* (Interim Award on Merits – Phase Two) 10 April 2001 7 ICSID Report 43.

international law's definition of expropriation, constituted a 'measure tantamount to expropriation' as provided for in paragraph 1 to Article 1110 of NAFTA, which can be defined as a broader concept than the expropriation definition based on customary international law.¹³⁶ The tribunal rejected the claimant's expropriation claim,¹³⁷ along with its interpretation of 'measure tantamount to expropriation'. The tribunal construed 'tantamount' as being no more than equivalent.¹³⁸

Of significance in the NAFTA regime is investor-state arbitration, which is set out in Section B (Articles 1115 to 1138). An investor can bring a suit against the host state by claiming a violation of one of the obligations in Chapter 11. When both the home and host states are parties to the ICSID, a foreign investor can rely on the rules of the ICSID. However, in a scenario when a state is not a party to the ICSID, then other available dispute settlement rules may be relied upon, such as the ICSID Additional Facility Rules of 1978 and the UNCITRAL Arbitration Rules. Because the United States is the only NAFTA party that is a signatory to the ICSID Convention, only the latter two choices are available.

The Association of Southeast Asian Nations (ASEAN) has ten member states,¹³⁹ which have considered the importance of a regional investment agreement and made efforts into realising such a provision. The first ASEAN investment agreement was introduced by way of the ASEAN *Economic Community Blueprint*, which set up a plan to rebuild ASEAN as a community of high economic integration by 2015.¹⁴⁰ On 26 February 2009, ASEAN's member states signed the ASEAN Comprehensive Investment Agreement (ACIA). The ACIA was designed to establish a comprehensive, rules-based framework for investment protection.¹⁴¹ Furthermore,

¹³⁶ *ibid* para 84.

¹³⁷ *ibid* para 100.

¹³⁸ *ibid* para 104.

¹³⁹ The ASEAN member states are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

¹⁴⁰ Zewei Zhong, 'The ASEAN Comprehensive Investment Agreement: Realizing a Regional Community' (2011) 6 *Asian Journal of Comparative Law* 1, 4.

¹⁴¹ *ibid* 5.

within the ACIA, ASEAN member states sought to embrace the principles of the US Model BIT and NAFTA Chapter 11.¹⁴²

In an attempt to establish a universal legal instrument regarding international investment, states negotiated to agree on rules concerning investment at a multilateral level, but to no avail. Subsequent to the failure to encompass investment protection in the Uruguay Round Agreements, the United States drove negotiations for a Multilateral Agreement on Investment (MAI) within the OECD.¹⁴³ The MAI was intended, as a harmonisation effort, to be a solution to deal with the paucity of unity in investment protection, caused by a great number of BITs.¹⁴⁴ However, the MAI was confronted with serious opposition from NGOs having the concern that it could undermine the regulatory authority of host states, while according advantages to foreign investors.¹⁴⁵ Under domestic electoral pressure, many states that advocated the MAI, such as the United States and France, withdrew their participation in 1998.

Lately, new negotiation efforts have been embarked upon in order to establish comprehensive regional free trade agreements, such as the Trans-Pacific Partnership (TPP), the Trans-Atlantic Trade and Investment Partnership (TTIP), and the Regional Comprehensive Economic Partnership (RCEP). The TPP originated from the Trans-Pacific Strategic Economic Partnership Agreement (Trans-Pacific SEP) of 2005 whose member states were Brunei, Chile, New Zealand, and Singapore. Following the joining of the United States in the negotiations, the Trans-Pacific SEP expanded, with the joining of Australia, Peru, Vietnam, Mexico, Canada, Malaysia, and Japan. The TPP is the first non-customs union trade agreement that is designed to develop into a large, multilateral free trade agreement.¹⁴⁶ According to the

¹⁴² *ibid.*

¹⁴³ Newcombe (n 1) 55.

¹⁴⁴ McLachlan and others (n 4) 219.

¹⁴⁵ *ibid.*

¹⁴⁶ New Zealand Ministry of Foreign Affairs and Trade Fact Sheet. See Meredith K Lewis, 'The Trans-Pacific Partnership: New Paradigm or Wolf in Sheep's Clothing?' (2011) 1(2) Victoria University of Wellington Legal Research Papers 29.

Congressional Research Service Report of the United States, in relation to foreign investment, it is likely that the standards of investment protection of the TPP will be mostly based on the US Model BIT, including non-discriminatory treatment, the rules on expropriation, and the transfer of funds.¹⁴⁷ Currently, one obstacle to the negotiations is Australia's objection to the inclusion of an investor-state dispute settlement mechanism. In addition, an issue that has been raised is whether in periods of global financial crisis a state is allowed to exercise its authority to impose controls on capital flow in order to weaken short-term balance of payments problems when the financial system becomes unstable.¹⁴⁸ Former US FTAs have protected the free transfer of funds. If the TPP employs the same approach, it will likely undermine a state's power to control a balance of payment problem when an economic crisis occurs.¹⁴⁹ An approach that is recommended by the International Monetary Fund (IMF) is to allow a state to control short-term capital in dealing with balance of payment problems.¹⁵⁰

The Trans-Atlantic Trade and Investment Partnership (TTIP) negotiations began on 14 June 2013, and were aimed at increasing trade and investment between the European Union (EU) and the United States by alleviating and removing the remaining barriers to transatlantic trade and investment. Because trade policy belongs to the EU's exclusive authority, the European Commission, being the EU's executive body, negotiates the TTIP on behalf of EU Member States, by maintaining close cooperative relationships with the EU's co-legislators, the Council of the EU and the European Parliament.¹⁵¹ Trade agreement negotiations can only begin once they are authorised by the Council on the basis of a mandate

¹⁴⁷ Congressional Research Service Report, 'The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress' (2015) 35.

¹⁴⁸ *ibid.*

¹⁴⁹ *ibid.*

¹⁵⁰ *ibid.*

¹⁵¹ Delegation of the European Union to the United States, 'The Transatlantic Trade and Investment Partnership: Benefits and Challenges of an Agreement Fit for the 21st Century' 5 <www.euintheus.org/transatlantic-trade-and-investment-partnership-ttip> accessed 5 May 2015.

(negotiating directives) set out by the European Commission.¹⁵² The conclusion of trade agreements is subject to the approval of both the Council and the European Parliament.¹⁵³ In the case of certain trade agreements that involve matters that belong to Member State jurisdiction, the additional requirement is ratification by the legislatures of the Member States.¹⁵⁴ As the EU's "mandate" proceeds, the TTIP will cover three key elements: (1) market access; (2) regulatory issues and non-tariff barriers; and (3) rules.¹⁵⁵

The Regional Comprehensive Economic Partnership (RCEP) is a free trade agreement between ASEAN states and ASEAN's FTA partners, such as Australia, China, India, Japan, Korea and New Zealand. The RCEP plan was pronounced by the ASEAN leaders in November 2011 during the 19th ASEAN Summit. The RCEP was conceived as an ASEAN-driven process through which the ASEAN would widen and reinforce its economic engagement with its FTA partners in pursuit of deeper economic integration, equitable economic development and economic cooperation.¹⁵⁶

1.2 The Investment Treaty Arbitration System

1.2.1 The Scope of Protection under International Investment Agreements

1.2.1.1 A Foreign Investor

A foreign investor refers to one who is entitled to exercise legal ownership or control of investment, whether directly or indirectly, and enjoys the protections accorded by international investment law. The definitions of a foreign investor and

¹⁵² *ibid.*

¹⁵³ *ibid.*

¹⁵⁴ *ibid.*

¹⁵⁵ *ibid.*

¹⁵⁶ Ministry of Trade and Industry of Singapore, 'Factsheet on the Regional Comprehensive Economic Partnership (RCEP)' (November 2012).

foreign-owned investment are the very factors that determine the scope of the application of international investment agreements.¹⁵⁷ In relation to expropriation, the concept of a foreign investor has an important bearing on the question as to who may be entitled to raise a claim that his or her investment was expropriated by a host state. The broader the definition of investor, the greater the exposure of host states to claims of regulatory expropriation.

Two types of investors exist: a natural person, and a juridical or legal person. The investor's nationality determines which foreign country takes jurisdictional precedence in relation to the investment.¹⁵⁸ The origin of investment has little bearing on the potential existence of a foreign investment.¹⁵⁹ What matters is the nationality of a foreign investor, as this determines the applicable treaty to which the investor bases his or her investment arbitration claim.¹⁶⁰

First of all, it is a well-established principle in international law that the nationality of the investor, as a natural person, is determined by the national law of the state in which nationality is claimed.¹⁶¹ The right of a state to grant and withdraw the nationality of a natural person is a sovereign matter.¹⁶² An important issue with which investment treaty arbitration tribunals are usually confronted is as to whether and to what extent a state can refuse to accept the nationality claim of a natural person.¹⁶³ The practice of international law concerning nationality has developed mainly in the context of diplomatic protection. The exemplary case of *Nottebohm*

¹⁵⁷ OECD, 'International Investment Law: Understanding Concepts and Tracking Innovations' (2008) 8 <www.oecd.org/investment/internationalinvestmentagreements> assessed 21 September 2012.

¹⁵⁸ Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (OUP 2008) 35, 46. Also see R Wisner and R Gallus, 'Nationality Requirements in Investor-State Arbitration' (2004) 5 JWIT 927.

¹⁵⁹ *ibid*; *Tradex Hellas SA (Greece) v Republic of Albania* (Award) 29 April 1999 (ICSID Case No ARB/94/2) paras 108–11.

¹⁶⁰ Dolzer and Schreuer (n 158) 46.

¹⁶¹ OECD, 'International Investment Law: Understanding Concepts and Tracking Innovations, Chapter 1 Definition of Investor and Investment in International Investment Agreements' (2008) 10.

¹⁶² *ibid* 11.

¹⁶³ *ibid*.

sheds light on the issue. In this case, the International Court of Justice (ICJ) held that, although it involves a state's own accord or legislation as to whether to grant nationality to a specific person, there must be an authentic connection between the state and the national:

Nationality is a legal bond having as its basis a social fact of attachment, a genuine connection of existence, interests and sentiments, together with the existence of reciprocal rights and duties. It may be said to constitute the juridical expression of the fact that the individual upon whom it is conferred, either directly by the law or as the result of an act of the authorities, is in fact more closely connected with the population of the state conferring nationality than with that of any other state. Conferred by a state, it only entitles that state to exercise protection vis-à-vis another state, if it constitutes a translation into juridical terms of the individual's connection with the state that has made him its national.¹⁶⁴

The International Law Commission's (ILC) Report on Diplomatic Protection, however, has admitted the limitations of the genuine link requirement set forth by *Nottebohm*:

It is necessary to be mindful of the fact that if the genuine link requirement proposed by *Nottebohm* was strictly applied it would exclude millions of persons from the benefit of diplomatic protection since in today's world of economic globalisation and migration, there are millions of persons who have moved away from their state of nationality and made their lives in states whose nationality they never acquire or have acquired nationality by birth or descent from states with which they have a tenuous connection.¹⁶⁵

¹⁶⁴ The *Nottebohm* case (*Liechtenstein v Guatemala*) 1955 ICJ Reports 4, 23.

¹⁶⁵ International Law Commission, 'Report on the International Law Commission on the Work of its fifty-eighth Session' UN Doc A/61/10, ch IV, 33.

However, the *Nottebohm* principles are still applicable in cases of dual or multiple nationalities when the claimed nationality is to be accepted as ‘predominant’.¹⁶⁶ The Iran-United States Claims Tribunal employed the ‘test of dominant and effective nationality’ in addressing the question of whether a claimant with dual US-Iranian nationality should be deemed predominantly American or Iranian, so as to be entitled to bring an arbitration claim before the Tribunal. In *Esphahanian v Bank Trejarat*, Chamber Two admitted the claimant’s entitlement to bring a claim for the reason that his ‘dominant and effective nationality at all relevant times was that of the United States and the funds at issue in the present case related primarily to his American nationality, not his Iranian nationality’.¹⁶⁷ In addition, the criterion of permanent residence is adopted by some BITs or RTAs, as an alternative to citizenship or nationality. For instance, in the Canada-Argentina BIT, the ‘investor’ refers to ‘any natural person possessing the citizenship of or permanently residing in a Contracting Party in accordance with its laws’.¹⁶⁸ The ECT and NAFTA also contain similar provisions that stipulate permanent residence.¹⁶⁹ In the absence of such provisional guidance in international investment agreements, general principles of international law will apply; having recourse to the ‘effective’ nationality test.¹⁷⁰ It should also be noted that when the ICSID Convention is applicable, it requires a claimant to demonstrate that they had the nationality of a contracting state on two dates: the date at which the parties consented to ICSID’s jurisdiction, and the date of the registration of the request for arbitration.¹⁷¹

¹⁶⁶ See Article 7 of the ILC Draft Articles on Diplomatic Protection (2006).

¹⁶⁷ *Esphahanian v Bank Trejarat (Case No 157)* (Award) No 31–157–2 (1983) 2 Iran-USCTR 157.

¹⁶⁸ Article 1(b) of the Agreement between the Government of Canada and the Government of the Republic of Argentina for the Promotion and Protection of Investment (1991).

¹⁶⁹ Article 1(7)(a)(i) of the Energy Charter Treaty and Article of the North American Free Trade Agreement.

¹⁷⁰ Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (Martinus Nijhoff 1995); OECD, ‘International Investment Law: Understanding Concepts and Tracking Innovations, Chapter 1 Definition of Investor and Investment in International Investment Agreements’ (2008) 14.

¹⁷¹ Article 25(2) of the ICSID Convention.

Secondly, the nationality of a juridical person has become complicated in today's world as it is common today for a company to extend its ownership or control chain across borders, incorporating itself under the laws of state A, operating its centre of control in state B, and conducting its main business activities in state C.¹⁷² On the other hand, international tribunals have tended to abstain from delving into a company's control structure when determining the nationality of a juridical person, instead typically considering the location of incorporation or seat.¹⁷³ Unlike the case of a natural person, the general practice in international investment agreements is to rely on objective criteria in order to determine the nationality of a juridical person. The most common objective criteria are incorporation, the main seat of business, or their combination. Some investment agreements require a 'preponderant interest' of nationals in a juridical person¹⁷⁴ or control.¹⁷⁵

An important issue has arisen as to the determination of the nationality of a juridical person who is locally incorporated and registered in the host state, but is controlled by a national of a third state. Host states frequently demand that investments be made through locally incorporated companies. On such occasions, it is normal that these local companies will not be deemed to be foreign investors and thus will not be entitled to enjoy ICSID Convention protection. Article 25(2)(b) of the ICSID Convention addresses such an occasion; it provides as follows:

National of another Contracting State means ... any juridical person which had the nationality of a Contracting State other than the state party to the dispute on the date on which the parties consented to submit such dispute to conciliation and arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign

¹⁷² OECD (n 170) 18.

¹⁷³ *ibid.*

¹⁷⁴ The Bolivia and Switzerland BIT (1987).

¹⁷⁵ Article 13(a)(ii) of the Multilateral Investment Guaranty Agency (MIGA) Convention (1988) requires incorporation and seat or, alternatively, control.

control, the parties have agreed should be treated as a national of another Contracting State for purposes of this Convention.¹⁷⁶

Prior to the development of investment treaty arbitration, the general rules of international law only allow the national state of the company to bring a claim. This can be observed by the judgment of the ICJ in the case of *Barcelona Traction*.¹⁷⁷ In this case, the Canadian company, which was majority owned by Belgians, was conducting business in Spain. As a result of acts of the Spanish government, the company became bankrupt. The ICJ rejected Belgium's standing to bring a claim on behalf of the Belgian shareholders against Spain, as according to the general rule of international law, only the national state of the company is entitled to bring a claim in the event of an unlawful act committed against the company.

However, the above ICJ ruling has never been truly respected in subsequent investment treaty arbitration cases.¹⁷⁸ The issue arose in the first BIT arbitration case, *Asian Agricultural Products Ltd v Sri Lanka*.¹⁷⁹ In this dispute, under the UK-Sri Lanka BIT (1980), a Hong Kong corporation owned 48 per cent of the shares in a Sri Lankan company that suffered due to the acts of the Sri Lankan government. The tribunal accepted the claimant's standing by concluding that the value of the shareholding in the joint-venture entity was to be protected by international law.

Article 25(2)(b) can be applied on the basis of an agreement between a host state and a foreign investor. Such an agreement can be included in the form of an ICSID arbitration clause in the relevant contract.¹⁸⁰ It is, however, generally the norm that contemporary investment treaty arbitration is not established on the basis of prior consent made by a host state and a foreign investor, but on the basis of an 'offer of

¹⁷⁶ Article 25(2)(b) of the ICSID Convention.

¹⁷⁷ *Barcelona Traction, Light and Power Co, Ltd (Belgium v Spain)* (Judgment) 5 February 1970 (ICJ Reports 1970, 4).

¹⁷⁸ McLachlan and others (n 4) 185.

¹⁷⁹ *Asian Agricultural Products Ltd v Republic of Sri Lanka* (Award) 27 June 1990 (4 ICSID Rep 245).

¹⁸⁰ Dolzer and Schreuer (n 158) 53.

consent' included in a treaty.¹⁸¹ Particularly, in a situation where an investment is made through a locally incorporated company, there can be no such prior consent.¹⁸² Instead, the 'proviso' in a treaty that a local company, due to foreign control, would be treated as a national of another contracting state, is part of the terms of the offer of consent to jurisdiction made by the host state.¹⁸³ When the offer to submit a dispute to the ICSID is accepted by the investor, the proviso forms part of the consent agreement between the parties to the dispute.¹⁸⁴ In *Vacuum Salt v Ghana* case,¹⁸⁵ the foreign investor party was incorporated in Ghana and the agreement between the parties carried an ICSID clause. In deciding the ICSID jurisdiction, the tribunal admitted that the ICSID clause indicated an agreement to treat the claimant investor as a foreign national and furthermore required foreign control:

The parties' agreement to treat Claimant as a foreign national 'because of foreign control' does not ipso jure confer jurisdiction. The reference in Article 25(2)(b) to 'foreign control' necessarily sets an objective Convention limit beyond which ICSID jurisdiction cannot exist ...¹⁸⁶

An additional issue exists as to foreign control. This issue focuses on whether a juridical person can claim the nationality of another contracting state based on a legal control or through actual control. In solving this issue, the most helpful case to look into is *Aguas del Tunari SA [AdT] v Republic of Bolivia*.¹⁸⁷ In this case, the claimant company, AdT, was incorporated in Bolivia and entered into a concession agreement. When the concession was completed, AdT's shares were co-owned by Bolivian companies (20%), a Uruguayan company (25%), and a small number of other companies. However, after a few months and prior to the termination of the

¹⁸¹ *ibid.*

¹⁸² *ibid.*

¹⁸³ *ibid.*

¹⁸⁴ *ibid.*

¹⁸⁵ *Vacuum Salt Products Limited v Government of the Republic of Ghana* (Award) 1 February 1994 (ICSID Case No ARB/92/1).

¹⁸⁶ *ibid* para 36.

¹⁸⁷ *Aguas del Tunari SA (AdT) v Republic of Bolivia* (Decision on Respondent's Objections to Jurisdiction) 21 October 2005 (ICSID Case No ARB/02.3).

concession, the whole ownership came to belong to a Dutch company. The claimant, AdT, claimed that as it was a national of Bolivia ‘controlled directly or indirectly’ by nationals of the Netherlands, in terms of claimant status, it was a national of the Netherlands under Article 1(b) of the BIT, which provided that ‘legal persons controlled directly or indirectly, by nationals of that Contracting Party, but constituted in accordance with the law of the other Contracting Party’. AdT contended that Bolivia’s actions and omissions regarding the concession violated the Netherlands-Bolivia BIT. Both Netherlands and Bolivia are parties to the ICSID Convention. In identifying the meaning of ‘controlled directly or indirectly’, the tribunal interpreted the BIT provisions by relying on Articles 31 to 32 of the Vienna Convention on the Law of Treaties (VCLT), which codified customary international law.¹⁸⁸ The tribunal concluded as follows:

The Tribunal, by majority, concludes that the phrase ‘controlled directly or indirectly’ means that one entity may be said to control another entity (either directly, that is without an intermediary entity, or indirectly) if that entity possesses the legal capacity to control the other entity. Subject to evidence of particular restrictions on the exercise of voting rights, such legal capacity is to be ascertained with reference to the percentage of shares held. ... In the Tribunal’s view, the BIT does not require actual day-to-day or ultimate control as part of the ‘controlled directly or indirectly’ requirement contained in Article 1(b)(iii). ... in the circumstances of this case, where an entity has both majority shareholdings and ownership of a majority of the voting rights, control as embodied in the operative phrase ‘controlled directly or indirectly’ exists.¹⁸⁹

In this respect, the tribunal was of the view that the ‘foreign control’ meant legal control based on ownership, as well as factual or actual control. Therefore, a foreign investor, whether a natural person or a juridical person, is entitled to raise an expropriation claim on the basis of ownership or foreign control.

¹⁸⁸ *ibid* para 88.

¹⁸⁹ *ibid* para 264.

1.2.1.2 An Investment

The definition of investment is the other key determinant of the scope of treaty protection.¹⁹⁰ Especially in order for a foreign investor to raise an expropriation claim, the investment owned by the investor should be deemed to be expropriated. Furthermore, it is significant to precisely determine the scope of an investment to be subject to protection, because the calculation of compensation in a case of expropriation is primarily based on the value of the expropriated investment. If the notion of investment is given a broad interpretation, the scope of state liability, including in cases of regulatory expropriation, becomes correspondingly greater. This will be more closely investigated in Chapter 4.

Investment has long been classified as either direct or portfolio investment. During the nineteenth and the early twentieth centuries, the prevalent form of foreign investment was portfolio investment.¹⁹¹ After the flow of direct and portfolio investment into developing countries was interrupted by two wars, the reinvigorated expansion of foreign investment in the form of multinational corporations occurred by establishing wholly or majority-owned subsidiaries.¹⁹² Earlier agreements that dealt with investment took a narrow approach of establishing the exhaustive list of notions of investment covered by the agreements. However, most contemporary international investment agreements tend to employ a broad notion of investment. In referring to foreign investment, the typical provision of these agreements stipulate ‘every kind of asset’ or ‘every kind of investment’ that is ‘directly or indirectly owned’ by a foreign investor. This concept can be exemplified in an illustrative list of several types of investment, such as: (i) tangible and intangible property, (ii) shares, bonds, and other interests in companies, (iii) the right to money or any performance with economic value, (iv) intellectual property rights, goodwill, and know-how, and (v) rights granted in law or contract, including concessionary

¹⁹⁰ UNTAD, ‘World Investment Report 1996’ (Geneva, United Nations 1997) 174.

¹⁹¹ OECD (n 70) 47.

¹⁹² *ibid.*

rights.¹⁹³ The scope of these notions extends beyond tangible and directly-owned assets that have been protected under customary international law.¹⁹⁴

Investment treaty tribunals should consider the definition of investment under two instruments: (i) the international investment agreement concerned, and (ii) Article 25 of the ICSID Convention.¹⁹⁵ This is because the term ‘investment’ does not only appear in the very treaty, but also in Article 25 as a jurisdiction requirement.¹⁹⁶ Two issues have arisen from this situation. The first issue is the interpretation of the term ‘investment’ in Article 25 of the Convention. The second issue is whether the term appearing in Article 25 is subject to the definition proposed in the treaty that provisionally endorses ICSID jurisdiction.¹⁹⁷ The practice of arbitral tribunals to interpret the notion of ‘investment’ in Article 25 of the ICSID Convention has existed independently of the particular investment clause in the BIT concerned.¹⁹⁸ Therefore, when an investment dispute arises under a BIT that contains the ICSID jurisdiction clause, it is necessary to scrutinise the two respective notions of investment; being the so-called ‘double keyhole approach’.¹⁹⁹ For instance, the tribunal in *CSOB v Slovakia* stated:

A two-fold test must therefore be applied in determining whether this Tribunal has the competence to consider the merits of the claim: whether the dispute arises out of an investment within the meaning of the Convention and, if so, whether the dispute relates to an investment as defined in the Parties’ consent to

¹⁹³ Gus Van Harten, *Investment Treaty Arbitration and Public Law* (OUP 2007) 76–77.

¹⁹⁴ *ibid* 77.

¹⁹⁵ Dolzer and Schreuer (n 158) 61.

¹⁹⁶ Article 25(1) of the ICSID Convention stipulates that ‘the jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State’.

¹⁹⁷ Dolzer and Schreuer (n 158) 61.

¹⁹⁸ *ibid*. See *Salini Costruttori SPA & Italstrade SPA v Kingdom of Morocco* (Decision on Jurisdiction) 23 July 2001 (ICSID Case No ARB/00/4) para 52: ‘ICSID case law and legal authors agree that the investment requirement must be respected as an objective condition of the jurisdiction of the Centre’.

¹⁹⁹ Dolzer and Schreuer (n 158) 61–62.

ICSID arbitration, in their reference to the BIT and the pertinent definition contained in Article 1 of the BIT.²⁰⁰

In addition, with regard to the ‘in accordance with the laws and regulations of the host state’ phrase adopted by many BITs, an issue arises as to whether this phrase indicates some exclusion from treaty protection, or is otherwise concerned with the definition of investment and provides a jurisdictional requirement. The positions of investment treaty arbitration tribunals diverge on this issue. In the ICSID case of *Salini v Morocco*, the tribunal understood the requirement as the former:

This provision refers to the validity of the investment and not to its definition. More specifically it seeks to prevent the Bilateral Treaty from protecting investments that should not be protected, particularly because they would be illegal.²⁰¹

Non-conformity with the laws and regulations of the host state was also construed as a jurisdictional requirement. In *Fraport v The Republic of the Philippines*, the tribunal stated that an ‘investment intentionally structured in violation of Philippine Law ... did not qualify as an investment and fell outside the ICSID jurisdiction and the competence of the tribunal’.²⁰²

The issue of nationality in a situation where a locally incorporated company is under foreign control leads to the issue of ‘indirect investment’.²⁰³ In terms of corporate structure, a locally incorporated company is an investment made by a national of another state, as well as by itself – a juridical person that possesses its own legal entity. This type of investment can be termed an ‘indirect investment’. Thus, the

²⁰⁰ *ibid* para 68.

²⁰¹ *Salini v Morocco* (n 198).

²⁰² *Fraport v The Republic of the Philippines* (Award) 16 August 2007 (ICSID Case No ARB/03/25).

²⁰³ McLachlan and others (n 4) 184; Campbell McLachlan QC uses the term ‘indirect investment’ when explaining the situation where an investment is locally made through the establishment of a local company and suffered losses.

issue arises as to whether investment treaty jurisprudence permits ‘piercing the corporate veil’.²⁰⁴ In other words, the issue is whether a foreign investor of another state party is entitled to claim losses sustained by its locally incorporated juridical entity under the BIT concerned.²⁰⁵ There are two possible claimants in relation to this issue. They are the holding company and the ultimate beneficiary. Firstly, a holding company can be any entity in a corporate ownership chain, except for the ultimate beneficiary and the local company directly affected by a state’s conduct.²⁰⁶ For instance, in *Tokios Tokelès v Ukraine*,²⁰⁷ under the Lithuania-Ukraine BIT (1994), the claimant, Tokios Tokelès, was organised under the laws of Lithuania and owned and controlled by Ukrainian nationals. In a dispute over ICSID jurisdiction, the respondent argued against jurisdiction as the claimant was not a ‘genuine entity’ of Lithuania, as it was owned and controlled predominantly by Ukrainian nationals.²⁰⁸ The tribunal, relying on the rules of the Vienna Convention on the Law of Treaties, found that the claimant was an investor in Lithuania under Article 1(2)(b) of the Ukraine-Lithuania BIT²⁰⁹, ²¹⁰ and confirmed that this interpretation accorded with the objective requirement of Article 25 of the ICSID Convention.²¹¹ Secondly, the ultimate beneficiary can bring an arbitration claim. In the case of *Franz Sedelmayer v The Russian Federation*, a German national brought a claim under the Germany-Russia BIT for the loss sustained by his investment, which was a United States corporation. The tribunal admitted the claimant’s standing as an investor under the BIT and additionally confirmed the ‘control

²⁰⁴ *ibid.*

²⁰⁵ *ibid.*

²⁰⁶ *ibid* 189.

²⁰⁷ *Tokios Tokelès v Ukraine* (Decision on Jurisdiction) 29 April 2004 (ICSID Case No ARB/02/18).

²⁰⁸ *ibid* para 21.

²⁰⁹ Article 1(2)(b) of the Ukraine-Lithuania BIT (1994) provides with regard to a juridical person that this is ‘in respect of Lithuania, any entity established in the territory of the Republic of Lithuania in conformity with its laws and regulations.’

²¹⁰ *Tokios Tokelès* (n 207) para 38.

²¹¹ *ibid* para 52.

theory’, stating that ‘the control theory leads to the piercing of the United States corporation’s corporate veil and to putting the de facto investor in the focus’.²¹²

One additional issue is whether or not a shareholder is entitled to raise an investment treaty claim. Investment can be made through the purchase of shares in a locally incorporated company and a shareholder of foreign nationality may seek to recover the loss of his or her shares. In the *Barcelona Traction* case, the ICJ denied the capability of the majority of shareholders of a company to pursue claims against a host state that did not represent the nationality of those shareholders.²¹³ The ICJ, however, accepted that this decision was made under customary international law and that treaties may provide otherwise.²¹⁴ In this respect, under current international law, the protection of shareholders is accorded by international investment agreements or by contracts between a foreign investor and a host state.²¹⁵ Still, the status of a minority shareholder does not appear sufficiently solid to accord the qualification of a foreign investor claimant because of a lack of control over the company. Even so, given that minority shares fall within the broad concept of investment protected by international investment agreements, it can be acknowledged that a minority shareholder owns a property to be protected.²¹⁶ Nevertheless, some complicated problems can occur if different shareholders seek different remedies for the loss of their shares or if the local company itself pursues domestic remedies.²¹⁷

The business practice of creating an investment by way of establishing a local company in a host state, in order to take advantage of favourable treaty terms, and thus the local company is simply used as a ‘conduit’ for the investment, has given

²¹² *Franz Sedelmayer v The Russian Federation* (Award) 7 July 1998 SCC Ad hoc Arbitration 27.

²¹³ *Barcelona Traction* (n 177) 56.

²¹⁴ *ibid.*

²¹⁵ Dolzer and Schreuer (n 158) 56.

²¹⁶ McLachlan and others (n 4) 186.

²¹⁷ Dolzer and Schreuer (n 158) 59.

rise to the concept of ‘treaty shopping’.²¹⁸ This action, albeit manipulative, has not been considered illegal. In *Soufraki v UAE*, under the Italy-United Arab Emirates BIT, the tribunal did not uphold the treaty shopping which had taken place. It concluded that the claimant did not hold Italian nationality and accordingly denied the claimant’s entitlement to invoke the BIT’s protection.²¹⁹ It additionally stated, ‘Had Mr. Soufraki contracted with the United Arab Emirates through a corporate vehicle incorporated in Italy, rather than contracting in his personal capacity, no problem of jurisdiction would now arise’.²²⁰

States which are a party to international investments can choose between two methods in order to address the treaty-shopping problem. One is to require a ‘bond of economic substance between the corporation and the state’.²²¹ The other is the use of a so-called ‘denial of benefits clause’ in treaty provisions on jurisdiction.²²² By having recourse to this clause, the state retains the right to deny the benefits of the treaty to a company that does not have an economic connection to the state whose nationality it claims.²²³ The economic connection can be determined either by looking at the national’s control in the state of nationality or by substantial business activity in that state.²²⁴ An important concern may arise in relation to the concept of an investment. Because the definition of an investment is very broad, there is a risk that this broad definition may be exploited to cover ‘international business in general’,²²⁵ thus expanding the scope of arbitral discretion to acquire jurisdiction over claims, as well as ‘state liability in public law’.²²⁶ This risk can result in an outcome in the increase of the extent of state exposure to arbitration and the number of regulatory expropriation claims.

²¹⁸ *ibid* 54.

²¹⁹ *Hussein Nuaman Soufraki v UAE* (Award) 7 July 2004 (ICSID Case No ARB/02/7) para 68.

²²⁰ *ibid* para 83.

²²¹ Dolzer and Schreuer (n 158) 55.

²²² *ibid*.

²²³ *ibid*.

²²⁴ *ibid*.

²²⁵ Sattorova (n 18) 267, 286; See Harten (n 193) 80.

²²⁶ *ibid*.

1.2.2 Applicable Law and Interpretation Approaches

For international investment agreements to be applied to a case, two fundamental questions arise: what is the applicable law that will establish the rules on issues, and how is the specific language in the relevant international investment agreements interpreted?²²⁷ In the case of international investment arbitration between a foreign investor and a host state, the applicable law will include the international investment agreement. This is because the foreign investor bases the claim on the protection accorded by the agreement and general international law.²²⁸ Rules on the applicable law can be found in Article 42(1) of the ICSID Convention. It provides that:

The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting state party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.²²⁹

Under Article 52(1)(b) of the ICSID Convention, the failure to apply the appropriate law can be a valid ground on which to claim the annulment or non-recognition of an award. Investment treaty tribunals in general rely on Articles 31 and 32 of the Vienna Convention on the Law of Treaties in interpreting international investment agreements. This is either because both states are parties to the VCLT or because the rules of interpretation it sets out represent customary international law.²³⁰ Article 31 stipulates a ‘general rule of interpretation’ by requiring that the interpretation be conducted ‘in accordance with the ordinary meaning to be given to the terms of the treaty’ in consideration of their context, and the object and purpose of the treaty.²³¹

²²⁷ Newcombe (n 1) 75.

²²⁸ *ibid* 77.

²²⁹ Article 42(1) of the ICSID Convention. Also, Article 54 of the ICSID Additional Facility Rules contains similar provisions.

²³⁰ See *Siemens AG v The Argentine Republic* (Award) 17 January 2007 (ICSID Case No ARB/02/8) para 80. The *Siemens* tribunal held that ‘the treaty should be interpreted in accordance with the norms of interpretation established by the Vienna Convention on the Law of Treaties of 1969.’

²³¹ Article 31 of the Vienna Convention on the Law of Treaties.

Article 32 provides for a ‘supplementary means of interpretation’, such as the ‘preparatory work of the treaty and the circumstance of its conclusion’.²³² *Travaux Préparatoires* (preparatory work) are among such supplementary means. Reliance on *travaux préparatoires* is primarily determined by its availability.²³³ The drafting history of the ICSID Convention, specifically because of its detail, is used as a supplementary means of interpretation by ICSID tribunals.²³⁴ On the other hand, the negotiating history of BITs, which is not well documented, is rarely used.²³⁵

While the basic principles for the interpretation of treaties are provided for by the VCLT, there are some supplementary principles or presumptions that international tribunals rely on to articulate the meanings of terms in international investment agreements.²³⁶ First, there is the principle of *expressio unius est exclusio alterius*, which means that the ‘specific mention of an item excludes others’. In *National Grid Plc v Argentina*, the tribunal, relying on this principle, concluded that owing to the BIT provision which provided for certain exceptions to the clause, dispute resolution was not included among the exceptions to the application of the clause.²³⁷ Another principle is the *ejusdem generis* doctrine, meaning that ‘general words following or perhaps preceding special words are limited to the genus indicated by the special words’.²³⁸ This principle originated from the fundamental rule of contract construction, being that the ‘meaning of a term is determined not in the abstract but in its context’.²³⁹ For instance, if there is a provision that enumerates a category of situations, including ‘war or other armed conflict, revolution, revolt, insurrection or riot, or state of national emergency’, the ‘state of national emergency’

²³² *ibid* art 32.

²³³ Dolzer and Schreuer (n 158) 33.

²³⁴ *ibid*.

²³⁵ *ibid*.

²³⁶ Newcombe (n 1) 112.

²³⁷ *National Grid Plc v The Argentine Republic* (Decision on Jurisdiction) 20 June 2006 UNCITRAL para 82.

²³⁸ I Brownlie, *Principles of Public International Law* (6th edn, OUP 2003) 604; See Newcombe (n 1) 112.

²³⁹ Oppenheim, *International Law* (9th edn, London 1992) vol 1, 1273. See Newcombe (n 1) 112.

can be construed as referring to a type of civil disturbance.²⁴⁰ Also, owing to the existence of highly similar or identical language among the provisions of international investment agreements, tribunals are allowed to take a comparative approach between the BIT concerned and other BITs to which the host state is a party.²⁴¹ When international tribunals interpret international investment agreements based on their object and purpose, tribunals usually rely on their titles and preambles.²⁴² Also related to this interpretation approach is the principle of the effectiveness or *effet utile* of treaty provisions. It means that an interpretation that delivers practical content to a treaty provision may override one that removes such an effect.²⁴³ In relation to interpretation, it can be considered that precedents may be helpful in maintaining the uniformity and stability of law and, accordingly, can reinforce the predictability of decisions and improve their authority.²⁴⁴ It is, however, well established that investment treaty arbitration tribunals are not bound by precedent. Even so, if tribunals, from a comparative perspective, find that they have common views to previous tribunals on a specific point of law they can freely follow their wisdom.²⁴⁵

An independent factor can exist outside the principles of interpretation that may in turn control the interpretation of international investment agreements. State parties can opt to circumscribe themselves to arbitral interpretation, as can be observed in the role of the NAFTA Free Trade Commission (FTC). The NAFTA FTC is authorised to ‘resolve disputes that may arise regarding the Agreement’s interpretation and application’²⁴⁶ and its interpretation binds a NAFTA tribunal.²⁴⁷ In 2001, the NAFTA FTC issued ‘Notes of Interpretation’ that provide certain guidance for the interpretation of NAFTA provisions relating to customary international law, as follows:

²⁴⁰ Newcombe (n 1) 112.

²⁴¹ *ibid* 113.

²⁴² *ibid* 114.

²⁴³ *ibid* 114.

²⁴⁴ *ibid* 35.

²⁴⁵ *ibid* 36.

²⁴⁶ NAFTA, art 2001(2).

²⁴⁷ *ibid* art 1131(2).

1. Article 1105(1) prescribes the customary international minimum standard of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.
2. The concepts of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.²⁴⁸

1.2.3 The Standard of Review

The goal for reviewing standards, in the international legal system, is to strike a proper balance between sovereign autonomy and the state’s compliance with international obligations.²⁴⁹ Thus, in relation to expropriation, the standard of review concerns how much deference is accorded to a state’s exercise of its right to expropriate and how deeply it can interfere with this. If greater deference is to be granted by investment treaty arbitration tribunals, it will lead on the one hand to the state enjoying greater sovereign autonomy. On the other hand, if standards of review are applied with stricter scrutiny, it will result in narrower sovereign autonomy and a greater risk of state responsibility.²⁵⁰ There are varying ranges relating to the standards of review when state acts are internationally scrutinised, depending on the degree of deference to sovereign autonomy in enacting laws and regulations. Firstly, in relation to treaty obligations, the orthodox approach permits a state to interpret the obligation itself and confers mandatory jurisdiction in order to determine whether the interpretation is correct.²⁵¹ Secondly, the procedural review is used to determine whether a state has complied with procedural, not substantive,

²⁴⁸ NAFTA Free Trade Commission (FTC), ‘Notes of Interpretation of Certain Chapter 11 Provisions B.1 and B.2’ (31 July 2001).

²⁴⁹ Caroline Henckels, ‘Balancing Investment Protection and the Public Interest: The Role of the Standard of Review and the Importance of Deference in Investor-State Arbitration’ (2013) 4(1) *Journal of International Dispute Settlement* 197, 200.

²⁵⁰ *ibid* 200–01.

²⁵¹ Joel P Trachtman, ‘International Legal Control of Domestic Administrative Action’ [2014] *Journal of International Economic Law* 1, 7.

requirements when enacting its rules.²⁵² Thirdly, the *de novo* review²⁵³ refers to an approach that allows a review to substitute a judgment in relation to the state's national decision or acts. It is very unlikely that this review approach will be instigated in the field of international law. Fourthly, there is a review of facts, which can determine the correct nature of the facts established by a state.²⁵⁴ This may be the most comprehensive and intrusive review considered. In the context of the WTO agreement, WTO panels are not allowed to conduct a *de novo* review of what a state established as a fact.²⁵⁵ Those four methods generally show a range of possible standards for international legal scrutiny.

Within these ranges of standards, there are more specific tests or principles that ICSID tribunals can rely upon for the arbitral scrutiny of state acts: (i) the least restrictive alternative test; (ii) the margin of appreciation principle, and (iii) the good faith test.

The least restrictive alternative test emerges from the jurisprudence of GATT and WTO panels. Articles 20 and 21 of GATT provide states with exceptions to their obligations, which resemble the 'non-precluded measures' (NPM)²⁵⁶ of BITs. For instance, GATT Article 20 allows a state to take measures in compliance with the *chapeau* requirements, such as 'necessary to protect public morals' or 'necessary to protect human, animal or plant life or health'. In relation to these exceptions, GATT and WTO panels scrutinise whether a state has taken the least restrictive measure reasonably available under GATT Articles 20 or 21. This test, when compared with

²⁵² *ibid* 8.

²⁵³ *ibid*.

²⁵⁴ *ibid*.

²⁵⁵ *ibid* 9; Appellate Body Report, *European Communities-Measures Concerning Meat and Meat Products (Hormones)* (1998) WT/DS26/AB/R, WT/DS48/AB/R, para 117.

²⁵⁶ Non-precluded measures (NPM) clauses, widely employed by BITs, permit a state party to taken measures that do not conform with the terms of international investment agreements concerned, such as measures taken for public order, security, human health, and the environment. See W Burke-White and Andreas von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties' 48 *Virginia Journal of International Law* 307, 311.

the ‘only means available test’, employed by the early ICSID tribunals to judge against Argentina in cases such as *CMS Gas Transmission Company, Enron*, and *Sempra*,²⁵⁷ is a public law approach that encompasses the ideal of balancing the parties’ rights.²⁵⁸ The least restrictive alternative test contains three stages of application. Three issues should be investigated: (i) whether a measure taken by a state is designed to fulfil objectives that are allowed under the treaty concerned; (ii) whether the measure is necessary on the basis of the balancing of three factors (the interests pursued by the state in taking the measure, the ‘contribution of the measure to the realization of the ends pursued by it’, and the ‘restrictive impact of the measure on international commerce’); and (iii) whether there was another measure reasonably available that would have been both less restrictive on international commerce and equally effective in fulfilling the objectives.²⁵⁹

The ‘margin of appreciation’ principle emerged in the context of human rights protection. However, the principle is available for application in other fields, such as those that embrace a degree of respect for sovereign autonomy. This is because the margin of appreciation principle connotes deference to such autonomy, particularly in the areas of public objective. This principle was formulated by the jurisprudence of the ECtHR that operates as a judicial organ under the European Convention on Human Rights (ECHR). It is described in detail as follows:

The margin of appreciation ... permits the Court to show the proper degree of respect for the objectives that a Contracting Party may wish to pursue, and the trade-offs that it wants to make ... while at the same time preventing

²⁵⁷ William W Burke-White and Andreas von Staden, ‘Private Litigation in a Public Law Sphere: The Standard of Review in Investor-State Arbitrations’ (2010) 35 *Yale Journal of International Law* 283, 297. Burke-White and Staden explain that the ‘only means available test’ derives from the customary law requirements of necessity.

²⁵⁸ *ibid* 303.

²⁵⁹ *ibid* 304.

unnecessary restrictions on the fullness of the protection which the Convention can provide.²⁶⁰

The NAFTA tribunal's position in the *SD Myers* case was supportive of the margin of appreciation principle. The tribunal based its judgment, concerning a breach of NAFTA protections, on a high respect for sovereign regulatory autonomy over domestic matters, 'A breach of Article 1105 ... That determination must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders'.²⁶¹

The 'good faith' standard adopts the approach of rational scrutiny. Good faith has traditionally been a key principle of international law. The 1949 Draft Declaration on Rights and Duties of States provides in Article 13 that 'every state has the duty to carry out in good faith its obligations arising from treaties and other sources of international law'.²⁶² The International Law Commission clarified this principle in its commentary, by stating that it is a 're-instatement of the fundamental principle *pacta sunt servanda*'.²⁶³ This principle sets a basic threshold of compliance for states when considering their international obligations, and thus can function as a standard of review. This standard grants a high deference to a state's regulatory autonomy, especially by granting the state the authority to balance competing rights and interests. Thereafter, the review task is merely a scrutiny as to whether the state has conducted the balancing exercise on a rational basis.²⁶⁴ The good faith standard of review exhibits a higher deference to regulatory autonomy than that of the margin of appreciation. This is because the former goes so far as to give the state the

²⁶⁰ Ronald St John Macdonald, 'The Margin of Appreciation in the Jurisprudence of the European Court of Human Rights, in 1 Collected Course of the Academy of European Law' (1992) 95, 160. See Burke-White and Staden (n 257) 305.

²⁶¹ Burke-White and Staden (n 257) 283, 311, citing *SD Myers, Inc v Canada* (Partial Award) 13 November 2000 NAFTA Arbitration 40 ILM 1408, para 263.

²⁶² Article 13 of the 1949 Draft Declaration on Rights and Duties of States with commentaries, 288.

²⁶³ *ibid.*

²⁶⁴ Burke-White and Staden (n 257) 313.

authority to weigh private as well as public interests and rights, while the latter accords such an authority to an investment treaty arbitration tribunal.

1.2.4 Standards of Investment Protection in International Investment Law

1.2.4.1 Introduction

Prior to the commencement of the modern BIT era, which relied on investor-state arbitration after World War II, the protection of aliens and foreign property was primarily realised through inter-state claims of state responsibility based on diplomatic protection.²⁶⁵ With regard to state responsibility, the 1926 case of *Neer* underlines this concept at the time. The issue in this dispute was whether the failure of Mexican authorities could bring about ‘an international delinquency’ so as to involve the international responsibility of Mexico towards the United States.²⁶⁶ The Mexico-US Claims Commissioners stated that:

The treatment of an alien, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognise its insufficiency.²⁶⁷

The development failure of customary international law in investment protection and in the establishment of a multilateral investment agreement consequently led to a development of BITs. BITs have established missing standards and treaty rights, and have occupied the content of rights. BIT development has possibly replaced potential advances in other areas of international law.²⁶⁸ As international investment law only provides for a framework of principles, and given the absence of a multilateral investment treaty, individual states have been able to freely codify their

²⁶⁵ McLachlan and others (n 4) 214.

²⁶⁶ *ibid* 215.

²⁶⁷ *Neer* (n 55) 17.

²⁶⁸ McLachlan and others (n 4) 220.

own *lex specialis* on matters of foreign investment through the creation of BITs.²⁶⁹ For instance, one significant consequence has emerged from the development of BITs. Under customary international law, a breach of the international minimum standard of treatment could only establish an international delict, bringing about diplomatic protection if a foreign investor had first exhausted local remedies.²⁷⁰ Article 26 of the ICSID Convention removes the necessity that local remedies must be exhausted by requiring that a state make express provision if it first requires the exhaustion of local remedies. In the absence of a jurisdictional requirement that local remedies be exhausted, a foreign investor can choose to bring a claim relating to various administrative treatments in circumstances where a home state could not claim diplomatic protection.²⁷¹ Contemporary BITs generally provide for varying standards of treatment, such as compensation for expropriation, fair and equitable treatment, national treatment, the most-favoured-nation treatment, full protection and security, the prohibition of arbitrary and discriminatory measures, and the free transfer of funds.

1.2.4.2 Expropriation and Compensation

In deference to territorial sovereignty, the traditional rules of international law have accepted that a host state retains the right to expropriate foreign-owned property in its territory.²⁷² International investment agreements usually only circumscribe this right by way of a small number of conditions, not requiring extra conditions beyond a few conditions for the lawfulness of the exercise of this right.²⁷³ In particular, international investment agreements normally state a host state's obligation to pay compensation if it expropriates foreign-owned property. This requirement has also been recognised under customary international law.²⁷⁴ In addition to compensation, international investment law generally requires that foreign-owned property be not

²⁶⁹ Subedi (n 8) 91.

²⁷⁰ McLachlan and others (n 4) 220.

²⁷¹ *ibid* 221.

²⁷² Dolzer and Schreuer (n 158) 89.

²⁷³ *ibid*.

²⁷⁴ Newcombe (n 1) 332.

expropriated or subject to governmental measures with an effect equivalent to expropriation unless three further conditions are met:

- (i) an expropriation must be pursued for a public purpose;
- (ii) it should be non-discriminatory; and
- (iii) it is taken in accordance with applicable law and due process.²⁷⁵

The most common formulations of expropriation provided for by international investment agreements include nationalisation, expropriation through direct or indirect means, and governmental measures that have an effect ‘equivalent’ or ‘tantamount’ to expropriation.²⁷⁶ Direct expropriation involves the actual taking of property by the host state by direct means. This requires the loss of all, or almost all, of the property, plus the loss of control of the property.²⁷⁷ The United States-Dominican Republic-Central America FTA (CAFTA) describes direct expropriation as a situation where ‘an investment is nationalised or otherwise directly expropriated through formal transfer of title or outright seizure’.²⁷⁸ The key element is that property must be ‘taken’ by state authorities or the investor must be deprived of it by state authorities. This element appears in formulations as follows:

In general, the term ‘expropriation’ carries with it the connotation of a ‘taking’ by a government-type authority of a person’s ‘property’ with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the ‘taking’.²⁷⁹

‘Taking’ is defined in the Restatement of the Law (Second) Foreign Relations Law of the United States as follows:

²⁷⁵ Subedi (n 8) 74.

²⁷⁶ *ibid.*

²⁷⁷ *ibid* 75.

²⁷⁸ CAFTA Annex 10–C 3.

²⁷⁹ *SD Myers* (n 261) para 280.

Conduct attributable to a state that is intended to, and does, effectively deprive an alien of substantially all benefit of his interest in property, constitutes a taking of the property ... even though the state does not deprive him of his entire legal interest in the property.²⁸⁰

The essential difference between direct and indirect expropriation lies in whether the legal title of the owner is affected by a host state's authorities' measures.²⁸¹ While the title is left intact, indirect expropriation has the effect of depriving a foreign investor of any meaningful utility of his investment.²⁸² The UN Conference on Trade and Investment (UNCTAD) stated that 'indirect expropriation occurs when the country takes an action that substantially impairs the value of an investment without necessarily assuming ownership of the investment'.²⁸³ For instance, there are different types of indirect expropriation, such as 'creeping' or 'incidental expropriations'. An ICSID tribunal described 'creeping expropriation' as follows:

It is clear, however, that a measure or series of measures can still eventually amount to a taking, though the individual steps in the process do not formally purport to amount to a taking or to a transfer of title. What has to be identified is the extent to which the measures taken have deprived the owner of the normal control of his property.²⁸⁴

Furthermore, although there is no traditional 'taking' of an investment, if the state causes significant interference with the enjoyment of its use or its benefit, this may constitute an indirect expropriation, as found in the tribunal decision of *Metalclad*, that stated:

²⁸⁰ The Restatement of the Law (Second) Foreign Relations Law of the United States.

²⁸¹ Dolzer and Schreuer (n 158) 92.

²⁸² *ibid.*

²⁸³ UNCTAD, *Bilateral Investment Treaties in the Mid-1990s* (1998) 6.

²⁸⁴ *Generation Ukraine, Inc v Ukraine* (Award) 16 September 2003 (ICSID CASE No ARB/00/9).

Covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state.²⁸⁵

A ‘taking’ can be distinguished from regulatory measures taken in pursuit of general welfare.²⁸⁶ In the US, such regulatory measures are referred to as ‘police power’.²⁸⁷ One of the most vigorously debated issues is how to distinguish between a non-compensable regulation and an indirect expropriation, where there is a compensation obligation when taking occurs. Under customary international law, not all deprivations of property are deemed to be expropriation. Property may be seized under a state’s criminal law provisions. Property can also be derived for the purpose of public health. General taxation is not expropriation. On these occasions, a state is not held responsible for the *bona fide* exercise of its sovereign police powers under specific commitments or a principle of proportionality and reasonableness.²⁸⁸ In general, three broad types of police power regulation exist which legitimise deprivation without compensation: (i) public order and morality, (ii) the protection of human health and the environment, and (iii) state taxation.²⁸⁹

Besides expropriation and compensation, there are other standards of treatment, such as fair and equitable treatment (‘FET’), national treatment (‘NT’), most-favoured nation treatment (‘MFN’), the prohibition of arbitrary and discriminatory measures, and the free transfer of funds. In international investment law, each standard of treatment respectively pursues different goals concerning investment protection. In particular, the prohibition of expropriation without compensation is aimed at addressing the loss of foreign-owned property or investments caused by a

²⁸⁵ *Metalclad v The United Mexican States* (Award) 30 August 2000 (ICSID Case No ARB(AF)/97/1).

²⁸⁶ Dolzer and Schreuer (n 158) 109.

²⁸⁷ *ibid.*

²⁸⁸ Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standard of Treatment* (Wolters Kluwer 2009) 358.

²⁸⁹ Newcombe (n 1) 358.

state's exercise of public authority. Thus, in order to clearly identify when to raise an expropriation claim and which standard of treatment other than the prohibition of expropriation without compensation is at issue, it is necessary to clearly understand what particular protections these standards of treatment are aimed at providing to foreign investors.

1.2.4.3 Fair and Equitable Treatment (FET)

Fair and equitable treatment is a central principle of international investment law on foreign-owned investment. This principle has been substantially shaped by customary international law.²⁹⁰ It provides for a fundamental level of protection and is based on the elements of fairness and equity.²⁹¹ According to the Cambridge dictionary, fairness is 'the quality of treating people equally or in a way that is right or reasonable'.²⁹² Since what is right and reasonable does not involve a fixed concept, the notion of fairness exists as an evolutionary one.²⁹³ With regard to the meaning of equity, three characteristics have been identified in international law. First, equity is an autonomous source for legal rules, as recognised in Article 38(2) of the ICJ Statute. A judge may use it in order to resolve a dispute only if the parties have expressly requested a review of their case based on '*ex aequo et bono*'.²⁹⁴ Second, the concept of equity is a general principle that demands an equitable application of the law for the purpose of avoiding absurd or unreasonable outcomes.²⁹⁵ Third, the term equity is construed as meaning equitable principles. International law on maritime delimitation and the distribution of natural resources has developed this concept.²⁹⁶

²⁹⁰ Subedi (n 8) 63.

²⁹¹ *ibid.*

²⁹² Cambridge International Dictionary of English.

²⁹³ Tudor (n 52) 126.

²⁹⁴ *ibid* 127.

²⁹⁵ *ibid* 128.

²⁹⁶ *ibid.*

Historically, the term ‘just and equitable treatment’ first appeared in Article 11(2) of the Havana Charter of the International Trade Organisation of 1948.²⁹⁷ The 1959 Abs-Shawcross Draft Convention on Investment Abroad stipulated at Article I the ‘fair and equitable treatment to the property of the nationals of the other Parties’, and Article 1(a) of the OECD Draft Convention on the Protection of Foreign Property of 1967 states that ‘each Party shall at all times ensure fair and equitable treatment to the property of the nationals of the other Parties’. The FET principle was also adopted in 1992 by NAFTA at Article 1105(1), plus the Energy Charter Treaty of 1994 at Article 10(1). In this regard, even though the FET principle has been formed under the influence of customary international law, it is possible owing to the development of international investment agreements and investment treaty arbitrations that the key concepts independently evolved in the system of international investment. An important issue arises as to whether the FET standard reflects the customary international law minimum standard, or sets forth an autonomous standard, that is additional to general international law. There are two predominant views in relation to the interpretation of the FET standard.

Firstly, the FET standard can be recognised as constituting an independent treaty standard with an autonomous meaning.²⁹⁸ According to this view, an investment treaty arbitration tribunal is allowed to exercise substantial discretion in determining whether a state’s conduct has breached fairness and equity.²⁹⁹ The FET standard can be interpreted by focusing on the text and wording of a treaty with substantial consideration being given to the purpose provision of the treaty, which is usually to promote and protect investment.³⁰⁰ One argument supporting this view is that state

²⁹⁷ Article 11(2)(a)(i) of the Havana Charter (1948) stipulates that ‘the Organization may, in such collaboration with other inter-governmental organizations as may be appropriate, make recommendations for and promote bilateral or multilateral agreements on measures designed to assure just and equitable treatment for the enterprise, skills, capital, arts and technology brought from one Member country to another.’

²⁹⁸ Newcombe (n 1) 265.

²⁹⁹ IISD, Fair and Equitable Treatment, Best Practices Series (Sept 2009) 8.

³⁰⁰ See *Occidental Exploration and Production Company v Ecuador* (Final Award) 1 July 2004 (London Court of International Arbitration Administered Case No UN3467) para 183;

parties could have inserted the minimum standard of treatment in provisions if they intended to, but they have not.³⁰¹ In this respect, the interpretation of the FET standard based on the ordinary meaning leads to the fact that the FET is an autonomous standard and cannot be equated with the minimum standard of treatment.³⁰²

Secondly, the alternative view is that the FET standard reflects the customary international law minimum standard of treatment. This standard was founded in the case of *Neer v Mexico*, in which the US-Mexico Claims Commissioners articulated the conditions with which the treatment of aliens would constitute an ‘international delinquency’.³⁰³

Article 5 of the 2012 US Model BIT states that:

1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security.
2. For greater certainty [the previous paragraph] prescribes the customary international minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments.³⁰⁴

An additional interpretative provision of the US FTAs defines ‘customary international law’ as:

MTD Equity Sdn Bhd and MTD Chile SA v Republic of Chile (Award) 25 May 2004 (ICSID Case No ARB/01/7) para 113; see Newcombe (n 1) 265.

³⁰¹ *ibid*; Newcombe (n 1) 265.

³⁰² *ibid*. See UNCTAD, ‘Fair and Equitable Treatment’ Series on issues in international investment agreements (New York and Geneva: United Nations 1999).

³⁰³ *Neer* (n 55).

³⁰⁴ Article 5 of the 2012 US Model Bilateral Investment Treaty (BIT).

The general and consistent practice of states that they follow from a sense of legal obligation ... The customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens.³⁰⁵

The aforementioned provisions can be considered as verification that the FET standard may be a customary international law standard, but only as long as it reflects the international minimum standard.³⁰⁶ The NAFTA FTC has expressed this position by issuing ‘Notes of Interpretation’ in 2001, in which it equated the FET with the customary international law minimum standard of the treatment of aliens.³⁰⁷ The *Mondev* tribunal took this view and went a step further by upholding the evolution of the customary international law minimum standard of treatment. It rejected the standard as formed in the *Neer* case and held that ‘the content of the minimum standard today cannot be limited to the content of customary international law as recognised in arbitral decisions in 1920s’.³⁰⁸

The *CMS* tribunal also held that:

The Treaty standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment, founded on solemn legal and contractual commitments, is not different from the international minimum standard and its evolution under customary law.³⁰⁹

It may be proposed that the first view allows an investment treaty arbitral tribunal greater discretion than the second. On the other hand, the second view may risk a restriction to the ordinary meaning of the fair and equitable standard, based on the interpreted understanding of fairness and equity. The international minimum

³⁰⁵ FTAs with Australia, Central America, Chile, Morocco, and Singapore.

³⁰⁶ Tudor (n 52) 57.

³⁰⁷ The NAFTA FTC (n 248).

³⁰⁸ *Mondev* (n 73).

³⁰⁹ *CMS Gas Transmission Company v The Argentine Republic* (Award) 12 May 2005 (ICSID Case No ARB/01/8) para 284.

standard represents a ‘minimum standard of treatment’ that frequently reaches higher than national treatment; however, the FET does not only concern a minimum standard.³¹⁰ The FET is intended to guarantee that the ‘most adequate standard’ is accorded in light of the circumstances of a case.³¹¹ An alternative approach is to renew the perspective towards the FET. While acknowledging the customary character of the FET, it should also be viewed as an independent standard, which is not interlocked with the international minimum standard.³¹²

1.2.4.4 National Treatment

The standard of national treatment is aimed at protecting a foreign investor from discrimination based on the nationality of the investor.³¹³ Under customary international law, a state has discretion to refuse the admission of a foreign investor into its territory, but must not discriminate against it once admitted. Some treaties, such as NAFTA and other US-modelled BITs, extend this protection by applying national treatment at the pre-establishment stage of investment.³¹⁴ European BITs usually contain a national treatment clause stipulating that the foreign investor and his or her investments are ‘accorded treatment no less favourable than that which the host state accords to his own investors’.³¹⁵

There are two steps in the application of the standard of national treatment. The first step is to identify comparable entities: a foreign investor and a domestic investor are to be compared under the terms of the standard of national treatment. International investment agreements typically require that they be placed in ‘like situations’ or ‘like circumstances’.³¹⁶ A question arises here as to whether the phrases ‘like situations’ or ‘like circumstances’ indicate that those foreign and domestic investors

³¹⁰ Tudor (n 52) 67.

³¹¹ *ibid.*

³¹² *ibid.*

³¹³ Subedi (n 8) 70.

³¹⁴ Harten and Loughlin (n 14) 84.

³¹⁵ Dolzer and Schreuer (n 158) 178.

³¹⁶ Newcombe (n 1) 160

are in the same business or the same business or economic sector. In an effort to operate under a wide review of a relevant measure under the standard of national treatment, tribunals generally seek to interpret the phrase broadly.³¹⁷ Thus, it appears that a wider concept than simply business is preferred in arbitral jurisprudence. For instance, the tribunal in *SD Myers* held as follows:

The concept of ‘like circumstances’ invites an examination of whether a non-national investor complaining of less favourable treatment is in the same ‘sector’ as the national investor. The Tribunal takes the view that the word ‘sector’ has a wide connotation that includes the concepts of ‘economic sector’ and ‘business sector’.³¹⁸

The next step is to determine whether treatment granted to a foreign investor is at least as favourable as the treatment of domestic investors. Most international investment agreements do not require identical treatment; they only require that the treatment is no less favourable.³¹⁹ In this regard, there exists a scope of the notion ‘no less favourable’ that does not necessarily mean ‘identical’. In undertaking this task it is necessary to answer two questions: (i) whether in the application of the standard of national treatment, the notion can cover *de facto* as well as *de jure* differentiations; and (ii) whether there is any justification for a differentiation in a certain case.³²⁰ There are certain cases in which tribunals rendered awards accepting a *de facto* differentiation; for instance, in the *Feldman* case.³²¹ The *Feldman* tribunal held that ‘*de facto* difference in treatment is sufficient to establish a denial of national treatment’.³²² As for the justification issue, the tribunal in *SD Myers* held that ‘the assessment of like circumstances’ must also take into account circumstances that would justify governmental regulations that treat them

³¹⁷ Dolzer and Schreuer (n 158) 180.

³¹⁸ *SD Myers* (n 261) para 250.

³¹⁹ Newcombe (n 1) 183.

³²⁰ Dolzer and Shreuer (n 158) 181.

³²¹ *Marvin Roy Feldman Karpa v United States Mexico* (Award) 16 December 2002 (ICSID Case No ARB(AF)99/1).

³²² *ibid* para 177.

differently in order to protect the public interest.³²³ According to the *Pope Talbot* tribunal, when interpreting the standard under Article 1102 of NAFTA, ‘no less favourable’ means equivalent to, not better or worse than, the best treatment granted to the comparator.³²⁴ It also made the following assertion:

Differences in treatment will presumptively violate Article 1102(2), unless they have a reasonable nexus to rational government policies that (1) do not distinguish, on their face or *de facto*, between foreign-owned and domestic companies, and (2) do not otherwise unduly undermine the investment liberalising objectives of NAFTA.³²⁵

1.2.4.5 Most-Favoured-Nation (MFN) Treatment

The MFN treatment clause has formed part of international economic treaties for centuries,³²⁶ but it is not required under customary law.³²⁷ With the goal of granting treatment to an investor of another state party to an international investment agreement, which is at least as favourable as the treatment that they accord to a foreign investor of the third state, the application of a MFN clause involves a consideration of the conduct of the host state in deciding its applicable scope.³²⁸ A MFN clause inserted in international investment agreements functions as a ‘potent ratchet’, by which the obligations or concessions of states established in treaty-making processes can raise the stakes in the obligations of the host state under the BIT concerned.³²⁹ Article 1103 of NAFTA stipulates that the MFN treatment standard applies to investors or investment in ‘like circumstances’. Some investment agreements refer to ‘like situations’.³³⁰

³²³ *SD Myers* (n 261) para 250.

³²⁴ *Pope & Talbot* (n 135) para 39.

³²⁵ *ibid* para 78.

³²⁶ OECD (n 70) 129–30.

³²⁷ Dolzer and Schreuer (n 158) 186.

³²⁸ *ibid* 186.

³²⁹ McLachlan and others (n 4) 254.

³³⁰ Article 2(2) of the US-Senegal BIT (1983).

In applying the MFN treatment standard to a dispute, investment treaty arbitration tribunals need to compare two elements. The first consideration is the treatment accorded to foreign investors and their investment under investment treaties made with a third state investor.³³¹ For this comparison, an actual or potential competitive relationship between the investors or investments in question is not necessary to acquire the benefit of MFN treatment. In such cases, a foreign investor in like circumstances with a third state investor is entitled to MFN treatment.³³² The second consideration is the treatment of foreign investors and their investments by domestic measures.³³³ In the application of the standard of MFN treatment, the issue is whether foreign investors or their investments are in like circumstances, and whether there are legitimate reasons for differentiating between investors and investments.³³⁴ In the case of *Parkerings-Compagniet AS*, the tribunal rejected the claim that there had been a MFN violation for the reason that the claimant's investment was not in like circumstances. This was because of legitimate grounds, such as historical and archaeological preservation and environmental protection.³³⁵ The tribunal also stated that 'less favourable treatment is acceptable if a state's legitimate objective justifies such different treatment in relation to the specificity of the investment'.³³⁶

A preliminary question has been raised in relation to the application of this standard. Since a foreign investor invokes MFN treatment issues in order to claim the benefits that a state may accord to another foreign investor of a third state, the MFN clause has the potential to transfer the treaty rights of the third treaty to the basic treaty in a manner that can replace the agreed intentions of state parties to the new treaty without limitation.³³⁷ Therefore, the preliminary question is whether the standard of MFN treatment should fall within the scope of the basic treaty. For instance, the

³³¹ Newcombe (n 1) 226.

³³² *ibid.*

³³³ *ibid.*

³³⁴ *ibid.*

³³⁵ *ibid.* para 396.

³³⁶ *Parkerings-Compagniet AS v Republic of Lithuania* (Award) 11 September 2007 (ICSID Arbitration Case No ARB/05/8) para 371.

³³⁷ Newcombe (n 1) 197–98.

tribunal in *Maffezini* admitted that the claimant who filed a claim under the basic treaty, the Argentine-Spain BIT, could enjoy the benefit of no requirement of resort to the domestic remedies accorded by the third treaty, the Chile-Spain BIT.³³⁸ The tribunal in *Plama*, however, did not accept the approach of the *Maffezini* tribunal, casting doubt on the applicability of the standard of MFN treatment to the basic treaty, as it was not sure whether the parties had really intended such applicability in the dispute settlement mechanism.³³⁹ The scope of the subject matter in the application of the standard of MFN treatment is related to arbitral jurisdiction and jurisdiction in international law is only decided by consent.³⁴⁰ Consent is established by a combination of a state's standing consent by treaty and a foreign investor's consent via the submission of its claim to arbitration.³⁴¹ Thus, it cannot be easily presumed that a foreign investor's invocation of benefits, conferred by the third treaty, can interfere with the parties' consents, which forms the scope of the subject matter of the basic treaty.³⁴²

1.2.4.6 Full Protection and Security

The traditional meaning of the 'full protection and security' standard was to protect a foreign investor from physical violence; for instance, from the invasion of the premises of the investment owned by the investor.³⁴³ In terms of traditional state responsibility, the standard does not impose on a state a duty of strict liability to prevent such violence;³⁴⁴ rather, it is generally construed as a state's obligation to exercise 'due diligence' to take protective measures.³⁴⁵ In *AMT v Zaire*, the claimant raised such a claim in relation to the destruction of his property caused by Zaire

³³⁸ *Emilio Agustín Maffezini v Kingdom of Spain* (Decision on Jurisdiction) 25 January 2000 (ICSID Case No ARB/97/7) para 64.

³³⁹ *Plama Consortium Ltd v Republic of Bulgaria* (Decision on Jurisdiction) 8 February 2005 (ICSID Case No ARB/03/24) para 191.

³⁴⁰ McLachlan and others (n 4) 257.

³⁴¹ *ibid.*

³⁴² *ibid.*

³⁴³ Dolzer and Schreuer (n 158) 149.

³⁴⁴ *ibid.* 149.

³⁴⁵ *ibid.* 150.

soldiers. The tribunal held that ‘The obligation incumbent upon Zaire is an obligation of vigilance, in the sense that Zaire as the receiving state ... shall take all measures necessary to ensure the full enjoyment of protection and security’.³⁴⁶

The protection of the standard today extends beyond physical protection to legal protection, including the safeguard against breaches of the investor’s rights by a host state through its enactment of laws and regulations.³⁴⁷ In the case of *CME*, the tribunal held that ‘The host state is obligated to ensure that neither by amendment of its laws nor by actions of its administrative bodies is the agreed and approved security and protection of the foreign investor’s investment withdrawn or devalued.’³⁴⁸

1.2.4.7 The Prohibition of Arbitrary and Discriminatory Measures

The term ‘arbitrary’ is frequently deemed interchangeable with ‘unjustified’ or ‘unreasonable’.³⁴⁹ The tribunal in *Lauder* considered the definition of ‘arbitrary’ by reference to the explanation in *Black’s Law Dictionary*. This dictionary states that ‘arbitrary’ suggests ‘depending on individual discretion’ or indicates action ‘founded on prejudice or preference rather than on reason of fact’.³⁵⁰ Additionally, the concept of arbitrary action was articulated, in contrast to the notion of the rule of law, in the ICJ case of *ELSI*, ‘Arbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law ... It is a wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety’.³⁵¹

³⁴⁶ *American Manufacturing & Trading, Inc v Republic of Zaire* (Award) 21 February 1997 (ICSID Case No ARB/93/1) para 6.05.

³⁴⁷ *ibid.*

³⁴⁸ *CME* (n 7) para 613.

³⁴⁹ Dolzer and Schreuer (n 158) 173.

³⁵⁰ *ibid.* See *Lauder* (n 6) para 221, cited in *Occidental v Ecuador* (Award) London Court of International Arbitration Administered Case No UN3467, para 162; and in *CMS* (n 309) para 291.

³⁵¹ *United States v Italy (Case Concerning Elettronica Sicula SpA (ELSI))* ICJ (1989) (March 1926) IV RIAA 41, para 128.

The ordinary meaning of the term ‘discriminatory’ is wide and covers a number of concepts in relation to discrimination, such as: (i) discrimination in breach of international human rights, such as discrimination based on race or sex; (ii) unjustifiable or arbitrary differentiations in the regulation of entities that are alike; (iii) intentionally motivated targeting; (iv) the discriminatory application of domestic law; and (v) nationality-based discrimination.³⁵² When a discriminatory measure is based on nationality, there may be an overlap with the standard of non-discrimination treatment.³⁵³

Because this type of protection concerns a measure that is arbitrary or discriminatory, it is different from other types of protection in that they concern ‘treatment’. The *Oxford English Dictionary* refers generally to the term ‘treatment’ as ‘conduct, behaviour: action or behaviour towards a person’. In the context of the protection of investment, the tribunal in the case of *Suez* discussed the notion when considering MFN treatment, ‘The ordinary meaning of that term within the context of investment includes the rights and privileges granted and the obligations and burdens imposed by a Contracting state on investments made by investors covered by the treaty’.³⁵⁴

The term ‘measure’, according to the ICJ definition in the *Fisheries Jurisdiction* case, ‘in its ordinary sense ... is wide enough to cover any act, step or proceeding, and imposes no particular limit on their material content or on the aim pursued thereby’.³⁵⁵ The NAFTA tribunal in *Ethyl v Canada* referred to Article 202(1) of NAFTA, which stipulates that a ‘measure includes any law, regulation, procedure, requirement or practice’, and accepted that ‘something other than a ‘law’, even something in the nature of ‘practice’, which may not even amount to a legal stricture,

³⁵² Newcombe (n 1) 304.

³⁵³ *ibid* 306.

³⁵⁴ *Suez, Sociedad General de Aguas de Barcelona SA, and InterAguas Servicios Integrales del Agua SA v The Argentine Republic* (Decision on Jurisdiction) 16 May 2006 (ICSID Case No ARB/03/17) para 55.

³⁵⁵ *Fisheries Jurisdiction Case (Spain v Canada)* (ICJ Judgment 1998) para 66.

‘may qualify’.³⁵⁶ In this respect, the concepts of ‘treatment’ and ‘measure’ may connote a state’s common conduct in the general sense. In the context of investment protection, the terms may differ. It appears that ‘treatment’ represents the effect or result of the conduct directed at the investment or investor in question,³⁵⁷ while ‘measure’ simply indicates conduct that is attributable to a state under the principle of state responsibility in international law.³⁵⁸

1.2.4.8 The Free Transfer of Funds

Conflicting interests exist between a foreign investor and a host state concerning the transfer of funds. A foreign investor needs to transfer funds into a host state in order to expand as well as to undertake investment. Additionally, the investor may need to transfer funds out of a host state in order to return profits or use funds for other business activities.³⁵⁹ Further, it will be critical for the investor to withdraw investments out of the host state if the investor decides to cease business activities.³⁶⁰ However, in certain circumstances, the host state can justifiably restrict transfers, including when there are significant national interests at stake, such as a financial crisis, the need for the protection of a creditor’s rights, or the enforcement of anti-corruption regulations.³⁶¹

Under customary international law, a state can enjoy almost full monetary sovereignty; however, this is subject to the international legal regime, which mainly consists of the Articles of Agreement of the International Monetary Fund (IMF), two OECD Liberalisation Codes: the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations, and the General

³⁵⁶ *Ethyl Corporation v The Government of Canada* (Award on Jurisdiction) 24 June 1988 NAFTA/UNCITRAL, para 66.

³⁵⁷ Newcombe (n 1) 182.

³⁵⁸ *ibid* 338.

³⁵⁹ *ibid* 399.

³⁶⁰ *ibid*.

³⁶¹ *ibid* 400.

Agreement on Trade in Services (GATS).³⁶² Transfer provisions in international investment agreements play a supplementary role.³⁶³ According to the Articles of Agreement of the IMF, no state member can impose restrictions on the ‘making of payments and transfers for current international transactions’ without IMF approval.³⁶⁴ On the other hand, if the transfer is for capital movements, a state member can regulate it.³⁶⁵ The Code of Liberalisation of Capital Movements is concerned with liberalisation: both the making of an investment and the proceeds earned from an investment. It plays the role of protector in relation to existing investments and liberalising the inflow of new investment.³⁶⁶ The Code of Liberalisation of Current Invisible Operations liberalises investment in the fields of major industries, such as transport, insurance, banking and finance, and tourism.³⁶⁷ For the purpose of protecting market access for services, GATS provides that, except for addressing balance of payment problems, a state should not ‘apply restrictions on international transfers and payments for current transactions relating to its specific commitments’.³⁶⁸

1.2.5 Dispute Resolution Mechanism

1.2.5.1 Introduction

Traditionally, international law has not accorded a foreign investor with the right to have recourse to international remedies in order to challenge a state for the violation of his or her right. Only state-to-state dispute settlements were available. It is an elementary principle of international law that a state is entitled to protect its citizens

³⁶² *ibid.*

³⁶³ *ibid.*

³⁶⁴ Section 2(a) of Article VIII of the Articles of Agreement of the International Monetary Fund (IMF); see Newcombe (n 1) 401.

³⁶⁵ Section 3 of Article VI of the Articles of Agreement of the International Monetary Fund (IMF); see Newcombe (n 1) 402.

³⁶⁶ UNCTAD, ‘Transfer of Funds’ Series on issues in international investment agreements (United Nations 2000) 19.

³⁶⁷ Newcombe (n 1) 403.

³⁶⁸ Article XII (Restrictions to Safeguard the Balance of Payments) and Article XI (Payments and Transfers) of the General Agreement on Trade in Services (1995).

who have been injured by another state's violation of international law.³⁶⁹ This principle of diplomatic protection is where a state exercises its own right when 'espousing' the claim of its national.³⁷⁰ The principle is based on the premise that an injury to a state's national is an injury to the state itself, for which it has the right to claim reparation from a responsible state.³⁷¹ Rather than being obligated to exercise diplomatic protection, a state enjoys a discretionary power, deciding whether or not to exercise it.³⁷² With the development of international investment agreements, a foreign investor could obtain the entitlement to claim directly against a state. In other words, there exists an investor-state dispute settlement mechanism, which prevails over diplomatic protection and depends on a state's political discretion to be initiated. The regime of investor-state arbitration is unlike international commercial arbitration, in that it is a procedure for 'public law adjudication'³⁷³ designed to settle 'regulatory disputes'³⁷⁴ involving the claimant's contention against a state's regulatory measure. An investment dispute that involves expropriation, whether it is direct, indirect or regulatory, is a regulatory dispute. Under the investment treaty arbitration system, a foreign investor is entitled to raise an expropriation claim, whether it is direct, indirect, or regulatory, in order to contend whether a host state has breached its obligation regarding the expropriation provisions of international investment agreements. In particular, if access to arbitration is broad (extended to a wide range of disputes and unhindered by procedural preconditions) the extent of host state exposure to claims of regulatory expropriation correspondingly increases. By contrast, if access to investor-state arbitration is delimited, such as in cases where an investor has to exhaust domestic

³⁶⁹ *Mavrommatis Palestine Concessions case* PCIJ Rep Series A No 2 (1924) 12; see Dolzer and Schreuer (n 158) 211.

³⁷⁰ The Permanent Court of International Justice (PCIJ) in the *Mavrommatis Palestine Concession case* (1924) confirmed this right of a state. *Mavrommatis Palestine Concessions case* PCIJ Rep Series A No 2 (1924) 12 <www.icj-cij.org/pcij/serie_A/A_02/06_Mavrommatis_en_Palestine_Arret.pdf> accessed 15 September 2012.

³⁷¹ Newcombe (n 1) 5.

³⁷² Andrew Newcombe and Lluís Pradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Netherlands, Kluwer Law International 2009) 6.

³⁷³ Harten (n 193) 4.

³⁷⁴ *ibid.*

remedies or abide by a waiting period, the extent of state exposure to investment arbitration can be controlled and the number of regulatory expropriation claims brought against it arguably stemmed.

1.2.5.2 Investor-State Dispute Settlement

1.2.5.2.1 Domestic Courts and the Fork-in-the-Road Clause

As a resolution method for an investment dispute between a state and a foreign investor, domestic courts may present limitations, especially from a foreign investor's perspective. The investor is unlikely to have high expectations for impartiality from a host state's domestic court.³⁷⁵ However, any court other than the host state's court, such as the home state's court or the third state's court, is likely to lack territorial jurisdiction over investments made in the host state.³⁷⁶ Furthermore, rules of state immunity will bar the foreign investor from raising a claim against the home state that is acting in a sovereign, rather than a commercial, capacity.³⁷⁷

Unlike the situation in traditional international law, it is now no longer a requirement that local remedies must be exhausted if consent has already been given to investor-state arbitration.³⁷⁸ Article 26 of the ICSID Convention stipulates that a state may make the exhaustion of local remedies a condition of consent to arbitration.³⁷⁹ However, the resort to domestic remedies can be regarded not as a jurisdictional issue, but as a consideration to be taken into account in the finding of a violation of the relevant standards accorded by international investment agreements. For instance, the tribunal in the *Waste Management* case held that 'in this context the notion of exhaustion of local remedies is incorporated into the

³⁷⁵ Dolzer and Schreuer (n 158) 214.

³⁷⁶ *ibid.*

³⁷⁷ *ibid.* 215.

³⁷⁸ *ibid.*

³⁷⁹ Article 26 of the ICSID Convention.

substantive standard and is not only a procedural prerequisite to an international claim'.³⁸⁰

Another approach available, to clear up the exhaustion of local remedies issue, is that of the 'Fork-in-the-Road' clause. This clause allows a foreign investor to choose between the host state's domestic courts and international arbitration; once made, that choice is irreversible. The ECT permits a foreign investor to choose any method to submit a dispute to a host state's domestic court, to any previously agreed upon resolution mechanism, international arbitration or conciliation.³⁸¹ Particularly, each party to a dispute must give its 'unconditional consent' to the dispute resolution of international arbitration.³⁸² However, this does not apply when a foreign investor has already submitted the dispute to a host state's domestic court or any other previously agreed upon mechanism for dispute resolution.³⁸³ The NAFTA does not provide for such a clause. Instead, it acquires a similar effect by requiring that there be a condition of consent to arbitration, and that a foreign investor claimant should submit a waiver to his or her right to recourse to a domestic court 'with respect to the measures of the disputing Party that is alleged to breach'.³⁸⁴

1.2.5.2.2 Preliminary Procedures

Many international investment agreements provide for a 'cooling-off' or a waiting period, which should expire before arbitration procedures begin. The period varies treaty-by-treaty, usually ranging from three months³⁸⁵ to six months³⁸⁶ or twelve months.³⁸⁷ During this period, the disputing parties usually seek to settle their dispute amicably through negotiation or consultation. The foreign investor and the host state in dispute should attempt to resolve the dispute amicably before the

³⁸⁰ *Waste Management* (n 69) para 97.

³⁸¹ Article 26(2) and (3) of the Energy Charter Treaty.

³⁸² *ibid* art 26(3)(a).

³⁸³ *ibid* art 26(3)(b)(i).

³⁸⁴ NAFTA, art 1121.

³⁸⁵ Article 8(3) of the UK Model BIT (1991).

³⁸⁶ Article 10(2) of the German Model BIT of 2008.

³⁸⁷ Article 8(2) of the Lebanon-Slovakia BIT of 2009.

foreign investor claimant notifies the host state of his or her intention to submit a claim to arbitration.

1.2.5.2.3 Investor-State Arbitration

The basic requirement for a tribunal's jurisdiction in investment treaty arbitration is the consent to arbitration by a foreign investor and a host state.³⁸⁸ Consent to arbitration can be established in three ways. Firstly, there may be a consent clause that provides an agreement to investor-state arbitration as a dispute settlement mechanism. This can be inserted into a contract made between a foreign investor and a host state.³⁸⁹ Secondly, a host state can enact legislation that includes a provision to the effect that it gives its consent to arbitration.³⁹⁰ When a state chooses this way, it is synonymous to an offer of consent to arbitration. The consent to arbitration may be established if a foreign investor claimant accepts the offer in writing while the legislation is valid or initiates arbitral proceedings.³⁹¹ Thirdly, like most international investment agreements, a treaty can be made between the host state and the home state of a foreign investor claimant.³⁹² In this scenario, the host state provides an offer of consent. The formation of the agreement to arbitrate is instigated by the foreign investor claimant's acceptance of the offer.³⁹³ Article 25 of the ICSID Convention or Article II of the New York Convention requires a 'consent/agreement in writing'. The 2012 US Model BIT provides that the host state's consent and the foreign investor claimant's 'submission of a claim to arbitration' shall meet the requirement of 'consent in writing'.³⁹⁴

The jurisdiction of an investment treaty arbitration tribunal under the ICSID Convention is dependent on five conditions, as follows:

³⁸⁸ Dolzer and Schreuer (n 158) 238.

³⁸⁹ *ibid.*

³⁹⁰ *ibid.*

³⁹¹ *ibid.*

³⁹² *ibid* 239.

³⁹³ *ibid.*

³⁹⁴ Article 25 of the 2012 US Model BIT.

- (1) a legal dispute;
- (2) arising directly out of an investment;
- (3) between a contracting state; and
- (4) the national of another contracting state; and
- (5) which the parties to the dispute consent in writing to submit to ICSID.³⁹⁵

If ICSID arbitration is chosen, other dispute resolution remedies, as well as diplomatic protection, are no longer available.³⁹⁶ Under the standard procedure for the appointment of arbitrators, arbitration tribunals usually consist of three arbitrators: one arbitrator is appointed by each party and the third arbitrator, who will take the position of president of the tribunal, will be appointed by agreement of the parties.³⁹⁷

1.2.5.3 ICSID Arbitration and Non-ICSID Arbitration

1.2.5.3.1 The International Centre for Settlement of Investment Disputes (ICSID)

The Convention on the Settlement of Investment Disputes between States and Nationals of Other States was drafted using the framework of the World Bank and adopted on 18 March 1965. It came into force on 14 October 1966. It established the International Centre for Settlement of Investment Disputes (ICSID). Rather than resorting to local remedies, a host state's ratification of the ICSID provides a guarantee to potential investors that this independent dispute settlement mechanism will always be available should a damage to their investment occur due to governmental acts.³⁹⁸ The jurisdiction of the ICSID Centre covers 'any legal dispute arising directly out of an investment, between a Contracting State (or any

³⁹⁵ Article 25 of the ICSID Convention.

³⁹⁶ Article 26 of the ICSID Convention.

³⁹⁷ Article 37 of the ICSID Convention and Article 9 of the UNCITRAL Arbitration Rules of 2010; see Dolzer and Schreuer (n 158) 258.

³⁹⁸ Subedi (n 8) 31.

constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State'.³⁹⁹ ICSID arbitration is an exclusive option once consent to arbitration is given. According to Article 26 of the Convention, the consent of the parties to arbitration under the ICSID is construed as consent to such arbitration 'to the exclusion of any other remedy.'⁴⁰⁰ ICSID investor-state arbitration is evaluated as having brought about a silent revolution in foreign investment law.⁴⁰¹

1.2.5.3.2 The ICSID Additional Facility

The Administrative Council of the ICSID established the Additional Facility in 1978. This Additional Facility provides an option for the dispute resolution of particular cases that are outside the ICSID's jurisdiction. Recourse to the Additional Facility can be made in situations where only one side is either a party to the ICSID Convention or is a national of a party to the ICSID Convention. Arbitration under the Additional Facility is not governed by the ICSID Convention. Instead, the Convention on the Recognition and Enforcement of the Foreign Arbitral Award of 1958 (the New York Convention) applies.

1.2.5.3.3 Non-ICSID Investment Arbitration

Some institutions designed primarily to address commercial disputes do not necessarily exclude investor-state arbitration. These include the International Chamber of Commerce (ICC) and the London Court of International Arbitration (LCIA). Such arbitrations are usually governed by the UNCITRAL Arbitration Rules of 1976 or by the ICC Arbitration Rules of 1998.⁴⁰²

³⁹⁹ Article 25(1) of the ICSID Convention.

⁴⁰⁰ Article 26 of the ICSID Convention stipulates that the 'Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy.'

⁴⁰¹ Subedi (n 8) 32.

⁴⁰² Dolzer and Schreuer (n 158) 225–26.

1.2.5.4 Review of Arbitral Decisions

Arbitral awards are ‘binding on the parties and not subject to any appeal or to any other remedy except those provided for in the ICSIS Convention’. Under limited circumstances, a review of an award is permissible. In non-ICSID arbitration, including arbitration under the ICSID Additional Facility, arbitral awards can be challenged in the court of the state where the tribunal sits or by the court empowered to enforce the award. There are several reasons enumerated by the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, for which the recognition and enforcement of non-ICSID arbitral awards may be declined at the request of a party:

- (i) The agreement that contains consent to arbitration is not valid;
- (ii) The proper notice of the appointment of arbitrator or the arbitration proceedings was not given;
- (iii) The award contains subject matter that reaches beyond the scope of submission;
- (iv) The arbitral tribunal or procedure was established in violation of the agreement or the law of the country where the arbitration occurred;
- (v) The subject matter is not capable of settlement by arbitration under the law of the state concerned; and
- (vi) the recognition or enforcement of the award runs counter to the public policy of that state.⁴⁰³

ICSID awards can neither be annulled nor subject to any other type of scrutiny by domestic courts. However, under the ICSID Convention, an *ad hoc* committee may annul the award at the request of a party.⁴⁰⁴ Annulment is only concerned with the procedural legitimacy of an award, not its substantive legitimacy.⁴⁰⁵ An appeal is

⁴⁰³ Article V of the UNCITRAL Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

⁴⁰⁴ Dolzer and Schreuer (n 158) 279.

⁴⁰⁵ *ibid.*

concerned with both procedural and substantive legitimacy, and can result in the replacement of the decision.⁴⁰⁶ This is different to an annulment situation when the original award is eliminated without replacement.⁴⁰⁷

1.3 Conclusion

Traditionally, the international investment law regime was represented by the rules of international law. These concerned a state's responsibility for injuries to aliens and accorded protection to foreign investors and their investments through the exercise of diplomatic protection. This regime could have evolved continuously; however, there existed a significant clash concerning the acceptable level of treatment – national treatment versus an international minimum standard. BITs, accompanied by FTAs, provided a significant breakthrough. With the development of these international investment agreements, substantial changes occurred to the regime; particularly, the advent of investor-state dispute settlement mechanisms. The vigorous influence of BITs and FTAs permitted a substantial advancement to take place in international investment law. Existing BITs and FTAs are facing a new threat situation in which they may be engulfed by the geographically more expanded FTAs, such as the TTP, the TTIP, and the RCEP. Additionally, in a few certain challenging circumstances, the credibility of investment treaty arbitration has been doubted. Firstly, it is an important and difficult task to balance a state's regulatory interests and a foreign investor's property interests, and to adequately draw a definite line between a state's normal regulation and a state's breach of foreign-owned investment. It can hardly be said that the perfect solution to this has been created. Particularly in relation to expropriation and compensation issues, international investment law recognises other types of expropriation more readily than direct expropriation or nationalisation; namely, indirect expropriation. Furthermore, as recognised in international investment agreements and investment

⁴⁰⁶ *ibid.*

⁴⁰⁷ *ibid.*

arbitral jurisprudence, the types of indirect expropriation have diversified; for instance, creeping and *de facto*, consequential expropriations (these types of indirect expropriation will be addressed in much more detail in the following chapters). It has become a trickier task to differentiate a state's regulatory taking from a state's expropriation that entails legitimate compensation not to breach investment protection. Another problem can occur with regard to achieving normative harmony or consistency between existing BITs and FTAs, and upcoming comprehensive regional FTAs. This is because these new comprehensive regional FTAs, if they are to materialise and develop, need to unify their own standards of treatment or protection, which additionally may be significantly different to those of existing BITs and FTAs. Furthermore, the two main sources of international law, international convention and customary international law, proceed in different ways as to the formation of international investment law: the former is based on a state's agreement on a bilateral or regional basis, and the latter is based on state practice and *opinio juris*. In an investment dispute, a foreign investor claimant bears the burden of proving the evolution of customary international law, as can be seen in the recent case of *Glamis Gold*.⁴⁰⁸ This burden of proof is very heavy and it is likely to be extremely hard for a foreign investor claimant to prove a higher or more evolved level of customary standard than the customary international law standard, as verified in *Neer*.

On the other hand, BITs and FTAs, competitively pursued by many states, can articulate rules of customary international law through codification and have the potential to lay the foundation for the formation of new rules of customary international law by inducing states to carry out treaty-complying acts. The appropriate interpretation and application of international investment agreements such as BITs and FTAs will invariably remain the most critical task in international investment law. In dealing with these challenges and the aforementioned critical task, the central question as to the extent to which a state can justifiably interfere with or expropriate foreign-owned investment within the legitimate boundaries of

⁴⁰⁸ *Glamis Gold, Ltd v United States* (Award) 8 June 2009 UNCITRAL Arbitration Rules.

international law can be approached by paying attention to certain secondary sources of international law, particularly, the general principles of law.⁴⁰⁹ This question will be attempted in the following chapters, focusing on expropriation, especially regulatory expropriation, with the help of relevant principles of law.

⁴⁰⁹ Article 38(1)(c) of the Statute of the International Court of Justice (ICJ).

Chapter 2: International Law on Expropriation

2.0 Introduction on a State's Right to Expropriate

Sovereignty is founded on key concepts such as a state's general independence and legal autonomy in inter-state relationships. It refers to the state's exclusive right to exercise its jurisdiction and supreme regulatory powers over its territory and people.⁴¹⁰ Once admitted into the state, a foreign investor's investment is placed under the host state's sovereign authority. According to Article 2 of the Charter of Economic Rights and Duties of States, a state has the right to exercise its regulatory power for public purposes, and, in particular, also enjoys the right to 'nationalise, expropriate or transfer ownership of foreign property', which gives rise to the 'appropriate compensation' obligation.⁴¹¹ It can be noticed here that the right to regulate for public purposes and the right to expropriate or nationalise, though both being placed under the sovereignty category, are conceptually distinguished in separate subparagraphs. Unlike the right to regulate, with regard to the right to expropriate, subparagraph (c) of Article 2 requires compensation, as follows:

Each state has the right to ... expropriate ..., in which case appropriate compensation should be paid by the state adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent.

Through the respect of a state's territorial sovereignty, rules of international law have long endorsed the host state's right to expropriate foreign-owned property. Treaty law in general only addresses the preconditions and consequences of an

⁴¹⁰ Tomer Broude and Yuval Shany, *The Shifting Allocation of Authority in International Law: Considering Sovereignty, Supremacy and Subsidiarity* (1st edn, Hart Publishing 2008) 300.

⁴¹¹ Article 2 of the Charter of Economic Rights and Duties of States.

expropriation, without affecting the right to expropriate any further.⁴¹² Expropriation usually refers to the ‘taking or deprivation by a state of property right or interest owned by a foreign company or investor’.⁴¹³ Further details relating to the concept of a state’s taking can be located by means of an observation of the 1961 Draft Convention on the International Responsibility of States for Injuries to Aliens, which was submitted by Louis B Sohn and RR Baxter:

A taking of property includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after the inception of such interference.⁴¹⁴

The 1986 Restatement (Third) of the Foreign Relations Law of the United States and the 2000 UNCTAD Issues Paper on Taking of Property have conceptualised the term ‘taking’ with a focus on its consequential influence on foreign-owned property. The Restatement provides that ‘a taking refers to actions that have the effect of “taking” the property, wholly or in large part, outright or in stages.’⁴¹⁵ The UNCTAD Issues Paper states that ‘some measures short of physical takings may amount to takings in that they result in the effective loss of management, use or control, or a significant depreciation of the value, of the assets of a foreign investor’.⁴¹⁶

Expropriation in a direct form was the classical type of expropriation; nationalisation has been classified in such a form. Expropriation in this sense refers to an outright taking by a state, normally through the transfer of title or ownership of

⁴¹² Dolzer and Schreuer (n 158) 89.

⁴¹³ Surya (n 8) 120.

⁴¹⁴ LB Sohn and RR Baxter, ‘Responsibility of States for Injuries to the Economic Interests of Aliens’ (1961) 55 AJIL 545, 553 (Article 10(3)(a)); Harvard Draft Convention.

⁴¹⁵ The 1986 Restatement (Third) of the Foreign Relations Law of the United States (§712).

⁴¹⁶ UNCTAD, ‘Taking of Property’ Series on Issues in International Investment Agreements (2004) 4.

foreign-owned property to the state or another state-designated party. In the twentieth century, expropriations and nationalisations were the dominant type of taking by the state.⁴¹⁷ The first phase of mass expropriations (nationalisations) occurred during the revolutionary movements in Russia and Mexico. A second phase of expropriations ensued with the era of decolonisation, which took place after World War II.⁴¹⁸

As states have become increasingly reluctant to expropriate foreign-owned property, due to concerns as to their negative influence on foreign investment inducement, direct expropriation has become a rare phenomenon.⁴¹⁹ However, expropriation can also occur through a state's regulatory interference with the use of private property or with the utility of economic benefits, even when deprivation does not occur and the legal title to the property remains unaffected. This type of expropriation is broadly referred to as indirect expropriation. The concept of indirect expropriation encompasses 'incidental', 'creeping' or '*de facto*' expropriation, or measures 'tantamount' to expropriation.⁴²⁰ For instance, the tribunal in *Norwegian Shipowners' Claims* observed that 'even though a state may not purpose to interfere with rights to property, it may, by its actions, render those rights so useless that it will be deemed to have expropriated them'.⁴²¹

Owing to the absence of a transfer of legal title or ownership of private property, indirect expropriation usually does not involve a tangible indication that legally and practically aids in the identification of a differentiation from direct expropriation. This feature renders it trickier to identify the existence of an indirect expropriation than that of a direct expropriation or to determine the legal consequences of it. This means, in investment cases, that it will be harder to identify and weigh the different

⁴¹⁷ UNCTAD, Series on Issues in International Investment Agreements II: 'Expropriation: a Sequel' (UN, New York and Geneva 2012) 1.

⁴¹⁸ *ibid.*

⁴¹⁹ Dolzer and Schreuer (n 158).

⁴²⁰ OECD, "'Indirect Expropriation' and the 'Right to Regulate' in International Investment Law' (2004) Working Papers on International Investment 4.

⁴²¹ *Norway v USA (Norwegian Shipowners' Claims)* Arbitration Award [1922] 1 RIAA 307.

public and private interests involved, plus factually determine the most appropriate outcome between the disputing parties.

Expropriation is *prima facie* not unlawful under international law because, in principle, it is a state's sovereign right.⁴²² The protection of private property has not been neglected in international law, especially in relation to the treatment of aliens.⁴²³ Thus, international law on expropriation should seek to consider the positions of both parties to an investment dispute and produce a balanced resolution. If necessary, both the state and the foreign investor should embrace restraints that can be imposed by international law on their respective interests. With regard to a state's right to expropriate, it has been recognised that the right should be enjoyed under certain conditions, such as compensation and a specific public purpose. The Fourth Report on State Responsibility by the Special Rapporteur of the International Law Commission in 1959 concluded that an expropriation could give rise to an international responsibility for a state taking such a measure unless it was taken in accordance with certain requirements, such as 'public utility' or 'public interest', non-discrimination, and a 'lack of arbitrariness'.⁴²⁴ The UN General Assembly resolutions verified the right to expropriate, stemming from the permanent sovereignty over natural resources. The 1962 UN General Assembly Resolution on Permanent Sovereignty over Natural Resources 1803 in paragraph 4 provided as follows:⁴²⁵

Nationalisation, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognised as

⁴²² Christoph Schreuer, 'The Concept of Expropriation under the ETC and other Investment Protection Treaties' 2 <www.univie.ac.at/intlaw/pdf/csunpublpaper_3.pdf> accessed 25 January 2015.

⁴²³ A Reinisch and others, *Standards of Investment Protection* 173 <www.oxfordscholarship.com/view/10.1093/acprof:oso/9780199547432.001.0001/acprof-9780199547432> accessed 15 January 2015.

⁴²⁴ Fourth Report on State Responsibility by Mr FV Garcia-Amador, Special Rapporteur Document A/CN.4/119 Yearbook of the International Law Commission (1959) (vol II).

⁴²⁵ GA Res 1803 (XVII) UN GAOR, 17th Session, Agenda Item 39 para 4, UN Doc A/RES/1803 (XVII) (1962).

overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the state taking such measures in the exercise of its sovereignty and in accordance with international law.

While customary international law is less reliable regarding the circumstances or conditions under which a state can lawfully exercise the right to expropriate, BITs and other international investment agreements are clearer in confirming the legal requirements for expropriation: (1) public purpose; (2) non-discrimination; (3) due process; and (4) compensation. For instance, the 1998 China/Poland BIT provides that:

each contracting party may, for security reasons or a public purpose, nationalize, expropriate. In expropriating, a State should comply with the requirement that the expropriation measure(s) shall be non-discriminatory and shall be taken under due process of national law and against compensation.⁴²⁶

Article 6 of the 2012 US Model BIT also provides:

Neither Party may expropriate or nationalise a covered investment either directly or indirectly through measures equivalent to expropriation or nationalisation (expropriation), except:

- (a) for a public purpose;
- (b) in a non-discriminatory manner;
- (c) on payment of prompt, adequate, and effective compensation; and
- (d) in accordance with due process of law and Article 5 [Minimum Standard of Treatment] (1) through (3).⁴²⁷

⁴²⁶ Article 4(1) of the 1998 China/Peru BIT.

⁴²⁷ Article 6 of the 2012 US Model BIT.

Those requirements are also expressed in Article 1110(1) NAFTA⁴²⁸ and in Article 13(1) of the Energy Charter Treaty.⁴²⁹ Among the legality requirements, the precise implication of the compensation requirement has long been debated. Relevant issues include, for example:

- i. When a state's regulatory interference with private property may constitute an expropriation that may incur the compensation obligation.
- ii. Whether it is absolutely required to pay full compensation for expropriation under international law.
- iii. Whether in some occasion an expropriation can evade the obligation of compensation.
- iv. Whether it is necessary to differentiate the level of compensation to be applied to lawful and unlawful expropriations.

2.1 Indirect Expropriation in International Law

2.1.1 The Concept of Indirect Expropriation

2.1.1.1 Direct Expropriation and Indirect Expropriation

In the traditional sense, expropriation typically involves the transfer of title to or the governmental seizure of foreign-owned property or investment. With the

⁴²⁸ Article 1110(1) NAFTA provides that 'No party shall 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 such an investment ("expropriation"), except: for a public purpose; on a non-discriminatory basis; in accordance with due process of law and Article 1105; and on payment of compensation in accordance with paragraph 2 through 6.'

⁴²⁹ Article 13(1) ECT provides that 'Investments of Investors of a Contracting Party in the area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation except where such Expropriation is: (a) for a purpose which in the public interest; (b) not discriminatory; (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation'.

development of international investment law, the concept of expropriation has become broader. Against this backdrop, when a state expropriates property, it normally creates a considerably negative effect on the property rights or interests involved. Key terms that formulate expropriation include a ‘taking’, ‘interference’, ‘deprivation’, and ‘appropriation’. Those terms are clarified with detailed commentaries in international legal instruments. The Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens provides at Article 10 3(a) A, that the:

‘Taking of property’ includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after the inception of such interference.⁴³⁰

The Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) further provides in Article 11(a)(ii) that it ‘may guarantee eligible investment against a loss resulting from’ expropriation, stipulating that:

any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment, with the exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories.

The 2012 US Model Bilateral Investment Treaty’s Annex B 2 provides that ‘an action or a series of actions by a Party cannot constitute an expropriation unless it

⁴³⁰ Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens provides in Article 10(3)(a)A.

interferes with a tangible or intangible property right or property interest in an investment’.

Therefore, a state’s expropriation is characterised as being intrusive upon and giving rise to considerable diminishing effect on the value of private property.

The term ‘indirect’ expropriation may be roughly understood as capturing a range of expropriations other than direct expropriation. In practice, this term is used to cover the broad range of expropriations in addition to direct expropriation. Certain BITs, RTAs, and international investment jurisprudence have employed additional terminology, which have appeared consistently in similar wordings, with almost identical meanings. An example of the additional terminology used is ‘a measure or a series of measures having effect equivalent or tantamount⁴³¹ to expropriation or nationalisation’. Even though it is generally recognised in international investment law that an expropriation can take place directly, indirectly, or through a measure or a series of measures having an effect which is equivalent to expropriation, certain international agreements do not provide any specific guidance that indicates which regulatory interference with foreign-owned property can fall within, for example, direct, indirect, or ‘tantamount’ expropriation.

For instance, Article 1110(1) of the North Free Trade Agreement provides that ‘no Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment’.⁴³² Article 13(1) of the Energy Charter Treaty simply stipulates that ‘Investments of Investors of a

⁴³¹ *SD Myers* (n 261) para 286. The tribunal concluded that ‘tantamount’ was to be equated with ‘equivalent’.

⁴³² The Negotiating Text of the Convention Establishing the Multinational Investment Guarantee Agency provides almost identical language in Chapter 4, stipulating that ‘a Contracting Party shall not expropriate or nationalize directly or indirectly an investment in its territory of an investor of another Contracting Party or take any measure or measures having equivalent effect’. The Germany-Bosnia and Herzegovina BIT (2001) also stipulates as regards expropriation. See OECD, “‘Indirect Expropriation’ and ‘Right to Regulate’ in International Investment Law’ (2004) Working Papers on International Investment 9.

Contracting Party in the Area of any other Contracting Party shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalisation or expropriation'.⁴³³ Unlike Article 1110(1) of NAFTA, Article 13 of the ECT does not offer any language distinguishing between direct and indirect expropriation. The Multilateral Agreements on Investment of the OECD (MAI) shares almost the same language, except that it employs 'equivalent' instead of 'tantamount', both of which are of little difference in terms of practical meaning and are even interchangeable.

NAFTA Article 1110(1) gives a clear indication that expropriation can occur directly, indirectly, or by taking a measure tantamount to expropriation. ECT Article 13(1) seems to be less clear in this respect, since it may leave one to question whether indirect expropriation is implied in the term 'expropriation' or belongs to a measure or measures having an effect that is equivalent to expropriation. There is little doubt that those three types of expropriation may reflect their conceptual distinctions. It cannot, however, ultimately determine their substantive differences.

There is no doubt that the distinction between direct and indirect expropriation is obvious in international investment law. The absence of a direct, physical taking is the very factor that differentiates indirect from direct expropriation.⁴³⁴ Direct expropriation in effect creates a substantial loss by direct taking, including the transfer of title to property. In the landmark case of *Chorzów Factory*,⁴³⁵ the Permanent Court of International Justice (PCIJ) also indicated that these two concepts form their respective category by concluding that the expropriation of the Chorzów Factory also constituted an indirect expropriation of the patents and contracts of the company 'Bayerische'. This conclusion shows that a direct

⁴³³ Article VI of the ASEAN Agreement for the Promotion and the Protection of Investments (1987) shares almost the same language. It provides that 'investments of nationals or companies of any Contracting Party shall not be subject to expropriation, nationalization or any measure equivalent thereto.'

⁴³⁴ Schreuer (n 422) 5.

⁴³⁵ *Chorzów Factory* (n 48).

expropriation of tangible property could constitute the indirect expropriation of an intangible property that exists independently of the expropriated property.

Nonetheless, even though indirect expropriation is typically equated with direct expropriation in international investment law, indirect expropriation remains in great need of further aid in order to allow for more concrete formulations of the concept. Currently, it is neither tangible nor as definite a concept as direct expropriation. The consistent lack of a concrete definition in relation to indirect expropriation in international investment agreements has left considerable uncertainty in the interpretation and application of international law in indirect expropriation cases. Thus, accordingly, it is of little help in the consideration of the credibility and stability of investment treaty arbitration. In these circumstances, the notion of indirect expropriation raises two issues. First is the scope of indirect expropriation. In other words, how far can the concept reach in the scope of governmental regulatory measures under scrutiny? Second is how to distinguish indirect expropriation that provides for compensation from that of a normal regulatory measure that does not result in compensation.

2.1.1.2 The Scope of Indirect Expropriation

Basic clues for identifying indirect expropriation can be obtained by focusing on the main substantive aspects which occur in direct expropriation. Looking at these substantive aspects, two main elements can be extracted which are deemed to reflect the existence of indirect expropriation.

Firstly, direct expropriation involves a governmental regulatory measure; more particularly, the transfer of the title to or the physical seizure of property, which gives rise to the consequence that a property owner loses their legal right to the property or the capability to enjoy all or at least substantial economic interest in the property. Direct expropriation also materialises through the state's decision to deal with private property in pursuit of a certain purpose. These two elements – the

expropriatory consequence or effect, and the state's decision – also establish the basic construction of indirect expropriation. If these elements are analysed in the context of indirect expropriation issues, it will shed light on the question of how indirect expropriation reflects them in practice in international investment law.

It is necessary to delve into certain types of treaty language that formulate indirect expropriation, and to assess the approach of arbitral practice towards indirect expropriation in interpreting such treaty languages. An example of this is set out in *Pope & Talbot*. Pope & Talbot, Inc was a Delaware company that possessed a British Columbia company producing and exporting softwood lumber to the United States. Pope & Talbot, Inc claimed that Canada's Export Control Regime, which was enacted following the implementation of a 1996 Softwood Lumber Agreement between Canada and the United States, violated certain standards of treatment under NAFTA Chapter 11. It argued that the Export Control Regime impaired its Canadian corporation's 'ordinary ability' to export softwood lumber to the United States and thus expropriated its investment.⁴³⁶ Article 1110(1) of NAFTA Chapter 11 provides as follows:

No Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory, or take a measure tantamount to nationalisation or expropriation of such investment ('expropriation'), except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1); and
- (d) in payment of compensation in accordance with paragraph 2 through 6.⁴³⁷

Article 1110(1) describes indirect expropriation by referring to the phrase: a 'measure tantamount to expropriation or nationalisation'. In construing the scope of protection under the Article 1110(1) expropriation provision, the claimant

⁴³⁶ *Pope & Talbot* (n 135) para 81.

⁴³⁷ NAFTA, ch 1 art 1110(1).

contended that Article 1110 ‘provides the broadest protection for the investments of foreign investors who may suffer harm by being deprived of their fundamental investment rights’⁴³⁸ and that Article 1110 produces a ‘*lex specialis* going beyond customary international law’. The phrase ‘measures tantamount to expropriation’ should be construed to encompass a ‘measure beyond an outright taking or creeping expropriation’.⁴³⁹ The tribunal rejected the contention and stated that the phrase ‘measures tantamount to nationalization or expropriation’ in Article 1110 would not expand the ordinary concept of expropriation under international law,⁴⁴⁰ because ‘tantamount’ could not mean more than ‘equivalent’.⁴⁴¹

2.1.1.3 The Consequential Effect of Indirect Expropriation

2.1.1.3.1 Introduction

It has been undoubtedly recognised that the effect of economic deprivation caused by a regulatory measure on a foreign-owned investment is the primary factor that determines the existence of an indirect expropriation. In finding an indirect expropriation, arbitral jurisprudence involving the indirect expropriation issue almost invariably does not deviate from its emphasis on the consequential effect that an indirect expropriation causes. The orthodox approach to identifying indirect expropriation has been the ‘sole effect’ doctrine that places the exclusive focus on the effect of a measure.⁴⁴² Different approaches are also conceivable.

Indirect expropriation has usually been found by determining that the economic effect of a regulatory measure went so far as to remove all usefulness of the property, irrespective of whether the state intended to do so or not. The tribunal in the *Metalclad* case provided that ‘covert or incidental interference’, which falls

⁴³⁸ *Pope & Talbot* (n 135) para 83.

⁴³⁹ *ibid* para 84.

⁴⁴⁰ *ibid* para 96.

⁴⁴¹ *ibid* para 104.

⁴⁴² *Newcombe* (n 1) 8.

short of a direct taking, if it gives rise to the effect of the whole or substantial deprivation of the use or the economic benefit of the property, could constitute expropriation. Also, the Iran-US Claims Tribunal in *Starrett Housing Corporation v Iran* confirmed the consequential effect as the prime consideration, as follows:

It is recognised in international law that measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been 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.⁴⁴³

While accepting that the economic effect is the primary concern, the tribunal in *Pope & Talbot v Canada* did not accept that an expropriation had occurred on the basis of an inadequate economic effect. It found that Canada's measure of limiting softwood lumber exports, while reducing the claimant's business profits, still did not completely bar it from maintaining its export business and obtaining profits from its exports.⁴⁴⁴ In *Glamis Gold v United States*, the tribunal declined the expropriation claim for the reason that the first condition, the effect, was not met sufficiently for there to have been the existence of indirect expropriation, since 'The first factor in any expropriation analysis is not met: The complained measures did not cause a sufficient economic impact to the Imperial Project to effect an expropriation of the Claimant's investment'.⁴⁴⁵

In *Chemtura Corporation v Canada*,⁴⁴⁶ the tribunal also based its rejection of an expropriation claim on the lack of substantial deprivation. The claimant, Chemtura Corporation, was engaged in the production of canola that was used in a certain pesticide, so-called, lindane. Canada's federal agency, in charge of controlling pest

⁴⁴³ *Starrett Housing Corporation v Iran* (1983) 4 Iran-USCTR 219, 225–26; see Newcombe (n 1) 8.

⁴⁴⁴ *Pope & Talbot* (n 135).

⁴⁴⁵ *Glamis Gold* (n 408) 66.

⁴⁴⁶ *Chemtura Corporation (formerly Crompton Corporation) v Canada* (Award) 2 August 2010 Ad hoc NAFTA Arbitration under UNCITRAL Rules.

control products for the protection of health and the environment, had terminated the registration of the claimant's lindane products and refused to review its decision as requested by the claimant. The tribunal concluded that because no substantial deprivation resulted from the measures in issue, no expropriation had occurred, as follows:

In assessing whether the Claimant has suffered an indirect expropriation or a measure tantamount to expropriation, the Tribunal must determine whether the measures challenged ... amounted to a 'substantial deprivation' of the Claimant's investment. ... the sales from lindane products were a relatively small part of the overall sales of Chemtura Canada at all relevant times. Under these circumstances, the interference of the Respondent with the Claimant's investment cannot be deemed 'substantial'.⁴⁴⁷

Looking more specifically at economic deprivation, the tribunal in *CME v Czech Republic* held that an economic deprivation would take place when a state takes measures 'that effectively neutralise the benefit of the property for the foreign owner'.⁴⁴⁸ The tribunal in *Telenor v Hungary* decided that the determinants in the finding of expropriation are the 'intensity and duration of the economic deprivation' inflicted on the foreign investor's investment.⁴⁴⁹ In *Venezuela Holdings, BV et al v Venezuela*,⁴⁵⁰ Venezuela Holdings, which was a corporation established under the laws of the Netherlands, held investments which were related to the right to develop and exploit oil reserves. Venezuela Holdings *et al* claimed that the four measures implemented by Venezuela 'permanently deprived them of the benefit of their rights'.⁴⁵¹ The four measures applied to their project were the imposition of a 'higher income-tax' in relation to oil projects, an 'extraction tax', 'unjustified and

⁴⁴⁷ *ibid* paras 259, 263.

⁴⁴⁸ *CME* (n 7). See UNCTAD 63.

⁴⁴⁹ *Telenor Mobile Communications AS v The Republic of Hungary* (Award) 13 September 2006 (ICSID Case No ARB/04/15) para 70.

⁴⁵⁰ *Venezuela Holdings, BV Mobil Cerro Negro Holding, Ltd v Bolivarian Republic of Venezuela* (Award) 30 September 2014 (ICSID Case No ARB/07/27).

⁴⁵¹ *ibid* para 282.

discriminatory production and export curtailments’, and the appointment of a ‘new operator’.⁴⁵² The tribunal articulated that its primary task was to decide whether the measures in question had an ‘effect equivalent to expropriation within the meaning of Article 6 of the BIT’^{453,454} and set out a criterion concerning the consequential effect of an indirect expropriation, as follows:

The Tribunal considers that, under international law, a measure which does not have all the features of a formal expropriation may be equivalent to an expropriation if it gives rise to an effective deprivation of the investment as a whole. Such a deprivation requires either a total loss of the investment’s value or a total loss of control by the investor of its investment, both of a permanent nature.⁴⁵⁵

On the other hand, some measures that give rise to a degree of deprivation or have some negative impact on property may be deemed as not causing a sufficient deprivation effect for an occurrence of indirect expropriation. The tribunal in *PSEG v Turkey*⁴⁵⁶ denied an indirect expropriation claim for this reason.⁴⁵⁷ The tribunal’s decision illustrates in detail some occasions where deprivation is neither whole nor substantial. In this case, the claimant PSEG made a concession contract with the Ministry of Energy and Natural Resources for the purpose of building a lignite-fired thermal power plant. Their dispute arose out of disagreements on certain commercial terms in the contract. The tribunal concluded that in relation to the measures at issue, the fair and equitable treatment standard was violated, but that the measures did not come close to expropriation or any type of taking. The measures taken by the Turkish administration, according to the tribunal, were categorised as

⁴⁵² *ibid.*

⁴⁵³ Agreement on the Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Republic of Venezuela of 22 October 1991.

⁴⁵⁴ *Venezuela Holdings* (n 450) para 286.

⁴⁵⁵ *ibid.*

⁴⁵⁶ *PSEG Global Inc and Konya Ilgin Elektrik Üretim Ve Ticaret Limited Şirketi v Republic of Turkey* (Award) 4 June 2004 (ICSID Case No ARB/025).

⁴⁵⁷ *ibid* para 245.

‘negligence’, ‘abuse of authority’, and ‘inconsistent acts’.⁴⁵⁸ These measures are good examples of some degree of negative effect being occasioned to PSEG’s enjoyment of its right or property; however, they were not adequate deprivation for the finding of an indirect expropriation. In the categorisation of ‘negligence’, the conduct of the administration during the negotiation of terms was considered, such as the lack of cooperation for narrowing down disagreements, disconnecting communications, and leaving the negotiation process abandoned.⁴⁵⁹ It was found that Turkey had committed an ‘abuse of authority’ by demanding renegotiation beyond its legally permissible scope.⁴⁶⁰ Among the ‘inconsistent administrative acts’, there included acts such as the administrative ignorance of the claimant’s legal rights as a policy and inharmonious decision-making.⁴⁶¹

It has been shown that the task of finding an indirect expropriation is primarily based on the consideration of the consequences that a regulatory measure is alleged to cause. The exclusive emphasis on the economic effect to which the orthodox approach adheres appears readily acceptable. Nonetheless, there is an approach that considers other significant factors in a decision relating to expropriation, as well as recognising the importance of effect. This approach considers that the economic effect factor can be outweighed by other important factors which can lead to a denial of indirect or regulatory expropriation and, accordingly, compensation. For instance, in *Archer Daniels Midland Company v Mexico*,⁴⁶² Archer Daniels Midland (ADM), the claimant, was a United States company, whose investment was established under the laws of Mexico. The company was involved in the production and distribution of an alternative and cost-effective sweetener. The Mexican Congress enacted a measure requiring a 20 per cent excise tax to be applied to soft drinks and syrup that used sweeteners, including the sweetener produced by ADM’s investment in Mexico. The claimants argued that the excise tax measures amounted

⁴⁵⁸ *ibid* para 246.

⁴⁵⁹ *ibid*.

⁴⁶⁰ *ibid*.

⁴⁶¹ *ibid*.

⁴⁶² *Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc v Mexico* (Award) 21 November 2007 (ICSID Case No ARB(AF)/04/05).

to an indirect expropriation of their investment within the meaning of Article 1110 of NAFTA.⁴⁶³ The tribunal, in its indirect expropriation scrutiny, primarily relied on the ‘effect test’ and, in addition, took other things into consideration. It articulated its position, stating:

Judicial practice indicates that the severity of the economic impact is the decisive criterion in deciding whether an indirect expropriation or a measure tantamount to expropriation has taken place. An expropriation occurs if the interference is substantial and deprives the investor of all or most of the benefits of the investment. ... Other factors may be taken into account, ... including whether the measure was proportionate or necessary for a legitimate purpose; whether it discriminated in law or in practice; whether it was not adopted in accordance with due process of law; or whether it interfered with the investor’s legitimate expectations when the investment was made.⁴⁶⁴

Even when it may seem as if an indirect expropriation has occurred as a result of the effect of economic deprivation, there may exist other factors which could enable the property owner, while still retaining ownership or control of the property or its economic benefit, to restore its original economic status in full or substantially in due course; unless the economic deprivation becomes irreversible. In this regard, it may be worthwhile to look at other relevant factors. Furthermore, the existence of a grave deprivation of foreign-owned investment does not always guarantee the arbitral recognition of indirect expropriation. The tribunal in *Feldman v Mexico* did not accept a compensable expropriation claim, despite the existence of a whole deprivation of economic value, stating:

Not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in application of the existing laws that makes it uneconomical to continue a

⁴⁶³ *ibid* para 104.

⁴⁶⁴ *ibid* paras 240–41, 250.

particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or change political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.⁴⁶⁵

In *CMS v Argentina*, the tribunal found that the suspension of the tariff adjustment regulation indeed caused a significant effect on the claimant's business, but declined to accept the expropriation claim because the investor retained full ownership and control of the investment.⁴⁶⁶ In this respect, the economic effect of a government measure can be the primary determinant for the finding of an indirect or regulatory expropriation, but in certain circumstances the significance of the effect can be outweighed by the fact that the property owner maintains the ownership and control of the investment, despite government regulations that hinder the owner from carrying out a certain business. By reflecting a deviation from the sole effect doctrine, some international investment agreements contain explicit provisions that deny the doctrine of indirect expropriation. For instance, Annex B.13(1) of the Canada Model BIT of 2004 provides:

The economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred.⁴⁶⁷

The 2012 United States Model BIT,⁴⁶⁸ the Colombia-India BIT of 2009⁴⁶⁹ and ASEAN Comprehensive Investment Agreements of 2009⁴⁷⁰ exhibit similar

⁴⁶⁵ *Marvin Roy Feldman Karpa* (n 321) para 112.

⁴⁶⁶ *CMS* (n 309) paras 262–63.

⁴⁶⁷ Annex B.13(1)(b)(i) of the Canada Model BIT of 2004.

⁴⁶⁸ Annex B.4(a)(i) of the United States Model BIT of 2012.

⁴⁶⁹ Article 6 of Colombia-India BIT of 2009 provides that 'the sole fact of a measure or series of measures having adverse effect on the economic value of an investment does not imply that an indirect expropriation has occurred'.

provisions indicating that the economic effect cannot solely establish an indirect expropriation.

It can be observed in general that such consequences can be categorised into the deprivation of economic value of the property right or investment and the total or substantial loss of control, which *de facto* render the right or investment economically meaningless. These categories are not exhaustive, and may only reflect the primary focus that tribunals tend to rely on for the finding of an indirect expropriation.

2.1.1.3.2 The Deprivation of the Economic Value of Right or Investment

The most frequently cited and recognised case in this context is *Chorzów Factory*.⁴⁷¹ In this case, the taking of a tangible property affected the patent rights of a company to which the property belonged. The tribunal articulated that the direct expropriation of some investment in practice created the effect of an indirect expropriation of the other investment by rendering it worthless. Several subsequent indirect expropriation cases demonstrate circumstances in which tribunals have found indirect expropriation on the basis of their recognition that a state's measure caused the deprivation of the economic value of a property right or investment. In *CME Czech Republic BV v Czech*,⁴⁷² the claimant, CME Czech Republic (CME), was a company established under the laws of the Netherlands. CME's joint venture investment was involved in a television broadcasting business with a license issued by the Czech Media Council. CME claimed that its investment was 'commercially destroyed by the actions and omission attributed to the Media Council, an organ of the Czech Republic',⁴⁷³ in breach of Article 5 of the Netherlands and Czech

⁴⁷⁰ Annex 2.3(a) of the ASEAN Comprehensive Investment Agreement of 2009.

⁴⁷¹ *Chorzów Factory* (n 48).

⁴⁷² *CME* (n 7).

⁴⁷³ *ibid* para 20.

Republic BIT.⁴⁷⁴ The tribunal accepted that an expropriation in a form other than direct expropriation could exist:

The expropriation claim is sustained despite the fact that the Media Council did not expropriate CME by express measures of expropriation. De facto expropriations or indirect expropriations, i.e. measures that do not involve an overt taking but that effectively neutralise the benefit of the property of the foreign owner, are subject to expropriation claims. This is undisputed under international law.⁴⁷⁵

In the case of *Middle East Cement*,⁴⁷⁶ the claimant Middle East Cement (MCE) argued that Egypt's action, of prohibiting the import of cement, in effect revoked the license that allowed MCE to manage a cement business in a free zone. It was alleged that this action amounted to an indirect expropriation under Article 4 of the Greece and Egypt BIT.⁴⁷⁷ The tribunal found an indirect expropriation, which left the ownership intact, connected to the effect of the measure at issue on the economic value of the right. The tribunal stated that the:

Claimant was deprived, by the Decree, of rights it had been granted under the License, ...When measures are taken by a state the effect of which is to deprive the investor of the use and benefit of his investment even though he may retain nominal ownership of the respective rights being the investment, the measures are

⁴⁷⁴ The Agreement on the Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic of 1991 provides in Article 5 that 'neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting party of their investments, unless the deprivation is taken in the public interest and under due process of law, is carried out non-discriminatorily, and is accompanied by just compensation.'

⁴⁷⁵ *CME* (n 7) para 604.

⁴⁷⁶ *Middle East Cement Shipping and Handling Co SA v Arab Republic of Egypt* (Award) 12 April 2002 (ICSID Case No ARB/99/6).

⁴⁷⁷ The 1993 Agreement for the Promotion and Reciprocal Protection of Investments between Greece and Egypt.

often referred to as a ‘creeping’ or ‘indirect’ expropriation or, as in the BIT, as measures ‘the effect of which is tantamount to expropriation’.⁴⁷⁸

The *CME* and *MEC* cases clearly illustrate that the existence of an indirect expropriation can be justifiably inferred from the effect of the state’s measures nullifying the benefit of economic value of the investment or right. The following case articulates the degree of effect which is required for the benefit to be nullified in order for an indirect expropriation to occur. In *Perenco Ecuador Limited v Ecuador*,⁴⁷⁹ the claimant Perenco Ecuador Limited (PEL) was a French national who explored and exploited hydrocarbon resources. PEL argued that the enactment and implementation by Ecuador of amending hydrocarbon legislation collectively brought about an expropriation of its assets in breach of Article 6 of the French and Ecuador BIT.⁴⁸⁰ In the tribunal’s investigation, it emphasised the required amount of deprivation through the citation of cases such as *Techmed v Mexico*,⁴⁸¹ *CME v Czech Republic*,⁴⁸² and *EnCana v Ecuador*.⁴⁸³ It stated:

This Tribunal is mindful ... that a distinction is to be drawn between a partial deprivation of value, which is not an expropriation, and a ‘complete or near complete deprivation of value’, which can constitute an expropriation. ... These

⁴⁷⁸ *Middle East Cement* (n 476) para 107.

⁴⁷⁹ *Perenco Ecuador Limited v Ecuador* (Decision on Remaining Issues of Jurisdiction and on Liability) 12 September 2014 (ICSID Case No ARB/08/6).

⁴⁸⁰ The Agreement between the Government of the French Republic and the Government of the Republic of Ecuador on the Reciprocal Promotion and Protection of Investments (1994).

⁴⁸¹ *Technicas Medioambientales Techmed SA v The United Mexican States* (Award) 29 May 2003 (ICSIC Case No ARB(AF)/00/2) para 115; the tribunal required that ‘measures radically deprived [the investor] of the economical use and enjoyment of its investment, as if the rights related thereto ... had ceased to exist’.

⁴⁸² *CME* (n 7) para 604; the tribunal stated that ‘an indirect expropriation can arise where there are measures that do not involve an overt taking but that effectively neutralize the benefit of the property of the foreign owner ...’

⁴⁸³ *EnCana Corporation v Republic of Ecuador* (Award) 3 February 2006 (LCIA Case No UN3481, UNCITRAL) para 174; the tribunal provided that a denial of VAT refunds did not amount to an indirect expropriation because there was no evidence to suggest that the measure ‘brought the companies to a standstill or rendered the value to be derived from their activities so marginal or unprofitable as effectively to deprive them of their character as investments’.

formulations as to the amount of deprivation of value required to be shown before an indirect expropriation will be found to exist tend in the direction of positing a very substantial amount of deprivation. It needs not to be complete, but it must be very substantial.⁴⁸⁴

In *Sergei Paushok v Mongolia*,⁴⁸⁵ the claimants owned an investment in Mongolia, which was a gold mining company. They claimed that the enactment and enforcement by Mongolia of a tax constituted an indirect expropriation. The tribunal rejected the claim because even though the tax resulted in a ‘significant drop in gold sales’ in the industry, the claimants maintained ownership of their investment and continued to conduct their business activities after the tax became effective.

2.1.1.3.3 The Deprivation of Effective Control

The expropriatory consequence or effect can occur in another way. Instead of depriving a foreign investor of the economic value of his or her investment, a state’s measure can impair a foreign investor’s capability to control his or her investment in the economic sense. Such a loss of control over an investment, if the loss is considerable, is usually likely to produce a destructive effect on the economic value of the property right or the investment. In relation to this kind of occasion, it is helpful to examine the case of *Starrett Housing Corporation v Iran*,⁴⁸⁶ a case reviewed by the Iran-US Claims Tribunal. The claimants were engaged in developing a housing project in Iran. They argued that their property interests in the housing project had been expropriated by Iran because it had deprived them of the ‘effective use, control and benefits of their property’ by implementing various

⁴⁸⁴ *Perenco Ecuador Limited* (n 479) paras 672–73.

⁴⁸⁵ *Sergei Paushok, CJSC Golden East Company, and CJSC Vostokneftegaz Company v The Government of Mongolia* (Award on Jurisdiction and Liability) 28 April 2011 United Nations Commission on International Trade.

⁴⁸⁶ *Starrett Housing Corporation, Starrett Systems, Inc, Starrett Housing International, Inc, v The Government of Islamic Republic of Iran, Bank Omran, Bank Mellat, Iran-USCTR* (Case No 24). See the case summary by the British Institute of International and Comparative Law <www.biicl.org/files/3945_starrett_housing_synopsis.pdf> accessed 29 June 2015.

administrative acts and imposing certain conditions that hindered them from accomplishing the project.⁴⁸⁷ The tribunal accepted this claim and found an indirect expropriation.

In *Inmaris Perestroika Sailing Maritime Services GmbH v Ukraine*,⁴⁸⁸ the claimant Inmaris Perestroika Sailing Maritime Services GmbH (IPS) ran a maritime tour service. As a result of a travel ban imposed by the Ukrainian government, IPS was unable to sustain its business. IPS claimed that the Ukraine's actions expropriated its investment without payment of compensation, in breach of Article 4(2) of the BIT.⁴⁸⁹ The tribunal concluded that the travel ban constituted an indirect expropriation by its deprivation of control of the claimant's key property. It stated as follows:

The continuation of the travel ban ... the act deprived Claimants of access to and control over the essential asset for its investment ... the withholding of a key asset could be viewed as an effective seizure of Claimant's right to use that asset. At a minimum, the travel ban amounted to an indirect expropriation in that it destroyed the value of Claimants' contractual rights and such diminution in value (due to the lasting damage to Claimants' business) was for all intents and purposes, permanent.⁴⁹⁰

In *Tza Yap Shum v Peru*,⁴⁹¹ the claimant Tza Yap Shum (Tza) had an investment concerned with the contracting, financing, and purchasing of raw materials. Two

⁴⁸⁷ *ibid* 2.

⁴⁸⁸ *Inmaris Perestroika Sailing Maritime Services GmbH and Others v Ukraine* (Award) 1 March 2012 (ICSID Case No ARB/08/8).

⁴⁸⁹ The Agreement between the Federal Republic of Germany and Ukraine for the Promotion and Reciprocal Protection of Investments (1993) provides in Article 4(2) that 'investments by nationals or companies of either Contracting party shall not be expropriated, nationalized or subjected to any other measures the effect of which would be tantamount to expropriation or nationalization in the territory of the other Contracting Party except for the public benefit and against compensation.'

⁴⁹⁰ *Inmaris Perestroika Sailing Maritime Services GmbH and Others* (n 488) paras 300–01.

⁴⁹¹ *Tza Yap Shum v Republic of Peru* (Award) 7 July 2011 (ICSID Case No ARB/07/6); see the Summary of Award (translated in English), University of Queen Mary, International

types of governmental measure were claimed to constitute indirect expropriation. The tribunal accepted that only one of these amounted to an indirect expropriation. First of all, Peru's taxing authority audited Tza's investment and concluded that the investment produced a false report about the amount of sales. The authority accordingly imposed 'back taxes' on Tza's investment.⁴⁹² Secondly, subsequent to the audit, the taxing authority imposed interim measures, as empowered under Peruvian law, to ensure the payment of tax debts. All Peruvian banks were instructed to hold any funds transferred through them in connection with the transactions in which Tza's investment was involved. As a result of the imposition of these interim measures, Tza was not able to use any Peruvian banks for its transactions and, as a consequence, Tza's investment's sales decreased substantially. The tribunal did not accept that the audit conducted by the Peruvian taxing authority could constitute an indirect expropriation of Tza's investment as the tribunal gave deference to the 'state's regulatory and administrative powers'.⁴⁹³ However, it did conclude that the interim measures imposed by Peru on Tza's investment constituted an indirect expropriation, because the measures 'significantly interfered with' the operations of Tza's investment and caused a substantial fall in sales.⁴⁹⁴

In *Tidewater v Venezuela*,⁴⁹⁵ the claimants, including Tidewater, were engaged in a maritime support service for state-owned companies. They claimed that Venezuela's legislative and administrative acts caused the effect of expropriating their property. The parties in the dispute agreed on the existence of expropriation, but disagreed over the scope of the expropriated investment. This case is noteworthy given the approach that was taken by the tribunal in the scrutiny of indirect expropriation. The

Arbitration Case Law <www.italaw.com/sites/default/files/case-documents/ita0882.pdf> accessed 27 June 2015.

⁴⁹² *ibid* 3.

⁴⁹³ *ibid* 5.

⁴⁹⁴ *ibid*.

⁴⁹⁵ *Tidewater Investment SRL and Tidewater Caribe, CA v The Bolivarian Republic of Venezuela* (Award) 13 March 2015 (ICSID Case No ARB/10/5).

approach suggested four considerations to be made when determining the expropriatory effect, which were adopted by the *Pope & Talbot* tribunal.⁴⁹⁶

In reaching an assessment of whether the measures had an effect equivalent to expropriation, the Tribunal finds it useful to consider the factors relied upon by the tribunal in *Pope & Talbot* as relevant in the determination of whether a state measure has such an effect, namely whether:

- (a) The investment has been nationalised or the measure is confiscatory;
- (b) The investor remains in control of the investment and directs its day-to-day operations, or whether the state has taken over such management and control;
- (c) The state now supervises the work of employees of the investment; and,
- (d) The state takes the proceeds of the company's sales.⁴⁹⁷

As can be seen above, the effective control on a daily basis is a factor which can be taken into account for the finding of an indirect expropriation. The cases reviewed so far demonstrate that the deprivation of the *de facto* effective control of an investment can constitute an indirect expropriation.

In addition, there exists case law that demonstrates that tribunals can base a rejection of an expropriation claim on the fact that the investor has retained control of his or her property. This type of decision is exhibited in the case of *Suez and Vivendi Universal v Argentina*.⁴⁹⁸ The tribunal here admitted that the 'economic impact caused by a regulatory measure' is a significant factor in determining the existence of expropriation.⁴⁹⁹ The claimants who were engaged in water and sewage services expected to obtain the tariff income under the concession they had with

⁴⁹⁶ *Pope & Talbot* (n 135).

⁴⁹⁷ *ibid*; *Tidewater v Venezuela* (n 495) para 105.

⁴⁹⁸ *Suez, Sociedad General de Aguas de Barcelona SA, and Vivendi Universal SA v The Argentine Republic* (Award) 26 March 2015 (ICSID Case No ARB/03/19).

⁴⁹⁹ *ibid* para 134.

Argentina. In this case, Argentina refused to confer such benefits to the claimants. The tribunal accepted that an indirect expropriation could be established by means of the existence of the substantial deprivation of an investment. However, the claim for expropriation was denied as the claimants had retained control of the concession and their power to operate the water and sewage system.⁵⁰⁰

2.1.1.3.4 Deprivation Not Qualified as Indirect Expropriation

Indirect expropriation typically involves the deprivation of the economic value of a right or an investment. However, not all types of deprivation can be deemed as indirect expropriation. By means of an examination of additional case law (below) it will be shown when indirect expropriation claims can be declined, even though a state's measure may have diminished the economic value of a right or an investment.

2.1.1.3.4.1 Termination of Contract and Expropriation

Firstly, there are certain occasions where the relationship between a state and a foreign investor is shaped by both a concession contract and the applicable international investment agreements, simultaneously. Such a concession contract can be made when a state's government allows a foreign investor or a locally incorporated company owned by the investor to join other domestic partners or to be assigned the development of a public utility project or infrastructure, and so on. Under a concession contract, a foreign investor is granted certain contractual rights. It has been recognised in international law that contractual rights can be expropriated since the *Norwegian Shipowners' Claims* case, in which the tribunal admitted that contractual rights and obligations had been taken, and, similarly, since the *Chorzów Factory* case, in which the tribunal concluded that the expropriation of tangible property resulted in the expropriation of intangible property rights. That a

⁵⁰⁰ *ibid* para 145. In conducting the expropriation scrutiny, the tribunal advocated that a governmental inaction or omission is less likely to constitute an expropriation than a governmental positive measure in para 144.

taking of contractual rights can constitute an expropriation of part or all of the investment has been confirmed by several tribunal awards, for instance, those rendered by the LIAMCO tribunal and the Iran-US Claims Tribunal in the *Starrett* and *Phillips Petroleum* cases.⁵⁰¹ Basically, contractual rights fall within the scope of investment as stipulated in the provisions of modern international investment agreements.⁵⁰² If a state's government terminates a contract, it usually results in a loss or deprivation of the contractual rights possessed by the foreign investor. Considering that contractual rights can be expropriated, the question can be asked as to whether it can constitute an indirect expropriation beyond a mere matter of a contract. This question can arise because a state which enters into a concession contract with a foreign investor holds double status as a sovereign entity exercising regulatory power and as a party to a contract. In this regard, the question can be rephrased as to whether an issue of the breach or termination of a contract can be an issue of violation of the expropriation provision in international investment law. The *Suez* tribunal has clarified the basic difference that exists between a contract issue and a treaty issue, and explains when an expropriation could occur out of such a termination, relying on part of the *Siemens* tribunal's award:

In investor-state arbitration involving the breaches of contracts, which have been concluded between a claimant and a host government, tribunals have made a distinction between *acta iure imperii* and *acta iure gestionis*, that is to say, actions by state in exercise of its sovereign powers and actions of a state as a contracting party. It is the use by a state of its sovereign powers that gives rise to

⁵⁰¹ *Libyan American Oil Co (LIAMCO) v Government of the Libyan Arab Republic* 62 ILR 140 (1980). The tribunal acknowledged that concession rights could constitute 'property' as long as those rights had a monetary value. In *Starrett Housing*, the tribunal stated that the property interest might comprise a right to manage a project (*Starrett Housing Corporation* (n 443); S Ripinsky and K Williams, *Damages in International Investment Law* (BIICL 2008)). In *Phillips Petroleum*, the tribunal maintained that property that could be expropriated, and included intangible property such as contract rights (*Phillips Petroleum Co Iran v Islamic Republic of Iran*, 21 Iran-USCTR 79 <www.trans-lex.org/232300> accessed 1 August 2015); McLachlan and others (n 4) 308.

⁵⁰² Article 1(6)(f) of the ECT and Article 1139 of NAFTA; UNCTAD, 'Taking of Property' Series on Issues in International Investment Agreements (2000); Dolzer and Schreuer (n 158) 116.

treaty breaches, while actions as a contracting party merely give rise to contract claims not ordinarily covered by an international investment treaty. As pointed out in *Siemens v Argentina*, ‘... for the behaviour of the state as a party to a contract to be considered a breach of an investment treaty, such behaviour must be beyond that which an ordinary contracting party could adopt and involve state interference with the operation of the contract’. In *Siemens*, the tribunal found that Argentina took a series of measures based not on its contract with the Siemens subsidiary but on the exercise of its public authority, one of which was a governmental decree not based on contract but which terminated the contract. It therefore found that Argentina had expropriated Siemens’ contractual rights.⁵⁰³

The tribunal articulated that two conditions must be met for a state’s conduct in the context of a contract to constitute a breach of an investment treaty: a state’s conduct that deviated from an ordinary contract party’s behaviour and the exercise of a state’s public authority. In *Suez*, the claimant’s company and Argentina entered into a concession contract that covered rights and responsibilities regarding the management of water and waste water systems.⁵⁰⁴ Argentina terminated the concession contract and secured the possession of the water distribution and waste water systems that were governed by the contract. The tribunal did not accept the claimant’s expropriation claim because the termination was an act in the exercise of contractual rights, as follows:

This Tribunal views the dispute between the Claimants and Argentina concerning the termination of the Concession as essentially contractual in nature. Indeed, Argentina’s action in terminating the Concession purportedly in accordance with the Concession’s terms was not an act of expropriation but rather the exercise of its alleged contractual rights. ... its assessment of the existence of a treaty breach, the Tribunal has taken into account, insofar as relevant, the contractual conduct of Argentina. It concludes, however, that measures taken by Argentina to terminate

⁵⁰³ *Suez* (n 498).

⁵⁰⁴ *ibid* para 98.

the Concession were ostensibly an exercise of its contractual rights but not measures of expropriation.⁵⁰⁵

In *Siemens*,⁵⁰⁶ the claimant ‘Siemens’ concluded a contract with Argentina with regard to the provision of an integral service for the implementation of immigration control, personal identification and an information system. Its investment included contractual rights and the right to complete the project. The contract was terminated by a decree under terms of emergency legislation. The tribunal noted that the decree, which was not based on the contract, but on the legislation, was a permanent measure and resulted in the termination of the contract.⁵⁰⁷ It concluded that it was an expropriation.⁵⁰⁸ Also, in *Occidental Petroleum Corporation*,⁵⁰⁹ the tribunal found an indirect expropriation on the basis of an act in the exercise of public authority. The dispute concerned the termination of a 1999 Participation Contract concluded between the claimants and Ecuador for the exploration and exploitation of hydrocarbons in a certain location. Ecuador terminated the contract by declaring a decree in the exercise of its authority under Hydrocarbons Law. The tribunal found an indirect expropriation, concluding that the ‘taking by the Respondent of the Claimant’s investment by means of this administrative sanction was a measure tantamount to expropriation’.⁵¹⁰

It follows that if a state terminates a contract in the exercise of its contractual right, causing a deprivation of the right, this does not constitute indirect expropriation. On the other hand, if such a termination is an act in the exercise of public powers or authority, a tribunal will continue to conduct an inquiry into the existence of indirect expropriation. Nonetheless, in relation to the exercise of public authority, there is a further factor that can prevent certain governmental deprivations of a right or an

⁵⁰⁵ *ibid* paras 155–56.

⁵⁰⁶ *Siemens* (n 230).

⁵⁰⁷ *ibid* para 271.

⁵⁰⁸ *ibid*.

⁵⁰⁹ *Occidental Petroleum Corporation and Occidental Exploration and Production Company v The Republic of Ecuador* (Award) 5 October 2012 (ICSID Case No ARB/06/11).

⁵¹⁰ *ibid* para 455.

investment from the inquiry into indirect expropriation. It is the so-called doctrine of police power.

2.1.1.3.4.2 The Doctrine of Police Power

The doctrine of police power refers to a general rule that a state is not responsible for an economic injury suffered by a foreign investor when the injury results from the state's exercise of its regulatory power that falls within its police power. In *Tza Yap Shum v Peru*,⁵¹¹ the tribunal briefly described the basic characteristic of the doctrine of police power:

The Tribunal recognised the deference given to a state's regulatory and administrative powers and noted the general rule that a state is not liable for any losses resulting from the good faith application of general taxes and regulations.⁵¹²

Likewise, in *Renée Rose Levy De Levi v Peru*,⁵¹³ the tribunal based its denial of a claim of indirect expropriation on the doctrine of police power. In this case, the claimant, Renée Rose Levy De Levi, was a shareholder of a bank company. He argued that the financial supervisory organ of the state had taken expropriatory measures, impairing the value and right of the investment. The tribunal accepted that the supervisory organ deprived the shareholder's legal and economic rights, plus hindered the shareholders from operating their company. Even so, the tribunal noted that it was the bank's own violation of the banking regulation that had caused the supervisor's interfering measures.⁵¹⁴ Fundamentally, the tribunal concluded that owing to the violation, the financial supervisory organ had taken the measures in the exercise of the police power, which did not constitute an indirect expropriation. It

⁵¹¹ *Tza Yap Shum* (n 491).

⁵¹² *ibid* 6.

⁵¹³ *Renée Rose Levy De Levi v The Republic of Peru*, Award, 26 February 2014 (ICSID Case No ARB/10/17).

⁵¹⁴ *ibid* para 483.

emphasised the clear distinction between acts of police power and expropriation, as follows:

In evaluating a claim of expropriation it is important to recognise a state's legitimate right to regulate and to exercise its police power in the interests of public welfare and not to confuse measures of that nature with expropriation. ... These were legitimate acts of 'police power' characteristic of bank officials ...⁵¹⁵

In general, the complete or substantial deprivation of an investment by a state's measure will be regarded as constituting indirect expropriation. Any other deprivation that falls short of the deprivation threshold will not constitute an indirect expropriation. In addition, there exist certain factors that tribunals consider in determining whether an indirect expropriation has occurred, such as the valid termination of a concession contract between a state and a foreign investor, and the exercise of police power.

2.1.1.4 The Intent of Indirect Expropriation: Less or Not Important

In addition to the contemplation of the consequence of indirect expropriation, there exists a subjective aspect to be considered by tribunals when determining the existence of an indirect expropriation: the intent of the state when taking the expropriatory measures. Arbitral jurisprudence has never deviated from its primary emphasis on the consequential effect of a state's measure in conducting the task of finding indirect expropriation. However, this does not mean that the intent of indirect expropriation is completely excluded from the scrutiny of indirect expropriation in general. Instead, it means that the significance of intent does not usually outweigh that of the consequential effect of indirect expropriation in the arbitral process. The aforementioned status of intent can be observed in the commentary of a number of tribunal decisions. In *Techmed v Mexico*,⁵¹⁶ the

⁵¹⁵ *ibid* paras 475–76.

⁵¹⁶ *Technicas Medioambientales Techmed SA* (n 481).

tribunal, conducting its arbitral scrutiny in the context of indirect or *de facto* expropriation, cited the tribunal decisions of *Tippetts* and *Phelps Dodge Corp*, stating:

The government's intention is less important than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects.⁵¹⁷

In *Inmaris Perestroika Sailing Maritime Services GmbH v Ukraine*,⁵¹⁸ the tribunal articulated the role of the intent factor in relation to the determination of indirect expropriation, citing the award of *Vivendi II*, stating:

While intent will weigh in favour of showing a measure to be expropriatory, it is not a requirement, because the effect of the measure on the investor, not the state's intent, is the critical factor. ... a state may expropriate property where it interferes with it even though the state expressly disclaims such intention. Indeed, international tribunals, jurists and scholars have consistently appreciated that states may accomplish expropriations in ways other than by formal decree; often in ways that may seek to cloak expropriative conduct with a veneer of legitimacy.⁵¹⁹

Thus far, this thesis has discussed and observed how investment treaty arbitration tribunals can approach the identification of an occurrence of indirect expropriation in an investment dispute case in the absence of concrete guidance concerning indirect expropriation other than the term 'indirect expropriation' itself. The consequential effect that an alleged expropriatory measure gives rise to an investment in terms of the right and control is obviously the primary concern. In

⁵¹⁷ *ibid* para 116.

⁵¹⁸ *Inmaris Perestroika Sailing Maritime Services GmbH and Others* (n 490).

⁵¹⁹ *Compañía de Aguas del Aconquija SA and Vivendi Universal SA v The Argentine Republic* (Award) 20 August 2007 (ICSID Case No ARB/97/3) para 7.5.20.

general, arbitral scrutiny of indirect expropriation is conducted in the context of a measure *vis-à-vis* an investment. However, there exists a situation where the relationship between a state and a foreign investor is formed gradually, with a foreign-owned investment being affected by more than one measure of a state. It is recognised that a series of measures can cumulatively produce a *de facto* expropriatory effect on an investment. This is called ‘creeping expropriation’. Before moving to the issue of distinguishing compensable expropriation from an ordinary regulation that does not incur the obligation of compensation, it is important to look into creeping expropriation.

2.1.1.5 Creeping expropriation

A range of different types of indirect expropriation exists, such as incidental, consequential, *de facto*, and creeping expropriation. Arbitral practice supports that cumulated stages forming a ‘*de facto* dispossession’ are to be construed as ‘measures equivalent to expropriation’.⁵²⁰ Except for creeping expropriation, the terms indicating the other types of indirect expropriation are interchangeable. The other types of indirect expropriation involve the expropriatory consequence which typically occurs when a direct form of expropriation takes place. The terms ‘incidental’, ‘consequential’, and ‘*de facto*’ all indicate expropriations that occur in different ways from that of direct expropriation. What differentiates creeping expropriation from other types of indirect expropriation is that it occurs through a gradual process, comprising more than a single governmental measure. Creeping expropriation is formed through a series of governmental measures, each of which does not necessarily constitute an internationally wrongful act. It is their cumulative effect that matters. For instance, in *Perenco Ecuador Limited v Ecuador*,⁵²¹ the claimant contended that the cumulative effect of a series of measures taken by

⁵²⁰ Schreuer (n 422) 15–19, citing *Biloune and Marine Drive Complex Ltd v Ghana* (Award) [1989] 95 LIR 184; *Tradex* (n 159); *Compañía del Desarrollo de Santa Elena, SA v Republic of Costa Rica* (Final Award) 17 February 2000 (ICSID Case No ARB/96/1); *Waste Management* (n 69); *Technicas Medioambientales Techmed SA* (n 481); *Phillips Petroleum* (n 501) 79; and *Generation Ukraine Inc* (n 284).

⁵²¹ *Perenco Ecuador Limited* (n 479).

Ecuador resulted in a complete taking.⁵²² Even though the tribunal concluded that no cumulative expropriatory effect had occurred, it took the approach of examining whether each measure constituted expropriation, and even after it concluded that no single measure amounted to expropriation, it examined whether the group of measures collectively produced an expropriatory effect on the claimant's investment. In *Tradex v Albania*, the tribunal recognised the potential impact of a series of measures which do not individually constitute an expropriation, but collectively amount to a creeping expropriation:

While the above examination ... has come to the conclusion that none of the single decisions and events alleged by Tradex to constitute an expropriation can indeed be qualified by the Tribunal as expropriation, it might still be possible that, and the Tribunal, therefore, has to examine and evaluate hereafter whether the combination of the decisions and events can be qualified as expropriation of Tradex's foreign investment in a long, step-by-step process by Albania.⁵²³

According to UNCTAD's 2003 World Investment Report, creeping expropriation is as follows:

Indirect takings include creeping expropriations, involving an incremental but cumulative encroachment on one or more of the range of recognised ownership rights until the measures involved lead to the effective negation of the owner's interest in the property.⁵²⁴

2.1.2 Drawing The Line Between Indirect Expropriation and Ordinary Regulatory Measures

⁵²² *ibid* para 256.

⁵²³ *Tradex* (n 159) para 191.

⁵²⁴ World Investment Report, United Nations Conference on Trade and Development (2003) 110.

With the emergence of the concept of indirect expropriation in international investment law, the scope of arbitral scrutiny has extended, beyond direct expropriation, to encompass a range of indirect forms of the taking of a foreign-owned investment by a measure attributable to a state. In order to avoid covering the whole range of measures under scrutiny, it becomes necessary to establish new criteria which tribunals can rely on to decide whether to afford foreign investors with compensation. Previously, the most common formulations of indirect, expropriatory deprivation could be observed through an arbitral case review. It was also noted that even though there may have been some deprivations, there could be occasions where these deprivations were not accepted as qualified indirect expropriations. Such deprivations, as will be shown, are captured by the doctrines with a view of identifying indirect expropriation among them. There exist mainly two doctrines that tribunals have recourse to: the 'sole effect' doctrine and the 'multifactor' doctrine. They do not differ from each other in recognising that the economic effect of a regulatory measure is far more relevant and determinative than other factors in the finding of an indirect expropriation. However, their approaches differ in relation to other considerations.

First of all, the sole effect doctrine only concerns the effect of the measure in issue. As noted earlier, there exist two parts for there to be an occurrence of an indirect expropriation, which may mirror the substantive aspects of direct expropriation: the consequential effect of a measure, and the decision, formed through certain processes by the state, to take the measure. The consequent effect of indirect expropriation is the deprivation by the state of a foreign-owned investment. It does not, however, cover all governmental measures that affect the economic value of or the foreign investor's capability to enjoy an investment. Governmental measures that qualify as expropriatory deprivations should fulfil certain criteria in terms of

magnitude, degree, or intensity.⁵²⁵ The *Metalclad* tribunal summarised the criteria as follows:

Thus, expropriation under NAFTA includes ... covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host state.⁵²⁶

According to the tribunal, the degree of deprivation required for governmental measures to be qualified as indirect expropriation should be full or substantial. Furthermore, the sole effect doctrine regards the effect of the measure as the core identity of an indirect expropriation. The effect is, therefore, not simply the primary, but the exclusive or absolute factor in determining the existence of indirect expropriation. It means that the effect can outweigh any other factors that may be involved in the occurrence of indirect expropriation. Under the sole effect doctrine, the intent or purpose of a state is not a meaningful concern for the finding of indirect expropriation. The *Metalclad* tribunal recognised that indirect expropriation could take place, in the absence of the definite intention to expropriate, as a result of a ‘covert or incidental interference with the use of property’. This was also clarified in the award of *Santa Elena v Costa Rica*. The tribunal maintained that 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’.⁵²⁷ Also, the tribunal in *Inmaris Perestroika Sailing Maritime Services GmbH and Others v Ukraine* asserted that an improper motive or intent would not be required for a finding of expropriation.⁵²⁸

⁵²⁵ L Yves Fortier and Stephen L Drymer, ‘Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor’ (2004) ICSID Review 293, 301.

⁵²⁶ *Metalclad* (n 285) para 103; *ibid* 321–23.

⁵²⁷ *Compañía del Desarrollo de Santa Elena, SA* (n 520) paras 71–72.

⁵²⁸ *Inmaris Perestroika Sailing Maritime Services GmbH and Others* (n 490) para 304.

Secondly, the multifactor doctrine, unlike the sole effect doctrine, involves the consideration of various factors, including effect. For instance, the *Feldman* tribunal under NAFTA did not define indirect expropriation solely based on the depriving effect of a governmental measure at issue; in particular, it embraced the deferential consideration of a state's right to regulate in a flexible way in addressing changing economic situations. It stated as follows:

Not all governmental regulatory activity, that makes it difficult or impossible for an investor to carry out a particular business, or change in the law and / or application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of their regulatory power, frequently change laws and regulations in a response to changing economic circumstances or changing political, economic or social considerations. Those changes may well cause certain activities to be less profitable or even too uneconomical to continue.⁵²⁹

It is significant to see how the tribunal in *Feldman v Mexico* approached the identification of an indirect expropriation. While the tribunal admitted the primary importance of effect, in order to determine the occurrence of an indirect expropriation, it additionally took into account factors such as the reasonableness of the measure at issue, legitimate expectations, proportionality (which also involves the consideration of a degree of burden borne by a foreign investor), and the purpose or aim of the measure at hand. It asserted that the tribunal would need to determine the following:

Whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. There must be a reasonable relationship of proportionality between

⁵²⁹ Fortier and Drymer (n 525) 322–23, citing *Marvin Roy Feldman Karpa* (n 321) para 112.

the charge or weight imposed to the foreign investor and the aim sought to be realised by any expropriatory measure.⁵³⁰

It can be observed that a multifactor doctrine is reflected in some Model BITs such as the US and Canadian Model BITs and the ASEAN Comprehensive Investment Agreement (ASEAN CIA) of 2009. For instance, the Canadian Model BIT of 2004 describes the finding of indirect expropriation as a ‘case-by-case, fact-based inquiry’ and provides that the tribunal should consider ‘among other factors, the economic impact of the government action, the extent of the government action’s interference with the legitimate expectation, and the character of the government actions’.⁵³¹

There is some academic interest in the multifactors doctrine. For example, Andrew Newcombe takes the position that the sole effect doctrine is incapable of providing precise criteria for a finding of expropriation.⁵³² In seeking useful clearer guidance for a finding of expropriation,⁵³³ he considers the ‘character of the government action’ and a ‘distinct, reasonable investment-backed expectation’, besides ‘the economic impact of the government action’.⁵³⁴ Also, Suzy H Nikièma maintains that any ‘legitimate objective of the measure’ taken by a government should be considered in identifying indirect expropriation.⁵³⁵

The difference that is immediately observable between the sole effect doctrine and the multifactor doctrine is the number of factors taken into account. The advent of

⁵³⁰ *ibid*; *Marvin Roy Feldman Karpa* (n 321) para 122.

⁵³¹ B.13(1) of the Canadian Model BIT of 2004.

⁵³² Newcombe (n 1).

⁵³³ *ibid*.

⁵³⁴ *ibid*.

⁵³⁵ Suzy H Nikièma, ‘Best Practices Indirect Expropriation’ (Canada, March 2012) International Institute for Sustainable Development (iiSD) Best Practices Series 17–20; See also Rudolf Dolzer, ‘Indirect Expropriation: New Developments?’ (2002) 11 *NYU Environmental Law Journal* 64; Esmé Shirlow, ‘Deference and Indirect Expropriation Analysis in International Investment Law: Observations on Current Approaches and Frameworks for Future Analysis’ (2014) 29 *ICSID Review No 3* 595, 598-99; Fortier and Drymer (n 525) 293; UNCTAD (n 417).

the multifactor doctrine suggests that the nature of identifying indirect expropriation has changed from a mere economic analysis to a normative balancing task. Moreover, the multifactor doctrine broadens the view from which to analyse an investment dispute by extending the scope of scrutiny, beyond the effect, to cover contextual details, including regulatory and private interests. However, what appears common in both doctrines is that they are directed at identifying certain elements that can construct an indirect expropriation. In this regard, it can be said that because they simply function to explain the character of indirect expropriation, rather than how to differentiate indirect expropriation from an ordinary regulation, they may be limited in terms of functionality in drawing the line between indirect expropriation that entails compensation and an ordinary regulation that does not. It will be more desirable for international investment law to be equipped with a doctrine that is more apt at serving the purpose of drawing this line more clearly. This possibility will be explored further in the next chapter.

2.2 The Lawfulness of Expropriation

2.2.1 The State's Right to Expropriate Subject to an International Standard

A state has the sovereign right to expropriate. Thus, external disciplines cannot bar a state from enjoying this right, but can only impose some restrictions on it. Under the rules of international law, a state's regulatory expropriation of foreign-owned property cannot be exercised without limit. The lawfulness of expropriation is governed by the rules of international law. In general, international investment agreements and customary international law require that a foreign-owned property can be expropriated for the purpose of public interest, in a non-discriminatory way, in accordance with due process, and with the payment of compensation. This list of requirements is not concerned with determining what may constitute an expropriation, but provides the criteria by which to determine the legality of an

expropriation. Examples of these conditions can be observed in certain BITs, as illustrated by the following.

Article VI of the Canada-Slovakia BIT:

Investments or returns of investors of either Contracting Party shall not be nationalised, expropriated or subjected to measures having an effect equivalent to nationalisation or expropriation (hereinafter referred to as ‘expropriation’) in the territory of the other Contracting Party, except for a public purpose, under due process of law, in a non-discriminatory manner and provided that such expropriation is accompanied by prompt, adequate and effective compensation.⁵³⁶

Article 1110(1) of NAFTA:

No Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalisation or expropriation of such an investment (expropriation), except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 11105(1); and
- (d) on payment of compensation in accordance with paragraphs 2 through 6.⁵³⁷

Article 13(1) of the ECT:

Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalised, expropriated or subjected to a

⁵³⁶ Canada-Slovakia BIT (2010).

⁵³⁷ Article 1110(1) of North American Free Trade Agreement (NAFTA).

measure or measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as ‘Expropriation’) except where such Expropriation is:

- (a) for a public purpose which is in the public interest;
- (b) not discriminatory;
- (c) carried out under due process of law; and
- (d) accompanied by the payment of prompt, adequate and effective compensation.⁵³⁸

It can be observed that these provisions exhibit almost the same language in relation to the four expropriation conditions. Their similarity may also indicate a similarity in their meanings or at least little deviation from their shared basic concepts.

2.2.2 The Four Requirements for Lawful Expropriation

2.2.2.1 Public Purpose

As a requirement for lawful expropriation, public purpose can be expressed through different terminology, such as public interest, public benefit, or national interest.⁵³⁹ In other words, public purpose is a broad concept that represents the public welfare interests that a state pursues, including the protection of human health and the environment, national security, and any other interests that a state may recognise as public. A state can enjoy a wide discretion in deciding what is in the public interest, because it is basically a matter of sovereignty. For instance, the European Court of Human Rights has employed the doctrine of a ‘margin of appreciation’, embracing that a state’s discretion to determine what is in the public interest is fully respected.⁵⁴⁰ In *James and Others v United Kingdom*, the court concluded that the state’s determination should be respected unless made in a definitively unreasonable way:

⁵³⁸ Article 13(1) of the ECT.

⁵³⁹ Newcombe (n 1) 370.

⁵⁴⁰ Reinisch and others (n 423) 182.

The Court, finding it natural that the margin of appreciation available to the legislature in implementing social and economic policies should be a wide one, will respect the legislature's judgment as to what is 'in the public interest' unless that judgment be manifestly without reasonable foundation.⁵⁴¹

International tribunals in general have been reluctant to review a state's sovereign conduct of a public purpose, not only because the concept is wide-ranging, but also because it cannot be effectively available to another state's review.⁵⁴² It does not mean, however, that a state's determination of public purpose is free from an international standard. In some cases, the hidden private objectives behind a superficial public cause and a politically-motivated, retaliatory intention have been recognised as the very factors that have rendered public purpose expropriations unlawful.⁵⁴³ The public purpose is required to be of a 'genuine' nature. In *ADC v Hungary*, the tribunal found that the public interest requirement requires some genuine interest for the public and rejected the argument that states have the free discretion to determine what is a public purpose or interest. It also *de facto* reversed the burden of proof by requiring the expropriating state to demonstrate such a genuine public interest.⁵⁴⁴

2.2.2.2 Non-Discrimination

It is recognised in customary international law, as well as in international investment agreements, that non-discrimination is required for lawful expropriation.⁵⁴⁵ The non-discrimination condition is breached when a state has expropriated the property of a foreign investor in a discriminatory way on the basis

⁵⁴¹ *James and Others v The United Kingdom* App no 8793/79 (ECtHR, 21 February 1986).

⁵⁴² Reinisch and others (n 423) 178.

⁵⁴³ *Walter Fletcher Smith Claim* case (private objective) and *British Petroleum v Libya* (politically-motivated retaliatory act) in Reinisch and others (n 423).

⁵⁴⁴ *ADC* (n 97) para 432. See Reinisch and others (n 423) 185.

⁵⁴⁵ AFM Maniruzzaman, 'Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview' (1998) 8 *Journal of Transnational Law & Policy* 57, 61 in Reinisch and others (n 423) 186.

of nationality.⁵⁴⁶ In the application of the non-discrimination condition, a strict approach is employed when distinguishing ostensible discrimination from practical discrimination. The European Court of Justice held, in *Italian Government v EEC Commission*, that:

The different treatment of non-comparable situation does not lead automatically to the conclusion that there is discrimination. An appearance of formal discrimination may therefore correspond in fact to an absence of material discrimination. Material discrimination would consist in treating either similar situations differently or different situations identically.⁵⁴⁷

Differential treatment will not be readily regarded as discriminatory. A judgment as to discrimination should be made on a reasonable basis. Different treatment on justifiable or reasonable grounds is permissible.⁵⁴⁸ In the case of *Aminoil*,⁵⁴⁹ the claimant argued that the nationalisation of the company under Decree Law constituted a discriminatory act because a foreign oil company (the Arabian Oil Company) was not nationalised under the law. The tribunal rejected the argument on the ground that there were adequate reasons for not nationalising the Arabian Oil Company. This case was concerned with the differential treatment between foreign-owned properties. The American Law Institute stated that takings that single out the property of a foreign investor of a certain nationality would be unreasonable discrimination.⁵⁵⁰ Such a differentiation, however, while based on nationality, might not be unreasonable if rationally related to the state's security and economic policies.⁵⁵¹

2.2.2.3 Due Process of Law

⁵⁴⁶ UNCTAD (n 417) 34.

⁵⁴⁷ *Italian Government v EEC Commission* (Judgment) 17 July 1963 (ECJ Case 13/63).

⁵⁴⁸ Maniruzzaman (n 545) 61.

⁵⁴⁹ *The Government of Kuwait v The American Independent Oil Company* (Award) 24 March 1982, Ad hoc Arbitral Tribunal (1984) 66 ILR 518.

⁵⁵⁰ Third Restatement of the Foreign Relations Law of the United States.

⁵⁵¹ *ibid.*

The requirement of due process of law is a procedural condition for lawful expropriation. While it is disputable whether customary international law has played a role in establishing the due process requirement, many BITs and international investment agreements expressly require due process. The due process of law in an expropriation case is largely construed as either requiring that an expropriation be made in accordance with domestic law⁵⁵² or providing for the availability of a prompt review by a host state's authority of the expropriation.⁵⁵³ For instance, according to Article 5(3) of the Austria-Georgia BIT:

Due process of law includes the right of an investor of a Contracting Party which claims to be affected by expropriation by the other Contracting Party to prompt review of its case, including the valuation of its investment and the payment of compensation in accordance with the provisions of this Article by a judicial authority or another competent and independent authority of the latter Contracting Party.

Furthermore, as a procedural control of expropriation, the due process of law may impose further procedural requirements on expropriation. In *ADC*, the tribunal provided that due process of law requires:

Some basic legal mechanisms, such as reasonable advance notice, a fair hearing and an unbiased and impartial adjudicator to assess the actions in dispute, are expected to be readily available and accessible to the investor to make such legal procedure meaningful.

Due process of law can make it available for a foreign investor to have the procedural opportunity to contest the existence of a legitimate public purpose, discriminatory expropriation, and compensation.

⁵⁵² Article 6(1) US Model BIT (2004); Article 13(1) Canadian Model BIT (2004)..

⁵⁵³ Article 5(1) UK Model BIT (1991); Article 13(4) Canadian Model BIT (2004); Article 13(2) Energy Charter Treaty.

2.2.2.4 Compensation

When a breach by a state of an international obligation owed to a foreign investor constitutes an internationally wrongful act,⁵⁵⁴ the state becomes responsible⁵⁵⁵ and will be ‘under an obligation to make full reparation for the injury caused by the internationally wrongful act’.⁵⁵⁶ Full reparation includes ‘an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.’⁵⁵⁷ Thus, if a state’s expropriatory taking of foreign-owned property failed to either pursue a public purpose, was discriminatory, was in violation of the due process of law, or was in breach of any other legal obligations, it would give rise to an obligation to compensate.

The *Chorzów Factory* case has been generally accepted as illuminating the fundamental principle of compensation in international law. The Permanent Court of International Justice in this case provided as follows:

The essential principle contained in the actual notion of an illegal act – a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals – is that reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place

⁵⁵⁴ Draft Articles on State Responsibility Article 2.

⁵⁵⁵ *ibid* art 1.

⁵⁵⁶ Draft Articles on State Responsibility, art 31. ‘Responsibilities of States for Internationally Wrongful Acts: Text of the Draft Article with Commentaries thereto’ (Crawford, Special Rapporteur) in Report of the International Law Commission on its Fifty-third Session in Campbell International Investment Arbitration: Substantive Principles 317.

⁵⁵⁷ *ibid*.

of it – such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.⁵⁵⁸

Accordingly, the fundamental remedy objective in a circumstance of expropriated property is to restore the original situation that would have existed if the unlawful expropriation had not occurred. If restitution in kind is not an available remedy, then payment of compensation in the same value shall be made.

Today, a number of BITs, RTAs and FTAs commonly carry compensation provisions. However, there is no universally accepted standard of compensation. Treaty terminology describes the standard of compensation as fair, just,⁵⁵⁹ appropriate, and full, albeit that their meanings are not confirmed as being identical, and the extent to which they vary is unclear when regarding the terminology itself. With regard to the standard of compensation, there has been historic controversy between two positions advocating between the Hull formula and the national standard (or the standard of less-than-full fair market value).⁵⁶⁰ The Hull formula articulates a small number of fundamental features of compensation, requiring that compensation be ‘prompt, adequate and effective’. Compensation is regarded as prompt if accorded without delay; adequate, if it has a reasonable bearing on the market value of the expropriated investment; and effective, if paid in convertible currency.⁵⁶¹ This formula was employed by the tribunal in the *Chorzów Factory* case.⁵⁶² The formula, however, lacks clarity and thus is unreliable in providing definite guidance as to compensation. Previously, it was accepted that the Hull rule represented customary international law standards. However, the status of the rule has been weakened by twentieth century sizeable nationalisations in developing countries and expropriation in Eastern Europe’s communist countries, as well as through the efforts to establish a New International Economic Order based on the

⁵⁵⁸ *Chorzów Factory* (n 48) para 125.

⁵⁵⁹ *Reinisch and others* (n 423), citing *Norwegian Shipowners’ Claims* (n 421) 338.

⁵⁶⁰ *Newcombe* (n 1) 377.

⁵⁶¹ UNCTAD (n 417) 40.

⁵⁶² *Chorzów Factory* (n 48) 32–33.

UN General Assembly resolution.⁵⁶³ In this respect, the Hull rule fails to reach the threshold where state practice assures the existing rule.⁵⁶⁴ This standard was transformed in the Restatement, which provides that an expropriation requires the payment of ‘just compensation’.⁵⁶⁵ It is construed as ‘in the absence of exceptional circumstances, an amount equivalent to the value of the property taken ... paid at the time of taking ... and in a form economically usable by foreign national’.⁵⁶⁶ On the other hand, the 1962 UN General Assembly Resolution on Permanent Sovereignty over Natural Resources⁵⁶⁷ asserted at paragraph 4 that ‘appropriate compensation’ shall be paid for expropriation.

Another significant issue is whether the standard of compensation can vary depending on whether an expropriation is lawful or unlawful. The PCIJ distinguished between an unlawful expropriation, which calls for reparation to re-establish the *status quo ante*, and lawful expropriation, requiring fair and just compensation equal to the ‘value of the undertaking at the moment of dispossession’,⁵⁶⁸ as it would be an unjust consequence if lawful liquidation and unlawful dispossession became indistinguishable.⁵⁶⁹ In *ADC*, the tribunal stated that the BIT only stipulated the standard of compensation applicable to a lawful expropriation, and that this standard ‘cannot be used to determine the issue of damage payable in the case of an unlawful expropriation since this would be to conflate compensation for a lawful expropriation with damages for an unlawful expropriation’.⁵⁷⁰

2.2.2.5 Implications of the Four Requirements in Relation to the Lawfulness of Expropriation

⁵⁶³ Reinisch and others (n 423) 194.

⁵⁶⁴ Rudolf Dolzer, ‘New Foundation of the Law of Expropriation of Alien Property’ (1981) 75 *American Journal of International Law* 553, 561–62.

⁵⁶⁵ Third Restatement of the Foreign Relations Law of the United States §712.

⁵⁶⁶ *ibid.*

⁵⁶⁷ GA Res 1803, 14 Dec 1962, reprinted in (1963) 2 *ILM* 223 in Newcombe (n 1) 377, 26.

⁵⁶⁸ *Chorzów Factory* (n 48) para 125.

⁵⁶⁹ *ibid* para 124.

⁵⁷⁰ Newcombe (n 1) 382, citing *ADC* (n 97).

A state has the sovereign right to expropriate foreign-owned property in international law; the exercise of this right involves a deprivation of a property right or interest owned by a foreign investor. In general, the four conditions that are required by international investment agreements and customary international law are intended, through the exertion of some constraints based on principles of law, to guide the appropriate ways in which a state exercises the right to expropriate under international law. Three of the four conditions can be differentiated from compensation and have a bearing on the expropriation measure at issue. The public interest condition reflects what a state can justifiably pursue in exercising its sovereign authority. If a state creates a normal regulation, the regulation is usually aimed at performing objectives of public interest. The non-discrimination condition intends to remove the risk that a foreign investor's property is targeted and injured on the basis of nationality. It requires a state to accord to a foreign investor equivalent treatment or otherwise reasonably differential treatment. This condition demands that a state exercises extra prudence, more than simply complying with its domestic law in exercising the right to expropriate. The due process of law exerts control over the procedural aspect of expropriation. On the other hand, even though compensation is triggered by the occurrence of an expropriation, it has no closer bearing on the expropriation measure at issue than the other conditions do. Instead, the standard of compensation has higher relevance to the financial value of an expropriated property. It means that compensation is a condition that more deeply concerns the consequence of an expropriation. Such a differentiation may lead to a divergence in evaluations of the lawfulness of expropriation, depending on which condition has been breached. For instance, in a regional context, the approach taken by the European Court of Human Rights (ECtHR), in relation to the legality of expropriation, is to distinguish between 'inherent illegality of an expropriation', which is in violation of one or more of the three conditions except for compensation, and the illegality of an expropriation that would otherwise only be lawful if accompanied by compensation.⁵⁷¹ Only the former is subject to a higher standard of compensation.⁵⁷²

⁵⁷¹ UNCTAD (n 417) 44, citing *Former King of Greece v Greece* App no 25701/94

Even though expropriation causes a substantial, injurious effect on property, it results from the exercise of a state's sovereign right, permitted under international law. Given that in the case of expropriation both the protection of investment and a state's sovereign regulatory power deserve legitimacy under international law, the arbitral task of judging private and public interests involving these two considerations cannot usually be simplified by merely choosing one over the other, but instead may come down to a careful balancing act between the two. It is thus tenable that the standard of compensation can deviate from the full financial value or even vary in degrees of reliance in which a foreign investor's investment is entitled to be protected when it is weighed against a state's sovereign exercise of expropriation. The European Court of Human Rights (ECtHR) takes the position that compensation for a lawful expropriation must be 'reasonably related to its value' and that 'legitimate objectives of public interest' may incur 'less than reimbursement of the full market value',⁵⁷³ by according a higher deference to a state's sovereign authorities in the exercise of the right to expropriate than to the protection of investment. In view of this, extra prudence is required in the case of regulatory expropriation for determining the standard of compensation, because this type of indirect expropriation involves a higher degree of sovereign autonomy and regulatory nature than any other type of indirect expropriation. Other than compensation, the three conditions are likely to apply to regulatory expropriation in the same way as other types of expropriation; however, further conditions, stemming from rules and principles of international law, may deserve recognition.

2.2.3 Conclusion

The exercise by a state of the right to regulate matters within its territory is not usually barred by any international legal regulation. A state is entitled to expropriate

(ECtHR, 28 November 2002) para 78, *Yagtzilar and Others v Greece* App No 41727/98 (ECtHR, 15 January 2004) para 25, and *Scordino v Italy* (No 1) (Judgment) 29 March 2006, para 255.

⁵⁷² *ibid.*

⁵⁷³ *Pincova and Pinc v The Czech Republic* (Judgment) App no 36548/97 (ECtHR, 5 November 2002) para 53; UNCTAD (n 417) 41.

foreign-owned investment in the exercise of its right to regulate. However, within this permissibility, international legal regulation on expropriation, formed customarily and through international investment agreements, is activated when the exercise of this right is deemed to be direct or indirect expropriation. As a result of the application of international legal regulations, as observed, some deprivations of the economic value of a right or an investment, and that of the effective control of an investment, can constitute indirect expropriation. Also, there are other cases of deprivation that could exclude the qualification of indirect expropriation.

The underlying implications of the international legal regulation of expropriation are, firstly, that without paying compensation, a state cannot take expropriation measures, and secondly, when a state expropriates a foreign-owned investment without paying compensation, it should immediately restore the monetary damage suffered by the investor through compensation. Regulation exerts some restraining influence in a way that warns a state to mind its international obligations towards a foreign investor when it takes measures interfering with a foreign-owned investment. With the policy goal of properly and legitimately weighing public and private interests, international investment law should help a state make an informed and appropriate decision as to whether to expropriate in exercising the right to regulate. The advent of the notion of ‘creeping expropriation’ suggests that international investment law is facing the challenge of dealing with regulatory measures in a wider scope of context than ever before. Accordingly, the task of balancing public and private interests in international investment law is becoming more complicated.

As for the task of finding indirect expropriation, the deviation from the sole effect doctrine reflects that the nature of the task of establishing indirect expropriation is shifting from a simple economic calculation to the exercise of normative and flexible prudence. In this direction, the concept of regulatory expropriation and the principles of international law can be valuable resources when considering whether an indirect expropriation has occurred.

2.2.4 The Principles of Necessity in International Law, the Necessity Defence of the WTO General Exceptions, and Lawful Regulatory Expropriation

2.2.4.1 Introduction

A state has the right to expropriate a foreign-owned investment under certain conditions that have been recognised by customary international law and codified in many international investment agreements: public interest, the due process of law, non-discrimination, and the payment of compensation. Also, it is unquestionable that a state is placed under relevant treaty constraints when exercising this right. If a state fails to meet any of these conditions or to comply with the relevant terms of international investment agreements in the taking of an expropriatory measure, it will constitute an unlawful expropriation. As a consequence, the state is held responsible for its unlawful act. In other words, an investment dispute concerning whether a lawful or unlawful expropriation has occurred can arise out of a state's alleged violation of its international obligations regarding expropriation under customary international law and international investment agreements. Besides the four conditions and terms of international investment agreements, there are also three types of rules, directly applicable to or offering legal guidance to, investment disputes relating to whether a lawful or unlawful expropriation has occurred: (i) the rules of international law on state responsibility, in particular, the customary principle of necessity; (ii) the so-called Non-Precluded Measures ('NPM') clause provided for by international investment agreements; and (iii) the necessity exception test of the WTO General Exceptions.

Given that a state can expropriate a foreign-owned investment in the exercise of its right to regulate for public purpose, the customary principle of necessity and the NPM clause are directly applicable to investment cases involving expropriation, including regulatory ones, because they especially concern a state's right to regulate its key domestic interests. The WTO general exceptions necessity test, although it

concerns a trade case, has a strong potential to provide for useful guidance because the necessity test is also related to a state's exercise of its right to pursue public interests. If are used by tribunals or expressly included in treaty texts, WTO-type exceptions can provide a useful defence mechanism to protect a host state's regulatory freedom.

First of all, the ILC Draft Articles on Responsibility of States for Internationally Wrongful Acts (the ILC Draft Articles) provide for rules of international law on state responsibility; rules that govern the legal consequences of a state's breach of international obligations. These rules deal with state-to-state disputes and investment treaty disputes arising out of a violation of international obligations that a state owes other states. In investment treaty arbitration, a foreign investor can refer a dispute to an arbitral tribunal in the exercise of the right that is derived from its home state's right under international investment law. In this regard, the ILC Draft Articles are directly available as applicable rules to investment treaty arbitration. Otherwise, they can provide an adjudicatory body with legal guidance when seeking to justify a state's right to regulate or expropriate under certain circumstances, by providing conditions precluding wrongfulness. Among these rules, the Draft Articles include the provision concerning necessity, reflecting the customary principle of necessity. The NPM clause is also called the 'essential interest' clause,⁵⁷⁴ which can be found in Article XI of the US-Argentine BIT and in Article 18 of the US Model BIT. This type of clause functions by excluding the application of BIT provisions to certain measures, which are taken in pursuit of a specific designated public interest, such as public order or essential security interests.

The customary principle of necessity and the NPM clause were invoked by Argentina in investment disputes that arose in the context of the Argentine economic crisis of 2001. In relation to several investment disputes, in which

⁵⁷⁴ Giorgio Sacerdoti, 'BIT Protection and Economic Crises: Limits to Their Coverage, the Impact of Multilateral Financial Regulation and the Defence of Necessity' (2013) 28(2) ICSID Review 351, 356.

Argentina defended as the respondent, Argentina pleaded both the principle of necessity and the NPM clause.

Also, the notion of ‘necessity’ appears in WTO law, particularly in the WTO General Exceptions (GATT Article XX and GATS Article XIV). GATT Article XX and GATS Article XIV use the necessity exception test in the protection of certain public purposes. The necessity exception can be invoked by a state in order to justify or defend its violation of international obligations under the WTO law. The necessity exception test, which belongs to the WTO regime which regulates international trade, may not have an immediate application to investment cases, as trade and investment basically fall within different categories and accordingly because rules of international trade and rules of international investment cannot be equated with each other. Nonetheless, the potential utility of the necessity defence for the operation of international investment law demands careful reconsideration because it is possible that the necessity exception test can provide useful legal guidance in scrutinising a state’s necessity plea under the principles of necessity. In the following, the customary principle of necessity and the NPM clause will be explored with a view to clarifying their applicability. Also, the necessity exception test will be reviewed in order to see its possible utility.

2.2.4.2 The Customary Principle of Necessity and the NPM Clause

The customary principle of necessity is effectively codified in Article 25 of the ILC Draft Articles:

1. Necessity may not be invoked by a state as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
 - (a) is the only way for the state to safeguard an essential interest against a grave and imminent peril; and

- (b) does not seriously impair an essential interest of the state or states towards which the obligation exists, or of the international community as a whole.
2. In any case, necessity may not be invoked by a state as a ground for precluding wrongfulness if:
- (a) the international obligation in question excludes the possibility of invoking necessity; or
 - (b) the state has contributed to the situation of necessity.⁵⁷⁵

According to Article 25, the customary principle of necessity functions to remove the unlawfulness of a state's act by providing for a justifying reason on a limited basis. Specifically, the necessity defence serves a certain purpose of protecting an essential interest. The notion necessity characterises the relationship between the means, a state's act or measure, and the end, the protection of an essential interest. Additionally, the situation (or state) of necessity⁵⁷⁶ that shapes the relationship has evolved through customary international law, covering a range of concepts such as military, humanitarian, environmental, and economic necessity. For instance, in the Anglo-Portuguese dispute of 1832, property possessed by British subjects was confiscated by the Portuguese government in violation of treaty obligations for the purpose of providing subsistence for troops engaged in subduing internal disturbances.⁵⁷⁷ It was mutually recognised between the two parties in dispute that:

The treaty could not be so stubborn and unbending a nature ... their stipulations ought to be so strictly adhered to, as to deprive the Government of Portugal of the

⁵⁷⁵ Article 25 of the UN Draft Articles on Responsibility of States for Internationally Wrongful Acts, with Commentaries (2001) Report of the ILC on the Work of its fifty-third session.

⁵⁷⁶ Article 25(2)(b) of the ILC Draft Articles.

⁵⁷⁷ The ILC Draft Articles; Sarah F Hill, 'The "Necessity Defense" and the Emerging Arbitral Conflict in Its Application to the U.S.-Argentina Bilateral Investment Treaty' (2007) 13 Law & Business Review of the Americas 547, 551.

right of using those means, which may be absolutely and indispensably necessary to the safety, and even to the very existence of the state.⁵⁷⁸

State practice acknowledged the doctrine of necessity as inherent, and the principle has since been extensively employed in other fields of international law where imminent harm entails the suspension of a legal obligation.⁵⁷⁹ As for humanitarian necessity, in the *Neptune* case, the arbitral tribunal, while having recognised the principle of necessity in international law, rejected the British necessity defence for justifying its act of confiscation of food owned by Americans in order to supply a food shortage in its country. The rejection was based on the reason that the British government had failed to exhaust all other alternatives for self-preservation as required by the principle. The High Seas Convention permits member states to take measures in cases of environmental necessity by providing that:

Parties to the present Convention may take such measures on the high seas as may be necessary to prevent, mitigate or eliminate grave and imminent danger to their coastline or related interests from pollution or threat of pollution of the sea by oil, following upon a maritime casualty or acts related to such a casualty, which may reasonably be expected to result in major harmful consequences.⁵⁸⁰

The High Seas Convention codified the customary defence of necessity and represents a pre-Draft Articles international agreement regarding the concept of the necessity.⁵⁸¹ Also, economic necessity is covered by the principle of necessity. For example, in *Société Commerciale de Belgique*, in response to the Greek government's necessity defence based on its refusal to pay the debt owed to a Belgian company, action could be justified due to the country's serious budgetary

⁵⁷⁸ *ibid.*

⁵⁷⁹ *ibid.* The necessity was also invoked in the *Caroline* case; ILC Draft Articles, 81; Hill (n 577) 552.

⁵⁸⁰ Article 1(1) of the International Convention relating to Intervention on High Seas in Cases of Oil Pollution Casualties of 1969; Hill (n 577) 554.

⁵⁸¹ Hill (n 577) 554.

and monetary situation.⁵⁸² The PCIJ implicitly endorsed the principle of necessity. Additional cases, related to the Argentine economic crisis of 2001, will be explored in order to scrutinise the applicability of the principle to economic emergencies and to clarify the relationship between the customary necessity defence and the NPM necessity clause.

The NPM clause represents the BIT-based necessity principle. The most frequently cited example in relation to the clause is Article XI of the US-Argentine BIT:

This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfilment of its obligations with respect to the maintenance or restoration of international peace and security, or the protection of its own essential security interests.⁵⁸³

Also, Article 18(2) of the US Model BIT provides for such a clause for essential security:

Nothing in this Treaty shall be construed to preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.⁵⁸⁴

The basic function of the clause is to exclude the application of a treaty from certain measures taken in pursuit of the protection of public order or security interests. In this regard, the customary principle of necessity and the NPM clause of necessity work to relieve a state of responsibility for violations against international obligations.

⁵⁸² The ILC Draft Articles 82.

⁵⁸³ Article XI of the US-Argentine BIT (1991).

⁵⁸⁴ Article 18(2) of the US Model BIT of 2012.

As previously noted, the necessity defence, whether based on customary international law or treaty law, serves to protect certain limited interests. Furthermore, the invocation of the necessity defence is limited by several conditions. The relationship between the customary principle of necessity and the NPM necessity clause should be given close attention because they are different in terms of nature and application. It can be observed that arbitral approaches have diverged over the understanding of the relationship. Specific conditions and their relationships can be more clearly observed by comparatively reviewing the Argentine investment cases, in particular, the cases of *CMS* and *LG&E*, in which the tribunals provided diverging approaches and contrasting conclusions in their awards.

Since the beginning of the Argentine economic crisis in around 1982, the Argentine government took reform measures, including the privatisation of the public utilities sector. Since then, a certain gas tariff regime has existed, under the system of government-issued licenses and Argentine regulations, and operated as regulated by the Convertibility Law.⁵⁸⁵ Under the gas tariff regime, tariffs were calculated in dollars and adjusted every six months in accordance with the US Producer Price Index (US PPI). The Convertibility Law applied a fixed exchange rate with the US dollar, setting the value of one peso at one dollar.⁵⁸⁶ On 6 January 2002, the Argentine government enacted the Public Emergency and Exchange Regime Reform Act (Public Emergency Act).⁵⁸⁷ The Public Emergency Act declared a state of emergency and accorded certain economic, administrative, financial and exchange, and social powers to the Executive, including the authority to renegotiate government contracts.⁵⁸⁸ Under the Act, the gas tariff regime and the Convertibility Law ceased to operate, which resulted in a series of arbitration claims at the

⁵⁸⁵ August Reinisch, 'Necessity in International Investment Arbitration: An Unnecessary Split of Opinion in Recent ICSID Cases? Comments on *CMS v. Argentina* and *LG&E v. Argentina*' (2007) 8 *Journal of World Investment & Trade* 191, 192–93.

⁵⁸⁶ *ibid.*

⁵⁸⁷ Hill (n 577) 548–49.

⁵⁸⁸ *ibid.*

ICSID.⁵⁸⁹ Among the several cases involving claims against Argentina, the cases of *CMS* and *LG&E* will be analysed. The tribunals in these cases reached diverging conclusions in dealing with the Argentine necessity defence. *CMS* Gas Transmission Company ('*CMS*') had invested in the gas transportation sector that conducted business with government-guaranteed licenses, and *LG&E* owned equity interests in various Argentine gas distribution companies. Both claimants contended that Argentine emergency measures violated the US-Argentina BIT provisions. In its defence, Argentina invoked the necessity principle under customary international law and under Article XI of the US-Argentina BIT. The *CMS* tribunal rejected the necessity plea, but the *LG&E* tribunal accepted it.

In determining whether Argentina was entitled to invoke the necessity defence, the *CMS* and *LG&E* tribunals took different approaches in defining and applying the customary principle of necessity and the US-Argentina BIT necessity clause. There are three perspectives concerning the relationship: (i) the confluence; (ii) the treaty-based necessity as *lex specialis*; and (iii) the separation of primary and secondary applications.⁵⁹⁰ From the perspective of the *CMS* tribunal, the customary principle of necessity and the BIT necessity were conflated. Article 25(2)(a) of the ILC Draft Articles provides that when the 'international obligation in question excludes the possibility of invoking necessity', it renders the necessity defence unavailable.⁵⁹¹ The ILC Commentary stated that this would concern, in particular, treaties excluding either 'explicitly or implicitly' reliance on necessity.⁵⁹² The *CMS* tribunal admitted that the US-Argentina BIT may constitute such a treaty excluding the possibility of invoking necessity and that such exclusion need not be explicit but can be evidenced implicitly 'by the very object and purpose of the treaty'.⁵⁹³ This indicates the confluent relationship between the customary principle of necessity

⁵⁸⁹ Reinisch (n 585) 193.

⁵⁹⁰ Jürgen Kurtz, 'Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis' (2010) 59 *International and Comparative Law Quarterly* 325.

⁵⁹¹ Article 25(2)(a) of the ILC Draft Articles with commentary.

⁵⁹² The ILC Draft Articles with commentary, 84.

⁵⁹³ *CMS* (n 309) para 354.

and the BIT necessity.⁵⁹⁴ The second perspective is to view and prioritise the treaty-based necessity as *lex specialis*, which establishes a specific advancement or updating of the general customary law.⁵⁹⁵ Taking this perspective, the *LG&E* tribunal provided that it would consider the BIT first and, in the ‘absence of explicit provisions’, general international law.⁵⁹⁶ The tribunal primarily relied on Article XI of the US-Argentina BIT in finding the validity of the necessity defence and then had recourse to Article 25 of the Draft Articles merely in confirming its conclusion.⁵⁹⁷ The third perspective relates to the treaty provisions at issue, whether they concern an obligation or exception, as primary legal standards that determine whether a state has committed an internationally wrongful act.⁵⁹⁸ Once any breach is determined by the treaty law, then the secondary scrutiny starts to determine whether the customary defence of necessity could justify the wrongful act.⁵⁹⁹ In fact, the difference between the second and the third perspectives is small, but the latter has the advantage of clarifying the treaty law as a ‘first-order primary norm’.⁶⁰⁰ Although the *CMS* and *LG&E* tribunals took different perspectives as to the relationship, they agreed that they could extend the potential invocation of a state of necessity to situations of economic emergency.⁶⁰¹ Nonetheless, they reached contrasting conclusions. The former tribunal did not accept the necessity plea because, even though the situation was severe, it was not sufficient for a finding of necessity.⁶⁰² The latter tribunal accepted the plea because Argentina’s essential

⁵⁹⁴ *Sempra Energy International v Argentine Republic* (Award) 9 September 2007 (ICSID Case No ARB/02/16). The *Sempra* tribunal provides for another clarification about the relationship by providing that ‘this Tribunal believes ... that the Treaty provision is inseparable from the customary law standard insofar as the definition of necessity and the conditions for its operation are concerned given that it is under customary law that such conditions have been defined’ (para 376).

⁵⁹⁵ Kurtz (n 590) 352.

⁵⁹⁶ *LG&E Energy Corp, LG&E Capital Corp and LG&E International Inc v Argentine Republic* (Decision on Liability) 3 October 2006 (ICSID Case No ARB/02/1) para 99.

⁵⁹⁷ *ibid* paras 245, 258.

⁵⁹⁸ Kurtz (n 590) 356.

⁵⁹⁹ *ibid* 357.

⁶⁰⁰ *ibid* 358.

⁶⁰¹ *CMS* (n 309) para 319; *LG&E* (n 596) para 251.

⁶⁰² *CMS* (n 309) paras 320–21.

interests were threatened.⁶⁰³ In reaching their own specific conclusions, they were confronted with certain issues: (i) whether the state's act was the only course of action it could have taken⁶⁰⁴ (the only way test); (ii) whether Article XI of the BIT is a self-judging clause; (iii) whether Argentina contributed to the crisis;⁶⁰⁵ and (iv) whether the necessity defence can exclude the obligation to pay compensation.

On the first issue, the tribunals clearly reached different conclusions. The *CMS* tribunal applied the test strictly and concluded that Argentina failed to meet the test because of the availability of other means, 'even if they may be more costly or less convenient', indicating that the measures in question were not the only ones available.⁶⁰⁶ On the other hand, the *LG&E* tribunal, although admitting that there might be other ways available to respond to the economic crisis, concluded that the measure taken was necessary according to the evidence presented to it.⁶⁰⁷ In relation to the question of whether Article XI of the BIT is a self-judging clause, the *CMS* tribunal recognised that such a self-judging clause could have been created by state parties expressly if they intended to do so.⁶⁰⁸ A good example is Article XXI(b) of the GATT, which provides that 'Nothing in this Agreement shall be construed ... to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests'.

The *CMS* tribunal noted that in the absence of the expressed intention to create a self-judging clause, an adjudicator and not the state concerned would retain the jurisdiction to judge, and concluded that Article XI of the BIT was not a self-judging clause.⁶⁰⁹ The *LG&E* tribunal also concluded that it was not self-judging, on the basis of the consideration of the intent of the parties.⁶¹⁰

⁶⁰³ *LG&E* (n 596) para 257.

⁶⁰⁴ Article 25(1)(a) of the ILC Draft Articles.

⁶⁰⁵ Article 25(2)(b) of the ILC Draft Articles.

⁶⁰⁶ *CMS* (n 309) para 324.

⁶⁰⁷ *LG&E* (n 596) para 257.

⁶⁰⁸ *CMS* (n 309) para 370.

⁶⁰⁹ *ibid* paras 371–72.

⁶¹⁰ *LG&E* (n 596) paras 212–13.

The two tribunals had a common understanding that contribution could exclude the possibility of the necessity invocation. However, the *CMS* tribunal found that Argentina ‘significantly contributed’ to the crisis,⁶¹¹ whereas the *LG&E* tribunal found no evidence indicating that Argentina contributed to the crisis.⁶¹² The ILC Draft Articles Commentary requires that ‘the contribution to the situation of necessity must be sufficiently substantial and not merely incidental or peripheral’.⁶¹³ In this regard, the *CMS* tribunal more closely reflected the ILC Draft Articles’ ‘substantial contribution’ test. The remaining issue is whether the necessity defence can exclude the obligation to pay compensation. Article 27(b) of the ILC Articles provides that the invocation of necessity is ‘without prejudice to the question of compensation for any material loss caused by the act in question’. The ILC commentary clarifies that the ‘compensation’ included in subparagraph (b) of Article 27 is different from the ‘compensation within the framework of reparation for wrongful conduct, which is the subject of Article 34’.⁶¹⁴ It supported the characterisation by explaining that:

It is concerned with the question whether a state relying on a circumstance precluding wrongfulness should nonetheless be expected to make good any material loss suffered by any state directly affected. The reference to ‘material loss’ is narrower than the concept of damage elsewhere in the articles: Article 27 concerns only the adjustment of losses that may occur when a party relies on a circumstance covered by Chapter 5.⁶¹⁵

The court in the *Gabčíkovo-Nagymaros* case made a supportive statement that the invocation of necessity could not remove the binding force of treaty obligations and concluded that the invocation would not exempt Hungary from its obligation

⁶¹¹ *CMS* (n 309) para 329.

⁶¹² *LG&E* (n 596) para 257.

⁶¹³ The ILC Draft Articles Commentaries, 205; *CMS* (n 309) para 328.

⁶¹⁴ The ILC Draft Articles Commentary, 86.

⁶¹⁵ *ibid.*

to compensate.⁶¹⁶ The *CMS* tribunal took the position that the invocation of the necessity could not affect the obligation, ‘The plea of state of necessity may preclude the wrongfulness of an act, but it does not exclude the duty to compensate the owner of the right which had to be sacrificed’.⁶¹⁷

The *LG&E* tribunal, however, drew a different interpretation from Article 27(b) of the ILC Draft Articles. It provided that:

Article 27 of the ILC’s Draft Articles, as well as Article XI of the Treaty, does not specify if any compensation is payable to the party affected by losses during the state of necessity. ... this Tribunal had decided that the damages suffered during the state of necessity should be borne by the investor.⁶¹⁸

The necessity defence can be relied on by a state temporarily, as long as the situation of necessity lasts. When such a situation ceases to exist, the original obligation will be restored. In this regard, it is more acceptable to understand that a state invoking the plea of necessity is still obliged to pay compensation for loss that resulted from the suspension of the fulfilment of international obligations. It seems that the *CMS* tribunal’s position is more persuasive.

Thus far, it has been observed how the principle of necessity in international law can operate. The customary principle of necessity and the treaty-based necessity defence can apply to a case involving the violation of an international obligation in combination or otherwise. As a general principle of law, if the NPM clause is not available, only the former can apply. Setting aside the direct application of the principles of necessity, it can be questioned whether the principles, which play the role of justifying a state’s act in international law, may offer certain implications on occasions where a state, in response to an economic emergency, expropriates a

⁶¹⁶ *Case Concerning the Gabčíkovo-Nagymaros Project* (Judgment) 25 September 1997, para 48.

⁶¹⁷ *CMS* (n 309) para 388.

⁶¹⁸ *LG&E* (n 596) para 264.

foreign-owned investment in the exercise of its regulatory power or, in so doing, abuses its police power authority. The same question can be cast with regard to the necessity exception in WTO law. In the following, the WTO General Exceptions will be reviewed to seek the relevant implications.

2.2.4.3 The Necessity Defence Based on the WTO General Exceptions

The WTO General Exceptions indicate GATT Article XX, which allows member states to exceptionally evade GATT obligations in limited circumstances. GATT Article XX in particular provides for the necessity test for certain purposes, as follows:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:

- (a) necessary to protect public morals;
- (b) necessary to protect human, animal or plant life or health; ... and
- (d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement ...⁶¹⁹

GATT Article XX consists of the *chapeau* that prescribes the basic conditions and specific exceptions, such as public morals and human health. This structure reflects that the Article XX analysis is two-tiered. Firstly, the measure at issue must meet the criteria of each specific exception and, secondly, the measure at issue must fulfil the requirements provided by the *chapeau*. GATS Article XIV is modelled on

⁶¹⁹ Article XX General Exceptions of the General Agreement on Tariffs and Trade (GATT) (1994).

GATT Article XX and it shares the same *chapeau* with GATT Article XX, but shows slight differences: GATS Article XIV provides:

- (a) necessary to protect public morals or to maintain public order;
- (b) necessary to protect human, animal or plant life or health;
- (c) necessary to secure compliance with laws or regulations which are not consistent with the provisions of this Agreement ...⁶²⁰

It contains the additional exception ‘necessary to maintain public order’ in subparagraph (a). The necessity exception test, which is based on WTO law, obviously concerns trade, not investment. Both are not equitable. Accordingly, it does not constitute a directly applicable rule for investment disputes. Even so, it should be noted that trade and investment are deeply interrelated. Furthermore, GATS can in fact affect an investment. GATS covers trade in services and one of the modes of supply of trade in services is ‘commercial presence’.⁶²¹ Commercial presence is defined as ‘any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office’.⁶²² Thus, the notion of commercial presence falls within the concept of investment. In this regard, WTO law and international investment law share common subject matter, namely, investment, and the WTO General Exceptions or GATS Article XIV can influence measures that affect an investment. Besides this connection between ‘trade in services’ and investment, the necessity exception test can potentially shed light on the extent to which a state can justifiably exercise the right to expropriate in pursuit of public interests.

As touched upon above, the operation of the necessity exception test is two-tiered. To explain this more specifically, in the first stage, the task is to identify whether a

⁶²⁰ Article XIV General Exceptions of the General Agreement on Trade in Services (GATS) (1995).

⁶²¹ Article I(2)(c) Scope and Definition of GATS.

⁶²² Article XXVIII Definitions of GATS.

measure at issue falls within any specific exception. It should be noted that under WTO law, WTO member states can enjoy the discretion to determine their own regulatory objectives and the level at which they wish to seek to fulfil them.⁶²³ In other words, WTO members have the right to determine the level of protection of a certain purpose that they consider proper in a given circumstance.⁶²⁴ Subsequent to identifying the regulatory objectives, such as public morals, human life, and health, a weighing and balancing analysis must be conducted. The factors to be weighed and balanced are the contribution of the measure at issue to the regulatory purpose and the restrictive impact of the measure on international trade.⁶²⁵ This is the so-called ‘minimum derogation principle’.⁶²⁶ This principle inquires whether there are alternative measures available that would be as effective as the one taken, being either WTO consistent or, if not WTO consistent, are less trade restrictive than the measure taken.⁶²⁷ This can be called the ‘less-restrictive measure test’. In the next stage, the *chapeau* analysis seeks to find out whether a state invoking the necessity exception meets the two preconditions laid out in the *chapeau*. First, the state must demonstrate that the measure taken is not applied in a manner that constitutes a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail.⁶²⁸ Secondly, any such measure should not constitute a disguised restriction on trade.⁶²⁹

⁶²³ WTO Appellate Body Report, *European Communities – Trade Description of Sardines* WT/DS231/AB/R, adopted 23 October 2002, para 7.120; Benn McGrady, ‘Necessity Exceptions in WTO Law: Retreaded Tyres, Regulatory Purpose and Cumulative Regulatory Measures’ (2009) 12(1) *Journal of International Economic Law* 153, 156.

⁶²⁴ WTO Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products* WT/DS135/AB/R, adopted 5 April 2001, para 168. McGrady (n 625) 156.

⁶²⁵ McGrady (n 623) 160.

⁶²⁶ Kevin C Kennedy, *International Trade Regulation: Readings, Cases, Notes, and Problems* (Aspen 2009) 270.

⁶²⁷ *ibid.*

⁶²⁸ *ibid.*

⁶²⁹ *ibid.*

A good example case is the case concerning Brazil's import ban of tyres.⁶³⁰ This was when Brazil placed a ban on the importation of used and remoulded tyres, for the purpose of the protection of human health. The EU filed a complaint against Brazil and the Panel found that the Brazilian measure was justifiable under Article XX(b), but that it failed to meet the terms of the Article XX *chapeau*. In conducting its analysis of the necessity of the import ban, the Panel first examined the contribution of the ban to the fulfilment of the objective. It observed that the objective of the ban was the reduction of the 'exposure to the risks to human, animal or plant life or health arising from the accumulation of waste tyres'⁶³¹ and also that 'Brazil's chosen level of protection was the reduction of the risks of waste tyre accumulation to the maximum extent possible'.⁶³² It concluded that in consideration of the significance of the interests protected by the objective of the ban, the contribution of the ban to the fulfilment of its objective outweighed its trade restrictiveness. The Panel then analysed possible alternatives to the ban. It found no other alternatives. The Appellate Body upheld the Panel's conclusion.

There is an important area in which the WTO necessity exception test may prove useful. In the application of the principle of necessity, one of the reasons that the *CMS* and *LG&E* tribunals reached different conclusions was that they diverged on how strictly the only way test should apply. The *CMS* tribunal, having taken a strict approach, reasoned that if other means existed, the measures at issue could not meet the only way test, no matter how much they cost or the inconvenience caused. On the other hand, the *LG&E* tribunal, taking a rather lenient approach, concluded that despite the availability of other means, it could decide that the measures at issue were necessary. In the former case, the *CMS* tribunal applied the test very strictly and, in the latter case, the *LG&E* tribunal left the criterion of the only way test unclear.

⁶³⁰ Report of the Appellate Body, *Brazil – Measures Affecting Imports of Retreaded Tyres* WT/DS332/AB/R (2007); Kennedy (n 626).

⁶³¹ *ibid.*

⁶³² *ibid.*

If ‘trade restrictive’ can be replaced with ‘investment restrictive’, and if the less investment restrictive measure test can be incorporated into the only way test, the less restrictive measure test can supplement the application of the only way test by mediating the *CMS* tribunal’s strict application of the test and the *LG&E* tribunal’s ambiguous application of the test. Therefore, if the arbitral tribunal had employed this elaborated test in applying the principle of necessity, and there was a less restrictive investment measure as an alternative to Argentina’s emergency measures, then the tribunal would not be able to accept the Argentine necessity plea.

2.2.4.4 Conclusion

Along with the four conditions that are required for lawful expropriation, the principles of necessity can be invoked in order to justify the lawfulness of the expropriation when the fact of expropriation has been established. As noted, the interpretation and application of the principles of necessity are based on an appropriate understanding of the relationship between the customary principle of necessity and the BIT-based necessity principle. Because key constituents of the principles of necessity include such protections as the protection of public order and the protection of essential interests, the principles of necessity are very likely to be contested in investment cases involving issues of regulatory expropriation that also include regulatory power and public purpose as key elements. Regulatory expropriation will be explored in the following chapter in detail. The WTO necessity exception test, being the least restrictive measure test, can for now pave the way to developing a more elaborated manner of interpreting and applying the principle of necessity. It is expected that further subsequent research will reveal the potentials that the test may have in contributing to the development of rules of lawful expropriation.

Chapter 3: Regulatory Expropriation

3.0 The Transnational Analysis of Rules of Law on Expropriation

3.0.1 Introduction

A governmental taking of private property can be an issue in the domestic legal arena as well as in the field of international law. Even though a governmental taking of its own citizen's private property and a governmental taking of foreign-owned property cannot be simply equated, both events share the inherent feature of a government's regulatory interference with property rights. There is a paucity of clarity in customary international law and international investment agreements concerning how to establish and evaluate the notion of expropriation. Because similar principles or rules of law exist, a close analysis of the domestic legal regime regarding expropriation can be a useful way to enlighten legal understanding of expropriation; in particular, in terms of the relationship between sovereignty and private property. The advent of the concept 'regulatory expropriation' represents the tension that occurs in the relationship between sovereignty and private property, which raises a critical question as to when a state's sovereign regulation can justifiably interfere with private property. The same question arises in the domestic legal system. Regulatory expropriation originates from indirect expropriation, which is equated with direct expropriation in international investment law.

The concept of expropriation has evolved beyond the original and traditional form of expropriation, which is direct expropriation or nationalisation, to encompass a certain range of indirect expropriation, such as incidental, creeping, consequential, or *de facto* expropriations, which are characterised as exerting a depriving economic effect in the absence of direct taking. Two basic elements take a central place in articulating the underlying framework of international law on both direct and indirect expropriation. These are the 'property' to be protected against expropriation

under international law and ‘a taking’ or ‘an expropriation’ that denotes a deprivation of foreign-owned property. There exist many principles and rules that arbitral tribunals and domestic courts have employed in relation to these two key elements. Among them, focus will be placed on the 5th Amendment of the US Constitution (the so-called US Takings Clause), the NAFTA rules on expropriation, and the jurisprudence of the ECtHR regarding expropriation. Immediately observable is that these provisions exhibit the use of similar terminology regarding expropriation.

The 5th Amendment of the United States Constitution, the so-called US Takings Clause, provides that ‘nor shall private property be taken for public use, without just compensation’.⁶³³ NAFTA, at Article 1110(1), provides provisions dealing with expropriation and compensation:

No Party may directly or indirectly nationalise or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment (expropriation), except:

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1); and
- (d) on payment of compensation in accordance with paragraph 2 through 6.

Article 1 of the First Protocol to the European Convention (Article 1 of Protocol No 1) sets out specific regulation on the protection of property:

Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

⁶³³ The 5th Amendment to the United States Constitution.

The preceding provisions shall not, however, in any way impair the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.⁶³⁴

It can be observed that the US Takings Clause and NAFTA Article 1110 share key concepts, even though they may be slightly different in relation to prescription, and retain shared core notions that can be grouped, such as a ‘property’ (the 5th Amendment) and an ‘investment’ (Article 1110), a ‘taking’ (the 5th Amendment) and an ‘expropriation’ (Article 1110), ‘public use’ (the 5th Amendment) and a ‘public purpose’ (Article 1110), and ‘just compensation’ (the 5th Amendment) and ‘compensation’ (Article 1110). Unlike the 5th Amendment and Article 1110, Article 1 of Protocol No 1 includes terms which in effect share common key notions, such as deprivation, possession, and public interest, but do not explicitly call for compensation. US law on expropriation is of long standing and has the potential to enlighten on principles concerning a state’s regulatory taking of an individual’s property. The practice of the European Convention system regarding expropriation deserves close attention because it contains provisions that exhibit relatively detailed formulations describing expropriation and other types of a state’s interferences with a property. An individual and comparative review of those provisions, rules, and principles will reveal whether they indicate shared ideas or principles behind their language, and, if they do, whether they can provide some useful guidance and contribution in the development of ideas concerning international law on expropriation in general and regulatory expropriation in particular.

3.0.2 US Takings Clause Doctrine

⁶³⁴ Article 1 (Protection of Property) of the First Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms (hereinafter ‘European Convention’).

The 5th Amendment to the United States Constitution (the US Takings Clause) provides that ‘nor shall private property be taken for public use, without just compensation’.⁶³⁵ The basic spirit of the Amendment is directed at restraining the government from taking private property without affording a fair reward and, by so doing, safeguarding personal liberty.⁶³⁶ In the United States, the Supreme Court has played a major role in shaping rules on governmental takings and compensation. The relevant jurisprudence and theories have accordingly developed as the court’s jurisprudence evolved regarding the scope of protected property and what constitutes a taking under the 5th Amendment.

The earlier approaches taken to distinguish a taking from the police power regulation were the ‘physical invasion test’ and subsequently the ‘diminution of economic value test’. Firstly, the physical invasion test was put forward by Justice Harlan in *Mugler v Kansas*.⁶³⁷ This test drew on the conception of property as ‘things-property’, which indicated a thing that is subject to the owner’s rights of ‘free use, enjoyment, and disposal’.⁶³⁸ In this case, Justice Harlan concluded that the regulation concerned did not constitute a taking because no deprivation of property for the public interest occurred and it only imposed a limitation on the use of the property owner.⁶³⁹ The weakness of the physical invasion test has been revealed in the face of Wesley Hohfeld’s criticism that property cannot be things; property can only be ‘rights over things’.⁶⁴⁰ The term ‘property’ can only denote the claims,

⁶³⁵ The 5th Amendment to the United States Constitution.

⁶³⁶ Molly S McUsic, ‘Redistribution and the Takings Clause: A Progressive Critique’ in David Kairys (ed), *The Politics of Law* (3rd edn, Basic Books 1998) 617.

⁶³⁷ 123 US 623 (1887). In this case, the state had prohibited the sale and manufacture of intoxicating liquors. It was claimed by the claimant that the claimant’s breweries were destroyed, or their value was at least materially diminished by the regulation and that this entailed compensation. Joseph L Sax, ‘Takings and the Police Power’ (1964) 74(1) *Yale Law Journal* 36, 38.

⁶³⁸ Leif Wenar, ‘The Concept of Property and the Takings Clause’ (1997) 97(6) *Columbia Law Review* 1923, 1925.

⁶³⁹ Sax (n 637) 36, 38.

⁶⁴⁰ Wesley Newcomb Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning* (Greenwood Press 1978). See Wenar (n 638) 1926.

privileges, powers, and immunities, which people retain, affording them control over ‘objects and spaces’.⁶⁴¹

The approach that subsequently emerged was the ‘diminution of economic value’ test, which materialised from the judgment of Justice Holmes in *Pennsylvania Coal Co v Mahon*. In this case, the court held that a Pennsylvania statute prohibiting all coal mining would drive the town atop the mines out of business.⁶⁴² The test prescribed that the government could lawfully regulate a private property insofar as the regulation did not ‘go too far’ in diminishing the value of the property.⁶⁴³ However, if the regulation went too far, it would be regarded as a taking.⁶⁴⁴ The test seeks to balance a wide range of factors in determining whether the action went too far or ‘unfairly singled out an owner’.⁶⁴⁵ The test relied neither on the property as things nor on the property as rights notion, and instead put primary focus on the loss of economic value sustained by the property owner in distinguishing compensable takings from uncompensable regulations.⁶⁴⁶

With regard to takings claims, two US Supreme Court decisions left diverging precedents in the cases of *Penn Central Transportation Co v New York City* (1978) and *Lucas v South Carolina Coastal Commission* (1992). In *Penn Central*, New York City denied the claimant the Grand Central development scheme pursuant to the Landmark Preservation Law that prohibited the construction of a large building above Grand Central Terminal for the purpose of the protection of architectural structures.⁶⁴⁷ The court took three factors into account in deciding in favour of the city: (i) the economic impact of the measure; (ii) the reasonable investment-backed

⁶⁴¹ *Wenar* (n 638) 1926.

⁶⁴² *Pennsylvania Coal v Mahon* 260 US 393 (1922).

⁶⁴³ Thomas J Miceli, ‘Regulatory Takings: When Should Compensation Be Paid?’ (2008) 23 *The Journal of Legal Studies* no 2 749, 751.

⁶⁴⁴ *Pennsylvania Coal v Mahon* (n 642).

⁶⁴⁵ *McUsic* (n 636) 623.

⁶⁴⁶ *Wenar* (n 638) 1923, 1929.

⁶⁴⁷ *Penn Central Transportation Co v New York City* 438 US 104 (1978); Jordan C Kahn, ‘A Golden Opportunity for NAFTA’ (2008) 16 *NYU Environmental Law Journal* 380, 407–08.

expectation; and (iii) the character of the measure.⁶⁴⁸ On the other hand, in *Lucas v South Carolina Coastal Council*, the court advocated the rule that a regulation constitutes a compensable taking if it deprived a property owner of ‘all economically beneficial uses’.⁶⁴⁹

Subsequently, US jurisprudence on takings, while not fully giving up the balancing method, has substituted it for a new doctrinal test, which is less favourable to governmental regulation. Along with the change, the court focused on two key considerations: (i) whether the regulation impinges on ‘essential’ or ‘fundamental’ property rights, and (ii) whether the regulation ‘substantially advances’ public interests.⁶⁵⁰ Firstly, the ‘essential’ or ‘core’ of property rights has been the so-called dominion interest in land-interests based on the right to control real property.⁶⁵¹

In *Loretta v Teleprompter Manhattan CATV Corp*,⁶⁵² the court denied the validity of a New York statute requiring that a landlord endure the installation of cable television facilities on his or her property for the reason that if a law deprived the whole bundle of dominion interests by prohibiting a property owner from possessing, using, or disposing of a part of his or her property, it was a *per se* taking.⁶⁵³ The primary dominion interest to be afforded almost full compensation in response to the government’s regulation was ‘possession’.⁶⁵⁴ In the two cases of *Nollan v California Coastal Commission* (1987) and *Dolan v City of Tigard*, the government issued a development permit for an expanded building on condition that the property owners provided a public easement. The court held that the loss of the right to exclude an outgrowth of the government’s public easement requirement made that requirement unconstitutional.⁶⁵⁵ The court extended its attention from

⁶⁴⁸ *ibid.*

⁶⁴⁹ 505 US 10003 (1992). The *Lucas* case is recognised as undermining *Penn Central* jurisprudence. Kahn (n 647) 409.

⁶⁵⁰ *McUsic* (n 636) 625.

⁶⁵¹ *ibid.*

⁶⁵² 458 US 419.

⁶⁵³ *McUsic* (n 636) 626.

⁶⁵⁴ *ibid.*

⁶⁵⁵ *ibid.*

possession and began to take into account all economically valuable uses of property.

In *Lucas v South Carolina Coastal Council*, the court, in addressing South Carolina's law inhibiting the build-up of any habitable object in a designated 'critical area' along its coastline, as gauged by annual erosion rates, found a taking, stating that the regulation cannot interfere with all the economically valuable uses of property, except in rare cases. The jurisprudence on the finding of a taking expanded the scope of essential property rights, encompassing such rights as the owner's right to leave a rental business and the right to control a disposition of land;⁶⁵⁶ nevertheless, it did not accept the finding of a taking where the regulation merely restrained profits or prices, or diminished the market value of property.⁶⁵⁷

The 'substantially advance test' was adopted as the court took a stricter stance than the 'rational basis' scrutiny in analysing the relation between the owner, the regulation, and public interests.⁶⁵⁸ Since the late 1930s, property rights have been subject to a 'rational basis test', a test required for the law concerned to be valid. This requires that a rational basis be established between the government's end and the means taken by it.⁶⁵⁹ On the other hand, the 'substantially advance test', a more strictly modified test, was adopted in the analysis of takings cases since *Nollan* in 1987. In this case, the California Coastal Commission, as the California Coastal Act⁶⁶⁰ required, prohibited the Nollans from constructing a family residence on their beachfront land unless they provided, on their land, for a public access easement to the beach.⁶⁶¹ The court nullified the requirement of an easement for public access to

⁶⁵⁶ *ibid* 627–28.

⁶⁵⁷ *ibid*.

⁶⁵⁸ *ibid*.

⁶⁵⁹ *ibid*.

⁶⁶⁰ The Coastal Act (1976) provided that unless certain exceptions applied, 'public access from the nearest public roadway to the shoreline and along the coast shall be provided in new development projects.' Cal Pub Res Code §30212(a) (West 1986).

⁶⁶¹ Andrea L Peterson, 'The Takings Clause: In Search of Underlying Principles: Part I. A Critique of Current Takings Clause Doctrine' (1989) 77 *California Law Review* 1299, 1305–06.

the beach on the ground that the permit requirement did not ‘substantially advance a legitimate state interest’.⁶⁶² The ‘substantially advance test’ is based on two sub-tests: a means-end test and a cause-effect test. The court prescribed that the ‘substantially advance test’ consists of a means-end sub-test that scrutinises whether the regulation in practice accomplishes its stated purpose by the means of its choosing, and a cause-effect sub-test that examines whether there exists a proportionate basis between the amount of public harm caused by the owner and the burden that the regulation imposed.⁶⁶³

5th Amendment jurisprudence was supplemented by the court’s decision in *Lingle v Chevron USA, Inc.*⁶⁶⁴ In this case, the claimant complained of a Hawaiian statute prescribing the limit of rent that oil companies could obtain from their dealers. The lower courts held that the statute ‘fails to substantially advance a legitimate State interest, and as such, effects an unconstitutional taking’.⁶⁶⁵ The higher court reversed this decision, concluding that the purpose and efficacy of a certain regulation is not to be taken into account under the Takings Clause.⁶⁶⁶ After *Lingle*, jurisprudence rendered the consideration of the purpose and efficacy of government acts irrelevant in deciding whether to compensate.⁶⁶⁷ The Takings Clause postulates that the government takes a measure for a legitimate public purpose.⁶⁶⁸

⁶⁶² McUsic (n 636); Peterson (n 661) 628–29.

⁶⁶³ Peterson (n 661) 629.

⁶⁶⁴ *Lingle v Chevron USA, Inc* 544 US 528 (2005).

⁶⁶⁵ *Chevron USA, Inc v Cayetano* 224 F3d 1030, 1033–37 (9th Cir 2000); *Chevron USA, Inc v Cayetano* 57 F Supp 2d 1003, 1014 (D Haw 1998). The US Supreme Court had relied on the ‘substantially advance’ test in a prior takings case, *Agins v City of Tiburon* 447 US 255, 260 (1980); Richard J Lazarus, ‘The Measure of a Justice – Justice Scalia and the Faltering of the Property Rights Movement Within the Supreme Court’ (2006) 57 *Hastings Law Journal* 759, 773.

⁶⁶⁶ *Lingle* (n 664) 548.

⁶⁶⁷ These factors are only relevant in deciding the lawfulness of government actions under the due process clause. The plaintiffs in *Lingle* voluntarily dropped their due process clause claim, so the court did not decide whether the Hawaii statute at issue was valid; *Lingle* (n 664) 549. See also Kahn (n 647) 411.

⁶⁶⁸ *ibid* 543.

The US Takings Clause doctrine has its root in the principle that the need for property protection can impose a certain degree of limits on a regulatory action. It evolved in a way that expanded the scope of property rights to be protected by redefining the definition of property, from things to rights, and encompassing the focus on the economically valuable use of property. The doctrine also refined the analysis of the connection between property rights, the government regulation's public purpose and means, and the regulatory burden on the owner. There exists a basic difference in the respective spirits of the US Takings Clause doctrine and international law on expropriation. The latter seeks to afford investment protection, whereas the US takings law intends to protect individual liberty and rights from unfair governmental regulation. Nonetheless, it will be shown, by way of the following analysis, that there exists an indication of kinship between the US Takings Clause doctrine and NAFTA and European expropriation rules, in light of the underlying balancing principle and the framework of the ends-means and the cause-effect test.

3.0.3 The NAFTA Expropriation Rule

As is true of other arbitral tribunals, the NAFTA tribunal normally confronts two key questions: (i) whether an interest concerned falls within the definition of investment, and (ii) whether the regulatory measure in question constitutes a taking; both under NAFTA Article 1110. Thus, the primary task is to construe the definition of the investment to be protected under NAFTA. For instance, in a case involving cigarette packaging, Philip Morris International claimed that Canadian legislation requiring plain packaging constituted an expropriation under NAFTA.⁶⁶⁹ Carla Hills, a former US trade representative who joined NAFTA negotiations, supported this claim, maintaining that the company's interests fell within the scope of the definition of investment in NAFTA provisions: an investment is 'real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose

⁶⁶⁹ David Schneiderman, 'NAFTA's Takings Rule: American Constitutionalism Comes to Canada' (1996) 46 *University of Toronto Law Journal* 499, 525.

of economic benefit or other business purposes⁶⁷⁰ and that the plain packaging requirement would constitute a taking of the company's registered trademark, entailing the obligation of compensation for the company. In *Pope & Talbot*, the tribunal accepted Pope & Talbot's claim that its market access is a property interest that is afforded protection by NAFTA Article 1110.⁶⁷¹ In *SD Myers*, beyond market access, market share was recognised as a property interest to be protected by Article 1110.

The second issue is what constitutes a taking under NAFTA. In *Glamis Gold*, Glamis Gold argued that the United States unduly delayed approval of its gold-mining project and that the state of California made the project economically unviable by employing an obligatory backfilling requirement for the reason of protecting a Native American area, alleging that all actions constituted a violation of Article 1110. The tribunal rejected Glamis Gold's claim, stating that neither the backfilling requirement nor the interim denial of the project in 2001 constituted direct or indirect expropriation.⁶⁷² The tribunal stated that an expropriation would consist of an 'action that is confiscatory or that unreasonably interferes with, or unduly delays, effective enjoyment of the property',⁶⁷³ and that an indirect expropriation could occur when the state's interference with a property right is eternal and 'renders almost without value the rights remaining with the investor', while not involving the transfer of title.⁶⁷⁴ The tribunal considered that the claimant formally owned its mining rights and could perform its mining work, and that the denial of the project was temporary and the backfilling requirement did not remove the project's economic value.⁶⁷⁵ The case of *DESONA* involved the claim that a regulatory act constituted both direct expropriation and indirect expropriation. In *DESONA*, the claimant alleged that the nullification of *DESONA*'s fifteen-year

⁶⁷⁰ NAFTA, art 1139(g).

⁶⁷¹ Joel C Beauvais, 'Regulatory Expropriations Under NAFTA: Emerging Principles and Lingering Doubts' (2002) 10 NYU Environmental Law Journal 245, 270.

⁶⁷² Stephan W Schill, 'International Decision: Glamis Gold, Ltd. v. United States' (2010) 104 AJIL 253, 256.

⁶⁷³ *ibid* para 354.

⁶⁷⁴ *ibid* para 355.

⁶⁷⁵ *ibid*.

concession contract to provide waste-related services to the city of Naucalpan constituted the direct expropriation of DESONA's contractual rights and the indirect expropriation of DESONA itself.⁶⁷⁶ The tribunal found that the contract was duly invalidated by the Mexican courts on the basis of DESONA's grave 'irregularities' and failure of compliance; thus DESONA's claim was rejected.⁶⁷⁷

As highlighted in *Glamis Gold* and *DESONA*, both direct and indirect expropriations can exist. Furthermore, NAFTA Article 1110 provides for additional language besides direct or indirect nationalisation or expropriation. It is 'a measure tantamount to nationalisation or expropriation'.⁶⁷⁸ In relation to this, an issue arises as to whether the language is intended to create a new treaty-based expropriation or simply reflects what would exist within a broad concept of indirect expropriation as recognised by customary international law. The United States, Mexico, and Canada have all agreed that this language did not create a new type of expropriation beyond what would be prescribed by customary international law.⁶⁷⁹ In relation to the finding of an expropriation, the prime and unavoidable issue is how to distinguish an expropriation and a lawful regulatory interference with private property that does not incur compensation. NAFTA tribunals have shown some differences. The *SD Myers* tribunal definitively drew a clear line between expropriation and non-discriminatory regulatory acts, depending on whether the regulatory acts concerned involved the deprivation of ownership or only amounted to a lesser interference.⁶⁸⁰ The *Pope & Talbot* tribunal, while admitting the probability that regulatory acts falling within the concept of police powers *per se* would not amount to expropriation, stated that 'regulations can indeed be exercised in a way that would constitute a creeping expropriation'.⁶⁸¹ The *Metalclad* tribunal also noted that

⁶⁷⁶ Beauvais (n 671) 268.

⁶⁷⁷ *ibid.*

⁶⁷⁸ NAFTA, art 1110(1).

⁶⁷⁹ Vicki Been and Joel C Beauvais, 'The Global Fifth Amendment?' (2003) 78 NYU Law Review 30, 53.

⁶⁸⁰ Patrick Dumberry, 'Expropriation under NAFTA Chapter 11 Investment Dispute Settlement Mechanism: Some Comments on the Latest Case Law' [2001] International Arbitration Law Review 96, 103.

⁶⁸¹ *Pope & Talbot* (n 135) para 99.

‘covert or incidental interference’ with the use of property could constitute expropriation.⁶⁸² The *SD Myers* tribunal took a rather simple approach by relying on the different degrees of interference with property, recognising that a deprivation of property constitutes an expropriation, whereas the tribunals in *Pope & Talbot* and *Metalclad* accepted that what began as a normal regulatory interference which fell short of a deprivation had the potential of developing into an expropriation.

Once it is concluded that the investment at issue is entitled to protection under NAFTA Article 1110, it will be appropriate for investment arbitral tribunals to become involved in embarking upon further in-depth analysis. The NAFTA tribunal employs the approach, similar to that taken by the US *Penn Central* Court, of considering three main factors: (1) the economic impact of a regulation; (2) the claimant’s expectation; and (3) the character of a government action.⁶⁸³ However, NAFTA and US jurisprudences are different in dealing with the second factor.

First of all, the NAFTA tribunals evaluate the economic impact of a regulation, just as the US Takings Clause doctrine does. They require a substantial economic impact in order to find whether a regulatory action violates Article 1110. For instance, in *Metalclad v Mexico*, the tribunal held that an Ecological Decree, issued by a Mexican state governor, had the effect of permanently preventing the operation of the landfill property owned by the claimant, and ‘effectively and permanently prevented the use by Metalclad of its investment’.⁶⁸⁴ In *Pope & Talbot*, the tribunal declined the claimant’s argument that Canada’s limitation on softwood lumber exports constituted an Article 1110 expropriation for the reason that it merely caused insubstantial economic impact.⁶⁸⁵

The second factor to be considered by arbitral tribunals is ‘the investor’s reasonable investment-backed expectations’ – also the starting point for the US courts in

⁶⁸² Dumberry (n 680) 103 [8].

⁶⁸³ Kahn (n 647) 419.

⁶⁸⁴ *ibid* 420.

⁶⁸⁵ *ibid*.

analysing the investor's expectation.⁶⁸⁶ This consideration is derived from the NAFTA preamble prescribing that states parties 'ensure a predictable commercial framework for business planning and investment'.⁶⁸⁷ The expectation enquiry begins with a question as to the level of regulation; it is whether the claimant conducts business in a 'highly regulated industry'.⁶⁸⁸ In *Methanex*, the tribunal did not accept the claim of a Canadian manufacturer of the prime MTBE ingredient, methanol, that California's prohibition of the gasoline additive MEBE violated Article 1110. The reason for this was that even though the prohibition undermined the economic value of the claimant's investment, the actual business environment of the industry was 'highly regulated' and should be taken into account in the enquiry in relation to the investor's expectation.⁶⁸⁹ In the second phase of the investment expectation enquiry, NAFTA tribunals and the US Takings Clause doctrine diverge in relation to their respective focus. NAFTA tribunals verify whether the investor indeed obtained 'specific assurances', so much so that it could proceed with its operation that was nullified by a regulatory measure.⁶⁹⁰ However, the US Takings Clause doctrine asks whether the challenged regulatory act was 'foreseeable' or could have been 'reasonably anticipated' in view of the 'regulatory environment'.⁶⁹¹ The *Methanex* tribunal required that specific commitments be provided for by the government for a regulation to be neither expropriatory nor compensable.⁶⁹²

With regard to the final factor, NAFTA tribunals, and the US courts that act under the Takings Clause doctrine, both consider the character of governmental acts. However, it has become rather unclear as to whether the Takings Clause doctrine has modified the approach to the character factor subsequent to the *Lingle* decision. On the other hand, NAFTA tribunals seem to have departed from their traditional position in considering the character of governmental acts, as shown in the cases of

⁶⁸⁶ *ibid* 424.

⁶⁸⁷ NAFTA preamble.

⁶⁸⁸ *ibid*; see Kahn (n 647) 424.

⁶⁸⁹ Kahn (n 647).

⁶⁹⁰ *ibid* 425.

⁶⁹¹ *ibid*; *Appollo Fuels* 381 F3d at 1349.

⁶⁹² *ibid*.

Fireman's Fund, *Corn Products* and *Glamis Gold*. Even though the US court in *Penn Central Transportation* took into account the character of governmental acts, along with two additional factors,⁶⁹³ as in the *Lingle* case, it did not further accept that the purpose and the effectiveness of governmental acts would be relevant under the doctrine. It put forward that the doctrine would presuppose that the government acted in pursuit of a legitimate public purpose.⁶⁹⁴ Under Article 1110 of NAFTA, the tribunal in *SD Myers* accepted that 'it is appropriate to examine the purpose and effect of governmental measures'.⁶⁹⁵ According to the tribunal, the purpose and effect of government regulations are considered for the finding of an expropriation.⁶⁹⁶ However, the *Fireman's Fund* tribunal took the position that 'the effects of the host State's measures are dispositive, not the underlying intent, for determining whether there is expropriation'.⁶⁹⁷ This position was subsequently accepted by the *Corn Products International* tribunal.⁶⁹⁸ The tribunal in *Glamis Gold* also considered the character of government regulation, but in a different way. In the finding of an expropriation, the tribunal placed its primary emphasis on a 'sufficient economic impact to effect an expropriation',⁶⁹⁹ however, it did not explore the character at this stage. Instead, it acknowledged that the character – for instance, a non-discriminatory 'bona fide regulation'⁷⁰⁰ – could be a determining factor, which requires consideration in order for a state to be exempt from responsibility. Quoting from the Restatement (Third) of Foreign Relations, the tribunal held that 'a state is not responsible ... for loss of property or for other economic disadvantage resulting from bona fide ... regulation if it is not

⁶⁹³ *Penn Central Transportation Co* (n 647).

⁶⁹⁴ *Lingle* (n 664).

⁶⁹⁵ *SD Myers* (n 261) para 281.

⁶⁹⁶ *ibid.* From paragraph 280 through to 282, the *SD Myers* tribunal, in clarifying the meaning of expropriation, made a distinction between expropriation and regulation. In this regard, the examination of the purpose and effect of government is directed at finding an expropriation.

⁶⁹⁷ *Fireman's Fund Insurance Company v Mexico* (Award) 17 July 2006 (ICSID Case No ARB(AF)/02/01) ICSID Additional Facility, para 176.

⁶⁹⁸ *Corn Products International, Inc v The United Mexican States* (Decision on Responsibility) 15 January 2008 (ICSID Additional Facility Case No ARB(AF)/04/01) paras 87–88.

⁶⁹⁹ *Glamis Gold* (n 408) para 536.

⁷⁰⁰ *ibid* para 354.

discriminatory'.⁷⁰¹ In this respect, NAFTA expropriation jurisprudence seems to move away from the position set out in *SD Myers*. One question thus remains as to whether the purpose or character of a governmental act, even though it may not serve for finding an expropriation, functions only as an exemption justification; this will be reviewed later in relation to regulatory expropriation.

It can be inferred that in the context of NAFTA, NAFTA Article 1110 could be broadly construed in a way that expands the scope of application beyond the reach of the US Takings Clause doctrine. This inference can be drawn by focusing on the two key elements factored into arbitral award-making: (1) the scope of takings, and (2) the level of compensation. The first question in identifying the scope of takings is the definition of the property to be protected. The US Takings Clause doctrine concentrates on real property, namely, land and the benefits stemming from the use of land.⁷⁰² Thus, the US Takings Clause doctrine has mainly been concerned with certain questions, such as where the borderline of the land affected by the regulation can be drawn and whether the right affected by the regulation is so fundamental to ownership that the nullification of the right has the equivalent effect of a physical deprivation of the land.⁷⁰³ The US Supreme Court employed a narrower scope to property that it deems to be worthy of protection than that adopted by NAFTA tribunals. In *Andrus v Allard*, the court dealt with a claim that a ban on the transaction of specific goods amounted to a taking. This claim was rejected, and the court stated that the property could be economically used in alternative ways.⁷⁰⁴ The conclusion was premised on the opinion that a mere deprivation of one 'strand' from a full bundle of rights would not constitute a taking.⁷⁰⁵ On the other hand, some NAFTA tribunal have shown that it does not deny the entitlement to protection for a specific right stemming from a bundle of property rights. In the case of *Pope & Talbot*, the tribunal did not accept the expropriation claims. However, it

⁷⁰¹ *ibid.*

⁷⁰² Been and Beauvais (n 679) 64.

⁷⁰³ *ibid.*

⁷⁰⁴ *ibid* 65–66.

⁷⁰⁵ *ibid.*

did embrace the claimant's claim that the right to sell its product in a certain market,⁷⁰⁶ namely, the right to market access, can constitute an investment that is subject to the protection against expropriation provision under NAFTA, and thus it demonstrated that it would construe the definition of property subject to protection more expansively than the US Takings Clause doctrine.

As for compensation, the NAFTA expropriation rule and the US Takings Clause doctrine can show stark differences when dealing with the compensation requirement, especially as to whether a judicial act can constitute a taking and thus incur the obligation of compensation. US courts have not accepted that a claim for a judicial taking may be established. For instance, in *Brinkerhoff-Faris Trust & Sav Co v Hill*, the court held that the

mere fact that a state court has rendered an erroneous decision on a question of state law, or has overruled principles or doctrines established by previous decisions on which a party relied, does not give rise to a claim under the Fourteenth Amendment,⁷⁰⁷

Whereas, NAFTA tribunals have accepted the possibility that a judicial act could constitute an expropriation in violation of NAFTA Article 1110. For instance, in the *Loewen* case, Loewen claimed that a series of judicial decisions made unfavourably to Loewen constituted an expropriation in violation of NAFTA Article 1110. The defending United States opposed the arbitration's jurisdiction, on the ground that a judicial decision cannot fall within the concept of a 'measure' in NAFTA Article 1110. The tribunal held that the term 'measures' in Chapter 11 does not exclude judicial acts.⁷⁰⁸ In this regard, the takings doctrine of NAFTA more readily accepts

⁷⁰⁶ *Pope & Talbot* (n 135).

⁷⁰⁷ *Brinkerhoff-Faris Trust & Sav Co v Hill* 281 US 673, 680 (1930).

⁷⁰⁸ *The Loewen Group, Inc and Raymond L Loewen v USA* 7 ICSID Rep 421 (2005) (Decision on Hearing of Respondent's Objection to Competence and Jurisdiction) 5 January 2001 (ICSID Case No ARB(AF)/98/3) para 49.

an expropriation claim concerning a judicial taking than the US Takings Clause doctrine.

3.0.4 The European Convention on Human Rights Expropriation Rule

Article 1 of Protocol No 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms (ECHR) provides provisions for expropriation and several rules and principles that are relied upon by the European Court of Human Rights (ECtHR) in determining whether a regulatory act constitutes an expropriation or is deemed to be a lesser regulatory interference. With a focus on expropriation, these rules and principles will be termed the European Convention expropriation rule.

Article 1 of Protocol No 1 to the ECHR provides for the rule on the protection of property, as follows:

Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.⁷⁰⁹

Article 1 can be summarised as follows: (i) the general guarantee of the peaceful enjoyment of the owner's property; (ii) no deprivation of property rights can be allowed unless certain conditions are met; and (iii) a state is entitled to enact legislation designed to control the use of property in pursuit of the general

⁷⁰⁹ Article 1 (Protection of Property) of the European Convention.

interest.⁷¹⁰ In this regard, under the ECHR, a state can exercise its right to expropriate private property in pursuit of the general interest. Several rules and principles are drawn from Article 1 that may operate in governing expropriation and lesser regulatory interferences.

Firstly, under the ECHR, a state is entitled to exercise its sovereign discretion to serve the essential interests of a democratic society.⁷¹¹ Articles 8 to 11 of the European Convention on Human Rights share a common structure that consists of two paragraphs. The first paragraph prescribes private rights, and the second prescribes a state's right to interfere with the rights, pursuant to the law, when a democratic society demands it in the public interest.⁷¹² Here, the European Convention on Human Rights adopts the 'margin of appreciation' doctrine to determine the extent to which a state can interfere with private rights without being subject to international scrutiny by the organs of the European Convention on Human Rights.⁷¹³ The ECtHR manages the scope of the margin of appreciation by considering three factors. It first assesses how fundamental a right is, which indicates how strictly it should be protected.⁷¹⁴ This evaluation produces a 'rights hierarchy' by scrutinising whether the right in question is expressed in broad terms, or whether the relevant language permits a state to restrain the right in question. In the former case, a state can enjoy very limited discretion and, in the latter case, a state can exercise wider discretion.⁷¹⁵ Next, the court views it as significant if there

⁷¹⁰ Article 1 of Protocol No 1 to the European Convention.

⁷¹¹ Peter Muchlinski, *Multinational Enterprises and the Law* (2nd edn, OUP 2007) 513.

⁷¹² *ibid.* See Articles 8 to 11 of the European Convention on Human Rights. For instance, Article 8 provides with regard to the 'right to respect for private and family life', that 'there shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national security, public safety or the economic well-being of the country ... for the protection of health or morals, or for the protection of the rights and freedom of others.'

⁷¹³ *ibid.*

⁷¹⁴ Elyse M Freeman, 'Regulatory Expropriation under NAFTA Chapter 11 and Some Lessons from the European Court of Human Rights' (2003) 42 *Columbia Journal of Transnational Law* 177, 197–98. See Laurence R Helfer, 'Adjudicating Copyright Claims Under the TRIPs Agreement: The Case for a European Human Rights Analogy' (1998) 39 *Harvard International Law Journal* 357, 406–08.

⁷¹⁵ *ibid.*

is any common standard among the Convention's signatories in regard to when such an interference with a right is justified.⁷¹⁶ If there is little consensus, the defendant state is entitled to a wide margin of appreciation.⁷¹⁷ Thirdly, the court creates a public 'interests hierarchy' based on the public interest advocated by the state defendant for restraining a right.⁷¹⁸ These three factors are usually considered on the basis of the strong presumption that a state validly restrains property rights in pursuit of public interests.⁷¹⁹ Accordingly, the court defers the legislature's determination as to what is in the public interest, unless the determination clearly lacks a reasonable basis.⁷²⁰

The ECHR employs the 'fair balance' test. It refers to a principle where, even in the case where a state is acting properly, 'a fair balance should be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights' so that the individual does not bear an unreasonably heavy burden.⁷²¹ Compensation is a factor to be taken into account in judging whether a regulatory act in issue conforms to the fair balancing test and whether it causes an undue burden to the claimant.⁷²² In this respect, it is very likely that a deprivation of property cannot be justified without adequate compensation. On the other hand, when a regulator interferes with the control of a property's use and the burden of interference is heavy, then the interference will not be justified without due compensation.⁷²³ Such regulatory interferences are deemed to be deprivations under the European Convention.⁷²⁴ As long as the property owner does not suffer a heavy burden due to the interference, it will not entail compensation.

⁷¹⁶ *ibid.*

⁷¹⁷ *ibid.*

⁷¹⁸ *ibid.*

⁷¹⁹ Freeman (n 714) 198; Monroe Leigh, 'European Human Rights Convention – Compensation to Nationals Following Expropriation of Property' (1987) 81 AJIL 425, 426.

⁷²⁰ *ibid.* 199.

⁷²¹ *ibid.* 188; Helen Mountfield, 'Regulatory Expropriations in Europe: The Approach of the European Court of Human Rights' (2002) 11 NYU Environmental Law Journal 136, 142.

⁷²² *Holy Monasteries v Greece* (1994) Series A No 301 ECtHR 3, 35.

⁷²³ Freeman (n 714) 195.

⁷²⁴ *ibid.*

Under Article 1 of Protocol No 1 to the ECHR, the notion of property or ‘possession’ is broadly construed as a range of economic interests.⁷²⁵ The deprivation of possession connotes a wide range of expropriations in that it implicitly encompasses the removal of the peaceful enjoyment of private property or one’s possession. In this regard, the deprivation indicates not only a formal transfer of ownership but also an indirect or *de facto* expropriation. The ECtHR recognises that indirect expropriation can take place. The court has accepted that an expropriation could take place even though it did not take the form of an ordinary expropriation. It stated in *Sporrong* that ‘in the absence of a formal expropriation ... the Court considers that it must look behind the appearances and investigate the realities of the situation complained of’.⁷²⁶ Thus, when can an indirect expropriation occur from the perspective of the ECtHR? The court, in *Papamichalopoulos*, recognised that if an interference, other than a formal expropriation, were too burdensome, then a *de facto* expropriation would take place. In this case, Greek nationals had been deprived of their property by a dictatorship. After the end of the dictatorship, the nationals received neither alternative land nor fair compensation. The court held that ‘the physical occupation of land was so extensive and the possibility of dealing with it in any useful way so remote that there was a *de facto* expropriation’.⁷²⁷

The scope of the control on the use of property may vary and it is not always clear as to whether it can constitute an expropriation. If a property consists of a conventional ‘bundle of rights’, the removal of one right is not usually regarded as an expropriation; rather, such interference would simply constitute a ‘control of use’ of the property.⁷²⁸ Any measure that imposes limits on private property, but falls short of constituting an expropriation, will be recognised as a control of use. Such measures may be, for example, ‘planning controls, environmental order, rent control, import and export laws, economic regulation of professions, the seizure of

⁷²⁵ *ibid* 189.

⁷²⁶ *Sporrong and Lönnroth* (1982) Series A No 52 ECtHR 24.

⁷²⁷ *Papamichalopoulos v Greece* (1993) Series A No 260 ECtHR 55.

⁷²⁸ Freeman (n 714) 192.

property for legal proceedings or inheritance laws'.⁷²⁹ Whether the control of use of the property can constitute an expropriation is determined by the application of the fair balance test. When a regulatory interference is deemed to be a control of use, then as long as it does not cause undue burden, it does not entail compensation.⁷³⁰ However, if the control of use causes the property owner to suffer a heavy burden due to regulatory interference, the interference cannot be justified without adequate compensation.⁷³¹ Such interferences are regarded as deprivations under the European Convention.⁷³² In addition, some regulatory interferences, which are neither classified as a deprivation nor a control of use, may entail compensation if the interference causes the property owner to bear a disproportionate burden under the fair balance test.⁷³³

3.0.5 A Comparative Review of the US Takings Clause Doctrine, the NAFTA Expropriation Rule and the European Convention on Human Rights Expropriation Rule

When considering the US Takings Clause doctrine, the NAFTA expropriation rule and the European Convention on Human Rights expropriation rule, it may be difficult to find exactly the same elements in their doctrines and rules. Nonetheless, it may be viable to draw from this comparative analysis certain rules or principles that share similar or common ideas running through the respective legal systems.

The noticeable feature that is most commonly observable among the US Takings Clause doctrine, the NAFTA expropriation rule, and the European Convention on Human Rights expropriation rule is that the purpose of the governmental measure in question is not a determinant for the finding of an expropriation. In US Takings Clause jurisprudence, subsequent to the *Lingle* case, the purpose became an

⁷²⁹ *ibid* 193; *Allan Jacobsson v Sweden* (1989) Series A No 163 ECtHR.

⁷³⁰ *Freeman* (n 714) 194.

⁷³¹ *ibid* 195.

⁷³² *ibid*.

⁷³³ *ibid* 200.

irrelevant factor. Similarly, NAFTA tribunals have shown in recent cases that they do not recognise the character or purpose of a regulatory act as being determinative for the finding of an expropriation. Additionally, the European Convention expropriation rule is not concerned with the character of a measure in finding expropriation.

When conducting a comparison, it is apparent that the primary concern of all is the economic effect that a government measure causes to a property. A finding of expropriation does not necessarily rely completely on the degree of interference with property, but does so to a significant extent. Since US Takings Clause jurisprudence adopted the physical invasion test, and afterwards replaced it with the diminution of economic value test, the impact of the measure in question has consistently been the major consideration. The same is true of NAFTA arbitral jurisprudence, as shown in arbitral cases. For example, the *SD Myers* tribunal distinguished between deprivation of ownership and lesser interference in finding expropriation, and the *Glamis Gold* tribunal admitted the occurrence of an indirect expropriation when a state's interference renders property rights almost valueless. Article 1 of Protocol No 1 to the European Convention essentially distinguishes between the deprivation of an owner's possession and the control of the use of the property when considering expropriation. It relies on the notion of deprivation and the proportionality principle, requiring a balancing exercise between the demands of the public interest and the requirement to protect fundamental rights.

On the basis of this comparative analysis, it can be observed that when conducting the task of finding expropriation, the US Takings Clause doctrine, the NAFTA expropriation rule, and the European Convention on Human Rights expropriation rule operate within the framework of the ends-means and cause-effect, as can be noticed from the observation of the 'substantially advance' test and the principle of proportionality.

3.1 The Concept and Conditions of Regulatory Expropriation

3.1.1 Introduction: Indirect Expropriation versus Regulatory Expropriation

Regulatory expropriation is recognised as a type of indirect expropriation. Indirect expropriation is a concept that is primarily relied upon to categorise a range of forms of expropriation other than direct expropriation as, although it does not involve a definite seizure of foreign-owned property, or any physical transfer of occupation or ownership of property, it still interferes with the use of or the economic benefit of property. Because the concept of indirect expropriation has not been concretely defined in international legal instruments, its meaning has been contested and still remains an open-ended question. There are several formulations that reflect varying forms of indirect expropriation, such as equivalent, tantamount, *de facto*, creeping, constructive, disguised, consequential, and regulatory expropriations.⁷³⁴ All these formulations share a common feature in that they involve the effect-based criterion. They can, however, possibly differ in characterising a legal link between a regulatory measure and the effect of the economic deprivation. The definition of indirect expropriation is effectively summarised by the tribunal in *Starrett*:

It is recognised in international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been 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.⁷³⁵

Additionally, the Restatement (Third) describes creeping expropriation as a situation where a state obtains the ‘same result (as with formal expropriation) by taxation and

⁷³⁴ Newcombe (n 1) 325.

⁷³⁵ *Starrett Housing Corporation* (n 443) 154.

regulatory measures designed to make continued operation of a project uneconomical so that it is abandoned'.⁷³⁶

Both the tribunal's award and the Restatement's description accept 'negative economic effect' as the central factor in reaching the conclusion that an indirect expropriation has occurred. The NAFTA tribunals in *Pope & Talbot v Canada* and *SD Myers* held that the phrase 'measure tantamount to nationalisation or expropriation' in NAFTA Article 1110, which indicates an indirect expropriation, does not broaden the ordinary concept of expropriation; tantamount means 'equivalent' and does not expand the meaning of expropriation. The *Waste-management* tribunal held that the meaning does not extend beyond what would be recognised by customary international law. Nonetheless, as in *Glamis Gold*, customary international law is not static and may evolve. Thus, the definition of the concept can change if customary international law evolves.

Indirect expropriation is a broad concept that conceptually encompasses all ranges of non-direct forms of expropriation. From the perspective of functionality, the notion itself may be neither effective nor precise enough for arbitral tribunals to depend on in finding such a type of expropriation. Furthermore, it may not effectively distinguish compensable indirect expropriation from an ordinary regulation that does not incur the obligation to compensate. In response to this challenge, it may be a viable solution to reconceptualise regulatory expropriation in such a way that the scope of the concept can be narrower and more specific than the term 'indirect expropriation', that encompasses the broad range of non-direct expropriation.

The reconceptualisation of regulatory expropriation will be able to promote or encourage an arbitral tribunal to give well-balanced and proper care to the public and private interests that are involved in investment disputes. Nevertheless,

⁷³⁶ American Law Institute, Restatement (Third) Foreign Relations of the United States (1987) vol 1, s 712, comment g.

regulatory expropriation cannot be defined with perfect definitiveness and arbitral tribunals are still left with a wide discretion in conducting a case-by-case analysis during the inquiry in relation to expropriation. Even so, it is likely that the reconceptualisation will bring about a more elaborated and prudent analysis than the case of the mere reliance on indirect expropriation.

Regulatory expropriation can be reconceptualised and newly established on the basis of a simple analysis of the central elements that constitute regulatory expropriation and with certain conditions for establishing regulatory expropriation. Particularly, the conditions, which will be identified, will serve, along with the use of the doctrine of police power, to find regulatory expropriation.

3.1.2 Key Constituents and *Bona Fide* Regulatory Expropriation

3.1.2.1 The State's Regulatory Autonomy and the State's Regulatory Interference with Property

Regulatory expropriation mainly consists of two key elements: a state's regulatory autonomy and a state's regulatory act of interfering with foreign-owned property that is regarded as expropriation. A state's regulatory autonomy can be defined as the exclusive authority that a state can exercise within its territory under its sovereignty. Sovereignty is the core basis of principles and rules of international law. The basic premise underlying international legal supervision on state conduct is based on a degree of deference to sovereignty. In examining breaches of investment treaty violations, tribunals maintain some measure of deference to a state's authority to regulate. Tribunals recognise a considerable degree of deference. For instance, the tribunal in *SD Myers* stated, in determining the breach of fair and equitable treatment, as follows:

The Tribunal considers that a breach of Article 1105 occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner

that the treatment rises to the level that is unacceptable from the international perspective. That determination must be made in light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders.⁷³⁷

Also, in examining the conditions for lawful expropriation, a tribunal gives deference to a state in its determination of public interest.⁷³⁸ Under NAFTA Chapter 11, a tribunal should not substitute its own judgments for those of the legislature or administration, and it is limitedly allowed to determine the occurrence of violations of international law.⁷³⁹ Even so, deference may not be limitless. For instance, this is demonstrated in *Tza Yap Shum v Peru*,⁷⁴⁰ where a claim was raised against the Peruvian tax authorities' taxes and interim measures on the claimant's investment, which was involved in the management of the purchase of raw materials. The tribunal emphasised that the deference to a state's regulatory power would be governed by the 'principle of reasonableness and non-arbitrariness', reflected in international as well as in domestic law, and concluded that the Peruvian measures at issue were arbitrary and unjustified because, in taking interim measures, the tax authorities failed to base those measures on a reasonable and non-arbitrary basis.⁷⁴¹

Sovereignty and, in particular, a state's regulatory autonomy to regulate economic affairs are well articulated in Articles 1 and 2(1) of the Charter of Economic Rights and Duties of States:

Article 1

Every state has the sovereign and inalienable right to choose its economic system as well as its political, social and cultural systems in accordance with the

⁷³⁷ *SD Myers* (n 261) para 63.

⁷³⁸ *Siemens* (n 230) para 273.

⁷³⁹ Schill, 'International Decision' (n 672) 257.

⁷⁴⁰ *Tza Yap Shum* (n 491).

⁷⁴¹ *ibid* 6–7.

will of its people, without outside interference, coercion or threat in any form whatsoever.

Article 2(1)

Every state has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities.⁷⁴²

According to the OECD Draft Convention on the Protection of Foreign Property, a state has the ‘sovereign right to deprive’ a foreigner of property located within its territory ‘in the pursuit of its political, social or economic ends’.⁷⁴³ Also, Article 1114 of NAFTA provides that a state has the right to take any measure that ‘it considers appropriate’ to regulate a private investment for the consideration of environmental concerns.

A state’s regulatory autonomy can be expressed in another way; for instance, by the so-called ‘margin of appreciation’. The margin of appreciation is a doctrine of deference adopted by the ECtHR for determining whether a state has complied with its obligations under the ECHR. It refers to a ‘space for manoeuvre’, within which state conduct is exempt from ‘fully fledged review’ by an international judicial body.⁷⁴⁴ While it has been developed to discern the distinction between ‘primary national discretion’ and ‘subsidiary international supervision’, the ECHR affords greater deference to the exercise of regulatory autonomy by employing the presumption in support of the legitimacy of a state’s interference with private

⁷⁴² The Charter of Economic Rights and Duties of States is UN General Assembly Resolution 3281 of 1974.

⁷⁴³ OECD Draft Convention on the Protection of Foreign Property, 18.

⁷⁴⁴ Stephan W Schill, ‘Deference in Investment Treaty Arbitration: Reconceptualizing the Standard of Review Through Comparative Public Law’ National University of Singapore Working Paper No 2012/33, 6.

property.⁷⁴⁵ The court endorses the legislature's determination of what is 'in the public interest', unless the determination lacks reasonable basis.⁷⁴⁶

Regulatory autonomy forms a core concept of police power. Police power refers to a state's regulatory autonomous power which it can exercise without international legal interference, in pursuit of public purposes, such as health, safety, national security, and so on. When a state exercises its police power, it does not incur state liability under international law. The *Methanex* tribunal held as follows: 'It is a principle of customary international law that, where economic injury results from a *bona fide* regulation within the police powers of a state, compensation is not required'.⁷⁴⁷

In spite of the international legal recognition of a state's sovereign regulatory autonomy, a state's economic right to take measures in pursuit of public objectives, in conflict with private interests, has been the subject of legal contention. For instance, recently, a state's 'plain' or 'standardized' tobacco packaging measures for health has been in issue, not only in the international investment law regime, but also in the World Trade Organisation (WTO) mechanism. Philip Morris Asia Limited (Philip Morris) was engaged in the production and distribution of tobacco products in Australia. Australia enacted a plain packaging legislation in 2011, which controlled the size, appearance, and shape of packaging. Philip Morris initiated arbitral proceedings against Australia under UNCITRAL Arbitration Rules and claimed that the legislation would expropriate Philip Morris' investments by causing the substantial deprivation of intellectual property and goodwill, and the destructive reduction in economic value of the relevant investment.⁷⁴⁸ Also, the Dominican Republic challenged the legislation for its violation of WTO obligations under

⁷⁴⁵ Freeman (n 714) 197.

⁷⁴⁶ *ibid* 198–99.

⁷⁴⁷ *Methanex Corporation v United States of America* (Final Award on Jurisdiction and Merits) 3 August 2005 NAFTA, p IV, para 410.

⁷⁴⁸ Notice of Claim under the Australia-Hong Kong Agreement for the Promotion and Protection of Investments, para 10(a); 'Philip Morris Launches Legal Battle Over Australian Cigarette Packaging' <www.ictsd.org/bridges-news/bridges/news/philip-morris-launches-legal-battle-over-australian-cigarette-packaging> accessed 12 July 2015.

Trade-Related Aspects of Intellectual Property Rights (TRIPS), which covers trademarks.⁷⁴⁹

The second key component of regulatory expropriation is a regulatory act or measure interfering with foreign-owned property. In an ordinary sense, a measure refers to a governmental act, and can usually be regarded to mean any law, regulation, procedure, requirement or practice.⁷⁵⁰ If a governmental measure is considered to directly seize a foreign-owned property or deprives the owner of a substantial part of it, it is readily recognised as direct expropriation. If a measure, while not taking the form of direct expropriation, is evaluated as amounting to expropriation, it is an indirect expropriation. Nationalisation or direct expropriation has been recognised as the traditional form of the governmental taking of property, whereas indirect expropriation reflects the advent of non-traditional types of expropriation. When a state's regulatory act or measure constitutes an indirect expropriation has been observed in the previous chapter, in terms of the deprivation of a foreign-owned investment. Therefore, how can a *bona fide* regulatory expropriation be described or characterised?

3.1.2.2 *Bona Fide* Regulatory Expropriation

The main focus of this thesis is directed at *bona fide* regulatory expropriation. *Bona fide* in a simplistic sense means 'with sincere intentions',⁷⁵¹ or 'made in good faith'⁷⁵² or 'without fraud'.⁷⁵³ Even though the term *bona fide* has a simple meaning, the frequent reference to the term in international legal instruments concerning the determination of expropriation appears to indicate that it may function as a decisive element in the task of this determination. It can be observed that the term *bona fide* appears in conjunction with the term 'police power' in treaty languages and arbitral

⁷⁴⁹ *ibid.*

⁷⁵⁰ NAFTA, art 201.

⁷⁵¹ Cambridge Dictionary.

⁷⁵² Black's Dictionary.

⁷⁵³ *ibid.*

awards. Both terms play the role of disqualifying a type of regulatory measure from an indirect expropriation. First of all, the tribunal in the *Sedco, Inc* case provided that ‘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 states’.⁷⁵⁴ Also, the tribunal in *Emmanuel Too* provided that ‘A state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation or any other action that is commonly accepted as within the police power of states’.⁷⁵⁵

The Investment Agreement for the COMESA Common Investment Area has recourse to *bona fide* and the principle of police power in differentiating an ordinary regulatory measure from an indirect expropriation:

Consistent with the right of states to regulate and the customary international law principles on police powers, *bona fide* regulatory measures taken by a member state that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, shall not constitute an indirect expropriation under this Article.⁷⁵⁶

According to the United States Third Restatement of the Law of Foreign Relations, *bona fide* regulation and ‘other action of the kind that is commonly accepted as within the police power of state’ are permissible regulatory measures.⁷⁵⁷ In summary, when a regulatory measure is taken *bona fide* and in the exercise of the police power, it does not constitute an indirect expropriation. From the conceptual perspective, *bona fide* regulatory expropriation, which is clearly a type of expropriation, may be positioned at a certain point on the spectrum ranging from *bona fide* regulation, conducted within the accepted police power, to a type of

⁷⁵⁴ *Sedco, Inc v National Iranian Oil Co* (1985) 9 Iran-USCTR 248, 275.

⁷⁵⁵ *Emmanuel Too v Greater Modesto Insurance Associates and the United States of America* (Award) (1989) Iran-USCTR vol 23, 1989–II, 378.

⁷⁵⁶ Article 20(8) of the Investment Agreement for the COMESA Common Investment Area of 2007.

⁷⁵⁷ US Third Restatement of the Law of Foreign Relations, s 712, comment g (1987).

indirect expropriation. In this regard, the concept may demand a careful observation when evaluating it.

On the other hand, the opposite concept is ‘bad faith’. In the case of *Neer*, the Mexico-US Claims Commissioners referred to the notion of ‘bad faith’ in identifying when the treatment of an alien could constitute international delinquency, as follows:

The treatment of an alien, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to wilful neglect of duty, or an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognise its insufficiency.⁷⁵⁸

As shown, bad faith is an element to be taken into account in deciding an international delinquency in terms of the treatment of alien. In this respect, the concept of *bona fide* can be understood as a legal element that may demonstrate a definite distance from an international delinquency. *Bona fide* is a significant, not necessarily absolute, consideration for exempting a regulatory measure from indirect expropriation scrutiny.

3.1.3 Conditions for Establishing Regulatory Expropriation

3.1.3.1 Introduction

According to international investment agreements and customary international law, an expropriation should be made for a public purpose in accordance with the principles of due process, in a non-discriminatory way, and with the award of adequate compensation. These conditions serve to determine the lawfulness of expropriation, but do not help to articulate the definition of expropriation. They should be distinguished from the conditions that are used to establish indirect

⁷⁵⁸ *Neer* (n 55) para 4.

expropriation. The conditions for establishing indirect expropriation have in prior periods been absent, with only the four conditions for lawful expropriation being in existence. However, conditions began to appear in the US and Canada Model BITs and subsequently with the US BITs with other countries. These Model BITs and other BITs share common elements with the three-part *Penn Central* test. This test was created by the US Supreme Court in *Penn Central Transportation Co v New York City* and subsequent cases, which examined the following three factors:

- (a) the economic impact of the regulation on the claimant;
- (b) the extent of interference with the property owner's reasonable investment-backed expectations; and
- (c) the character of the government action.⁷⁵⁹

The 2012 United States Model BIT at Annex B.4(a) provides that the determination of an indirect expropriation should consider the following factors:

- (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation occurred;
- (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
- (iii) the character of the government action.⁷⁶⁰

The 2004 Canada Model BIT also contains similar rules in Annex B.13(1), and subsequent BITs or FTAs do as well, such as the United States' FTAs with Australia (2004), CAFTA-DR (2004), Morocco (2004) and Peru (2006); Canada's BITs with Peru (2007), and Romania (2009); Australia-Chile (2008), and India-

⁷⁵⁹ Gary H Sampliner, 'Arbitration of Expropriation Cases Under U.S. Investment Treaties – A Threat to Democracy or the Dog That Didn't Bark?' (2011) 14 ICSID Review 11.

⁷⁶⁰ Annex B [Expropriation] 4(a) of the United States Model BIT of 2004.

Republic of Korea (2009).⁷⁶¹ Most provisions concerning indirect expropriation that are found in recent FTAs and BITs are based on the United States and Canadian Model BITs.⁷⁶² In particular, the 2008 China-New Zealand FTA recognises additional conditions for scrutinising a state's conduct, including proportionality, discrimination, and the breach of the state's previous written commitments to the investor.⁷⁶³

These three conditions, set out above, are taken into account generally for the finding of an indirect expropriation. With regard to regulatory expropriation, additional conditions can be sought in order to aid with the finding of such an expropriation. This is possible because certain distinctive features can be observed when a regulatory expropriation occurs. Thus, for regulatory expropriation, along with the above three conditions, a further examination needs to be conducted regarding the intention and motive of governmental conduct, proportionality, and the exercise of the police power. The tribunal in *Fireman's Fund Ins Co v Mexico*, for instance, enumerated the conditions to be taken into account for the finding of a compensable expropriation, as follows:

To distinguish between a compensable expropriation and a non-compensable regulation by a host state, the following factors (usually in combination) may be taken into account: whether the measure is within the recognised police powers of the host state; the (public) purpose and effect of the measure; whether the measure is discriminatory; the proportionality between the means employed and the aim sought to be realised; and the *bona fide* nature of the measure.⁷⁶⁴

The conditions which may be selected when considering whether regulatory expropriation has occurred can vary case-by-case or tribunal-by-tribunal. Even so,

⁷⁶¹ Annex B.13(1) of the Canada Model BIT of 2004; UNCTAD, 'Expropriation: a Sequel' 58.

⁷⁶² UNCTAD (n 417) 60.

⁷⁶³ *ibid.*

⁷⁶⁴ *Fireman's Fund* (n 697).

some conditions can be derived from scholarly discussions and the review of investment cases that exhibit shared concerns with regard to indirect and regulatory expropriation. In the following pages, certain conditions will be explored, derived from analysing relevant elements of regulatory expropriation.

3.1.3.2 Factors that can be Considered as Conditions for Establishing Regulatory Expropriation

3.1.3.2.1 Intention and Motive

In the finding of regulatory expropriation, the intent of a government taking a regulatory measure receives relatively less attention than the effect of an act of expropriation in international investment law.⁷⁶⁵ This is because the effect of an act is the strongest indicator that a regulatory interference with a foreign-owned property has caused an indirect expropriation. In international law, malice or *dolus*, namely an intention to cause harm, has no relevance in state responsibility.⁷⁶⁶ *Mens rea* has never been relied upon to oblige a state to make an award of compensation for expropriation.⁷⁶⁷

For instance, in the case of *Phillips*, the tribunal held that a government's liability to compensate for the expropriation of foreign-owned property is not decided by whether expropriatory intent was involved.⁷⁶⁸ Instead, rather than serving as a condition for state responsibility, the intention or motive of a government retains effective evidentiary value. It can establish 'imputability' when it is proven that *dolus* existed on the part of a government organ, and it can provide clues as to the

⁷⁶⁵ *Tippetts, Abbott, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran* (1984) 6 Iran-USCTR 219, 225–26.

⁷⁶⁶ Brownlie (n 238).

⁷⁶⁷ Subedi (n 8) 79.

⁷⁶⁸ *Phillips Petroleum* (n 501) 115; Simon Baughen, 'Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven' (2006) 18(2) *Journal of Environmental Law* 207, 210.

remoteness of damage and the breach of duty.⁷⁶⁹ It can also help to establish causality between a state's regulatory measure and the deprivation of a foreign-owned investment.⁷⁷⁰ As for the intention to expropriate in the simple sense, the fact that the expropriation was intended does not affect the issue of state responsibility. On the other hand, when such an intention, which did not exist at the beginning of a regulatory measure, surfaces at a later stage, it can assist tribunals to verify the emergence of an expropriation and choose the moment of valuation for compensation.⁷⁷¹

3.1.3.2.2 The Depriving Effect of a Regulatory Measure

Regulatory expropriation is a concept that originates from the broad notion of indirect expropriation. The former is a concept that is intended to shed light on the aspect of a state's exercise of regulatory power in conducting indirect expropriation scrutiny. The former and the latter concepts both share a fundamental factor, namely, the depriving effect that a regulatory measure at issue gives rise to. A range of formulations of economic deprivation that is involved in the occurrence of indirect expropriation have been observed in the preceding chapter. There are also certain deprivations that cannot be qualified as indirect expropriation. The same principles apply when dealing with regulatory expropriation.

3.1.3.2.3 Legitimate Expectation

A foreign investor's legitimate expectation concerns the regulatory framework at the time when an investment was made, which induced the investor to initiate its investment in the host state. With regard to usage, legitimate expectation is not only observed as a notion connoted within the fair and equitable treatment standard but also in the context of the standard of compensation.⁷⁷² However, it also plays a

⁷⁶⁹ Brownlie (n 238).

⁷⁷⁰ Baughen (n 768) 207, 210.

⁷⁷¹ Reisman and Sloane (n 104) 130–31.

⁷⁷² Tudor (n 52) 163.

significant role in establishing indirect expropriation. Legitimate expectation does not constitute a property interest or an investment; thus, it is not an object protected by international investment agreements. It instead constitutes a factor taken into account in finding an indirect expropriation. For instance, the tribunal in *Metalclad* held:

Expropriation under NAFTA includes ... also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or 'reasonably-to-be-expected economic benefit of property' even if not necessarily to the obvious benefit of the host state.⁷⁷³

A foreign investor's legitimate expectation is directed at a certain economic benefit of the property. The 'reasonably-to-be-expected economic benefit of property' is what is to be deprived in the occurrence of an indirect expropriation.

A more specific formulation of legitimate expectation can be found in the award of the tribunal in *Thunderbird v Mexico*, which stated that:

The concept of 'legitimate expectation' relates, within the context of the NAFTA framework, to a situation where a Contracting Party's conduct creates reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the NAFTA Party to honour those expectations could cause the investor (or investment) to suffer damages.⁷⁷⁴

In view of this formulation, the role of the concept of legitimate expectation is to refine the process of finding the causality between a state's regulatory measure and the damages suffered by a foreign investor. The process takes two stages. Firstly, the state's regulatory measure that will be subject to an expropriation scrutiny

⁷⁷³ *Metalclad* case (n 285) ch 4, 103.

⁷⁷⁴ *International Thunderbird Gaming Corporation v Mexico* (Award) 26 January 2006 UNCITRAL Arbitration Rules 147.

should be the measure which is relied on by the foreign investor in proceeding with the investment. If a series of regulatory measures appear, which is likely to frequently occur in a longstanding relationship between a host state and a foreign investor, the scope of regulatory measures subject to the scrutiny can be determined by using the reliance criterion. In addition, whether a causal nexus exists between the failure to fulfil a foreign investor's expectation and the damage inflicted on the foreign investor should be examined.⁷⁷⁵ Legitimate expectation initially determines a state's regulatory measure or measures that will be subject to the expropriation scrutiny on the basis of the reliance criterion. Then, the legitimate expectation identifies the damage that would result from the frustrated legitimate expectation.

In *Metalclad*, from the outset of Metalclad's investment-making, Metalclad received assurance that the federal government would support and help Metalclad obtain all the necessary permits for the operation of the landfill. Metalclad was later granted a federal permit for the operation of the landfill.⁷⁷⁶ Metalclad had already previously been accorded a federal permit to construct a hazardous waste landfill and a state land use permit to construct the landfill.⁷⁷⁷ In these circumstances, Metalclad formed a reasonable and legitimate expectation that it was entitled to proceed with the construction.⁷⁷⁸ However, Metalclad's application for a municipal construction permit was denied. As a result, even though Metalclad completed the construction, it failed to obtain the full entitlement to operate the landfill and was in effect barred from operations. In this case, the foreign investor had relied on the federal official's assurances and the relevant federal permits when proceeding with the construction. The denial of the municipal construction permit reflected that Metalclad's legitimate expectation was not fulfilled and led to Metalclad sustaining damage. The tribunal followed this line of reasoning when considering all of the Mexican government's measures, consequentially finding an indirect expropriation:

⁷⁷⁵ Tudor (n 52) 166.

⁷⁷⁶ *Metalclad* (n 285) paras 33–35.

⁷⁷⁷ *ibid* paras 28–29.

⁷⁷⁸ *ibid* para 89.

These measures, taken together with the representations of the Mexican federal government, on which Metalclad relied, and the absence of a timely, orderly or substantive basis for the denial by the Municipality of the local construction permit, amount to an indirect expropriation.⁷⁷⁹

Further, the NAFTA expropriation enquiry of legitimate expectation demonstrates that certain factors can be considered in order to inspect a breach of legitimate expectation. It examines whether the foreign investor's business was conducted in a 'heavily regulated industry' and considers whether the foreign investor was afforded 'specific commitments or assurances' that certain state regulations would not be enacted. The first consideration is general in nature, reflecting how seriously an industry can be regulated. The second consideration is directed specifically at the relevant foreign investor. This enquiry method was clearly demonstrated in the case of *Methanex*. The tribunal, in *Methanex*, while admitting that California's ban of the gasoline additive MTBE diminished the value of the foreign investor's investment, also observed that the industry was already highly regulated:

Methanex entered a political economy in which it was widely known, if not notorious, that government environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organisations and a politically active electorate, continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons.⁷⁸⁰

Secondly, if a state committed to a foreign investor that certain regulations would not be enacted, regulations in breach of such commitments could be evaluated to constitute indirect expropriation, even though the regulations were not in themselves expropriatory. The *Methanex* tribunal admitted that the police power, which was

⁷⁷⁹ *ibid* para 107.

⁷⁸⁰ *Methanex* (n 747) pt IV, ch D, para 9.

exercised in violation of the specific commitments, could be deemed expropriatory and compensable:

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 alia*, 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.⁷⁸¹

The ECtHR and the European Court of Justice (ECJ) recognise the principle of legitimate expectation in expropriation scrutiny on the basis of specific commitments.⁷⁸² Likewise, the Iran-US Claims Tribunal in *Starrett Housing Corporation v Iran* relied on legitimate expectation in concluding that the claimant's expropriation claim could not be upheld because no legitimate expectation existed.⁷⁸³

Given the role of legitimate expectation and the considerations that can be taken into account in its operation, it is important to note that it is not a stand-alone element in the context of indirect or regulatory expropriation. Even if a state fails to implement its commitments or representations, the breach of legitimate expectation will not justify a finding of indirect expropriation unless a substantial deprivation of foreign-owned property occurred.⁷⁸⁴ Therefore, in this way, it only provides assistance in the process of finding indirect expropriation.

3.1.3.2.4 The Principle of Proportionality

⁷⁸¹ *ibid* para 7.

⁷⁸² Thomas Waelde and Abba Kolo, 'Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law' (2001) 50(4) *International and Comparative Law Quarterly* 811, 844; *Fredin v Sweden* (1991) ECtHR 12033/86, para 54. The ECHR denied the expropriation claim for the reason that no legitimate expectation was formed.

⁷⁸³ *Sampliner* (n 759); *Starrett Housing Corp* (n 443).

⁷⁸⁴ *Newcombe* (n 1) 351.

The principle of proportionality is a criterion which weighs the relevant factors for the purpose of determining whether a state's regulatory measure constitutes indirect expropriation. The principle, as a means-end test, seeks to find whether a balance or a 'reasonable relationship of proportionality'⁷⁸⁵ exists between the regulatory measure that a state takes and the public purpose that the state seeks to achieve. This principle puts forward a standard that may sit somewhere between the requirement that there be a 'plausible basis' for the measure and the requirement that the measure is the least restrictive option required to achieve the public purpose.⁷⁸⁶ It also takes into account whether the consequence of the measure is an excessive burden to the foreign investor. If the relationship between a regulatory measure and its public goal is disproportionate, the state's regulatory measure will be deemed to constitute indirect expropriation.

This principle has been used by the ECtHR and certain NAFTA tribunals which appear to have embraced the principle from the ECtHR. The ECtHR in *James and Others v United Kingdom*, in stipulating the principle, quoted the principle of 'fair balance', another formulation of the principle of proportionality, from the ruling of the ECtHR in *Sporrong and Lönnroth*. It held that:

Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim 'in the public interest', but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised ... This latter requirement was expressed in other terms in the *Sporrong and Lönnroth* judgment by the notion of the 'fair balance' that must be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights ... The requisite balance will not be found if the person concerned has had to bear 'an individual and excessive burden'.⁷⁸⁷

⁷⁸⁵ *Technicas Medioambientales Techmed SA* (n 481) para 122.

⁷⁸⁶ *Newcombe* (n 1) 365.

⁷⁸⁷ *James and Others* (n 541) para 50.

Certain NAFTA tribunals, in finding an expropriation, have quoted the ECtHR's rulings containing the principle of proportionality; for instance, the tribunal in the *Techmed v Mexico* case.⁷⁸⁸ The tribunal in the *Fireman's Fund* case also adopted the principle requiring the 'proportionality between the means employed and the aim sought to be realised'⁷⁸⁹ and clarified that the *Techmed* tribunal had also depended on this principle. The tribunal in *LG&E* also employed the principle of proportionality, as follows:

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 case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being challenged.⁷⁹⁰

The tribunal in *Azurix Corp v The Argentine Republic* acknowledged that the principle of proportionality, as adopted by the *Techmed* tribunal and the court in the *James and Others* case, would be a useful criterion serving to determine whether a state's regulatory measures could constitute indirect expropriation where the compensation obligation could occur.⁷⁹¹ The principle of proportionality that has been relied on by these tribunals and the court is in fact very similar to the 'substantially advance test' which was adopted by the US Supreme Court since *Nollan*. This test, as previously observed, consists of two sub-tests: a means-end sub-test and a cause-effect sub-test, and examines whether the regulatory measure can in practice fulfil its purpose and whether there exists a proportionate basis between the amount of public harm caused by the owner and the burden that the regulation imposed.

⁷⁸⁸ *Technicas Medioambientales Techmed SA* (n 481) para 122. The tribunal adopted and quoted the ECtHR's employment of the principle of proportionality.

⁷⁸⁹ *Fireman's Fund* (n 697) para 176(j).

⁷⁹⁰ *LG&E* (n 596).

⁷⁹¹ *Azurix Corp v The Argentine Republic* (Award) 14 July 2006 (ICSID Case No ARB/01/12) paras 311–12.

On the other hand, the principle of proportionality operates on the basis of a reasonable proportionality between means and ends, and the fair balance test. The principle and the 'substantially advance test' are similar to each other in that they operate within the framework of the ends-means and the cause-effect tests. However, they are a little different from each other with regard to the cause-effect principle. The principle of proportionality concerns the demands of public interest, while the test concerns the public harm caused by an owner of a property or investment. The public harm element in the test also indicates the need for protecting the public interest; thus, the common element shared by both of them is their concern for the public interest. Therefore, in other words, the principle of proportionality that operates within the framework of the ends-means and the cause-effect requires that there be a reasonable proportionality between governmental objectives and means, and a fair balance between the safeguarding of the public interest and the protection of the investment. This principle is capable of serving to identify regulatory expropriation in international investment law by embracing a balanced approach towards considering private and public interests in an investment dispute which involves a state's exercise of regulatory power and a foreign-owned investment interest.

3.1.3.2.5 Due Exercise of Police Power

It has been generally recognised in international law that a state's regulatory act of interfering with foreign-owned property, falling within the scope of its police powers in pursuit of what a state deems to be in the public interest, does not constitute an indirect expropriation. This is the so-called 'doctrine of police power'. A variety of regulatory measures fall within the scope of police power:

- (a) forfeiture or a fine to punish or suppress crime;
- (b) seizure of property by way of taxation;
- (c) legislation restricting the use of property, including planning, environment, safety, health and the concomitant restrictions to property rights; and

(d) defence against external threats, destruction of property of neutrals as a consequence of military operations and the taking of enemy property as part of payment of reparation for the consequences of an illegal war.⁷⁹²

The principle of police power has been described in scholarly opinions, legal instruments, and arbitral awards; for instance:

state measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation.⁷⁹³

Regulatory functions are a matter of sovereign right of the host state and there could be no right in international law to compensation or diplomatic protection in respect of such interferences.⁷⁹⁴

International authorities have regularly concluded that no right to compensate arises for reasonable necessary regulations passed for the protection of public health, safety, morals or welfare.⁷⁹⁵

A state is not responsible for the loss of property or for other economic disadvantages resulting from *bona fide* taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of state.⁷⁹⁶

The reference ... to ... ‘measures tantamount to expropriation or nationalisation’ ... does not establish a new requirement that Parties pay compensation for losses

⁷⁹² UNCTAD (n 417) 79.

⁷⁹³ Brownlie (n 238) 532.

⁷⁹⁴ M Sornarajah, *The International Law of Foreign Investment* (Cambridge University Press 1994) 357.

⁷⁹⁵ Newcombe (n 1) 23.

⁷⁹⁶ Restatement (Third) of Foreign Relations of the United States, s 712, comment (g).

which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments.⁷⁹⁷

It 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.⁷⁹⁸

The relevant state agency took measures within its mandate, in a non-discriminatory manner, motivated by the increasing awareness of the dangers presented by lindane for human health and environment. A measure adopted under such circumstances is a valid exercise of the state's police powers and, as a result, does not constitute an expropriation.⁷⁹⁹

The exercise of police power basically involves a state's autonomous determination of what is in the public interest. In the context of US 5th Amendment jurisprudence, the Supreme Court in *Lingle v Chevron USA, Inc*, held that the purpose and effectiveness of governmental action has no bearing on the obligation of compensation.⁸⁰⁰ The Takings Clause gives deference by presupposing that the government has taken measures for a valid public purpose.⁸⁰¹ In this respect, in the context of NAFTA, the *Lingle* tribunal would not accept the relevance of the purpose of governmental action in addressing Article 1110 expropriation claims.⁸⁰² The *SD Myers* tribunal, in contrast, stated that 'it is appropriate to examine the purpose and effect of governmental measures' for the analysis of Article 1110.⁸⁰³ If it is accepted that an arbitral tribunal should offer some degree of deference to a government's regulatory autonomy and, accordingly, its judgment as to what is in

⁷⁹⁷ Interpretative note to Article 5 of the draft MAI 'Expropriation and Compensation'.

⁷⁹⁸ *Saluka Investments BV v The Czech Republic* (Partial Award) 17 March 2006 UNCITRAL Arbitration para 255.

⁷⁹⁹ *Chemtura* (n 446) para 266.

⁸⁰⁰ *Lingle* (n 664) 548; *Kahn* (n 647) 411.

⁸⁰¹ *ibid.*

⁸⁰² *ibid* 430.

⁸⁰³ *ibid.*

the public interest when taking a regulatory measure, the finding of an expropriation is not likely to be affected by a state's decision with regard to public purpose. Specifically, if 'no error of fact or law, an abuse of power or a clear misunderstanding of the issue' exists, an arbitral tribunal should respect the discretion of the government of what are imperatives of public need or national interest.⁸⁰⁴ This may reflect the basic function of the doctrine of police power. The doctrine of police power can play the basic role of demarcating between regulatory autonomy and international legal regulation.

Even though it can be recognised that this doctrine is useful and widely employed, the issue should be discussed in more depth as to whether the application of the principle can guarantee an unconditional exemption from a state's responsibility. With regard to the nature of the doctrine, it has been viewed that police power can be the sole determinant which can outweigh any other considerations and guarantee the unconditional exemption from the obligation to compensate. However, on the other hand, there exists the view that police power should be taken into account, in combination with other relevant factors, for the finding of an expropriation.⁸⁰⁵ According to the first view, a state can justify its regulatory act of interference with private property simply by declaring that its act falls within police power. This view runs the risk that the public interest consideration can both easily and predominantly outweigh the protection of a property interest.⁸⁰⁶ Alternatively, the second view, which recognises police power not as the sole determinant but as one of a number of significant factors to be taken into account for the finding of regulatory expropriation, may provide a more balanced approach in the application of the doctrine, by not ruling out private interests from consideration. Therefore, a state's contention that its regulatory act of interfering with foreign-owned property falls

⁸⁰⁴ *Antoine Goetz et al v Burundi* (Award) 21 July 2012 (ICSID Case No ARB/95/3) para 126. The tribunal found that 'in the absence of an error of fact or of law, of an abuse of power or of a clear misunderstanding of the issue, it is not the Tribunal's role to substitute its own judgment for the discretion of the Government of Burundi of what are imperatives of public need ... or of national interest.'

⁸⁰⁵ OECD, "Indirect Expropriation" and "Right to Regulate" in *International Investment Law* Working Papers on International Investment (2004) 18.

⁸⁰⁶ *ibid* 377.

with the scope of its police power cannot bar an arbitral tribunal from rendering an award after an enquiry of all other considerations.⁸⁰⁷

Under international law, a state is entitled to exercise the right to expropriate as a sovereign right, and is also accorded a wide discretion to determine what regulations will be pursued to serve the public interest.⁸⁰⁸ A state, thus, enjoys the presumption of validity in such an exercise, which means that a state is presumed to act in good faith unless proven otherwise.⁸⁰⁹ Therefore, ‘if the reasons given are valid and bear some plausible relationship to the action taken no attempt may be made to search deeper to see whether the state was activated by some illicit motive.’⁸¹⁰ In view of the presumption of validity, the foreign investor endures the burden of proving that the measure is ‘*mala fide*’, fails to seek a genuine public purpose, or violates discrimination and the due-process requirement.⁸¹¹ However, prior to this point, the state should make a *prima facie* case to prove that its regulatory measure pursues a legitimate public purpose, is not discriminatory, and was conducted in accordance with due process.⁸¹²

The commentary to the American Law Institute’s Restatement (Third) of Foreign Relations Law of the United States provides useful guidance when dealing with the issue of how to discern a normal regulation from an indirect expropriation:

⁸⁰⁷ George C Christie, ‘What Constitutes a Taking of Property Under International Law?’ [2009] BYIL 338.

⁸⁰⁸ Jon A Stanley, ‘Regulatory Takings as Defined in International Law and Compared to American Fifth Amendment Jurisprudence’ [2015] Emory International Law Review 349, 387. According to Jon A Stanley, while both the US Takings Clause doctrine and international law accord some deference to a state’s discretion in exercising its police power, they are different in terms of the degree of deference. The US Supreme Court has considered it as one of factors used for a balancing test, whereas international courts and tribunals have accepted that police power is a far more significant factor in comparison with other factors.

⁸⁰⁹ UNCTAD (n 417) 92.

⁸¹⁰ Christie (n 807) 338; UNCTAD (n 417) 93.

⁸¹¹ Newcombe (n 1) 366; UNCTAD (n 417) 93.

⁸¹² *ibid.*

A state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime or other action of the kind that is commonly accepted as within the police powers of the states, if it is not discriminatory ...⁸¹³

In *Emmanuel Too v Greater Modesto Insurance Associates*, the Iran-US Claims Tribunal denied an expropriation claim on the basis of the police powers doctrine. It held as follows:

A State is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation or any other action that is commonly accepted as within the police power of states, provided 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.⁸¹⁴

What is commonly observable in the commentary and in the *Emmanuel Too* case is that both put forward a common additional condition, in addition to the exercise of police powers, in order for a state to be exempt from a responsibility for ‘loss of property’ or ‘other economic disadvantage’. The commentary additionally demands that the regulation that is taken in the exercise of police powers be non-discriminatory; this is mirrored in *Emmanuel Too*. The additional requirement of non-discrimination means that police powers are to be exercised in a non-discriminatory way. If police powers are exercised in a discriminatory manner, then the state will not be able to evade responsibility by invoking the doctrine of police powers. This indicates that even though the doctrine of police power can create the presumption of validity, the police power still needs to be exercised in a certain way. Here, it was a non-discriminatory way. It was noted that a normal regulation which was initiated as an exercise of police power could develop into an indirect expropriation. In *Pope & Talbot*, in addressing the claim that Canada’s export quota

⁸¹³ The commentary to the American Law Institute’s Restatement (Third) of Foreign Relations Law of the United States, 20, s 712, comment g.

⁸¹⁴ *Emmanuel Too* (n 755).

policy under the US-Canada Softwood Lumber Agreement violated the prohibition of expropriation, the tribunal did not find an expropriation; however, it did admit the potential for a normal regulation to constitute ‘creeping expropriation’, as follows:

Regulations can indeed be exercised 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 protections against expropriation.⁸¹⁵

In the same vein, the UN ILC Fourth Report on International Responsibility stated:

The intrinsic lawfulness of such measures [ie, certain ‘police power’ measures] does not ... exclude the possibility of their adoption or application amounting to a ‘denial of justice’, and of the act of omission concerned consequently giving rise to international responsibility.⁸¹⁶

It is obvious that a state’s regulatory autonomy and its exercise of its police power should be respected. However, a normal state regulation can develop into a violation of international law in certain circumstances; more specifically, by the state abusing the use of its police power authority.⁸¹⁷ Caution needs to be taken when considering the possibility that a regulatory interference with private property, conducted in the undue exercise of police power, can result in regulatory expropriation. In consideration of international investment agreements, principles of international law, and investment arbitral jurisprudence, certain conceivable conditions, circumscribing certain ways in which police powers are to be properly exercised, can exist. This consideration is similar to the reasoning of Justice Holmes, being that if a regulation went too far, it would constitute a taking.⁸¹⁸ Under international

⁸¹⁵ *Pope & Talbot* (n 135).

⁸¹⁶ ‘Fourth Report on International Responsibility’ (1959) 2 Yearbook of the International Law Commission 1, 11, para 43, UN Doc A/CN.4/SER.A/1959/Add.1; Stanley (n 810) 377.

⁸¹⁷ Stanley (n 808) 378.

⁸¹⁸ *Pennsylvania Coal* (n 642).

investment law, a state is ultimately under specific legal restraints when exercising its regulatory power. When a state enters into an international investment agreement, it accepts treaty-based restraints, based on the terms and provisions set out in the agreement. The state is not entitled to override such restraints in conducting its regulatory interference with foreign-owned property. If treaty-based restraints are breached in the exercise of police power, the state will not be able to justify its regulatory measure.

Additionally, a state should also comply with the principles of international law. Two principles, for instance, can be drawn from investment arbitral jurisprudence, which govern the exercise of police powers. The first is the principle of legitimate expectation, which has been previously explored. If, as an exercise of police power, a regulatory act creates a reasonable expectation for a foreign investor and this investor conducts investment activities in reliance on the state's act, the police power should be exercised in a way that does not breach the investor's expectation. If a state's regulatory interference could not be expected as the industry where the foreign investor conducted investment activities was not heavily regulated, or if specific commitments provided for by a state were violated, then the regulatory act, even if initiated through police powers, will constitute a regulatory expropriation.

The second principle is that if the exercise of police powers results in the irreversibility of the deprivation of property rights or interests, it should be regarded as constituting a regulatory expropriation. In certain circumstances, when a state undertakes a regulatory interference of foreign-owned property, substantial or total deprivation of property interests can result. If such a regulatory interference was not temporary, but has continued its deprivation effect irreversibly, it could violate the prohibition of expropriation. The NAFTA tribunal in *Metalclad* found that such an irreversible deprivation of property interests could constitute expropriation. It stated that the Ecological Decree issued by the Mexican local government gave rise to the 'effect of barring forever the operation of the landfill'⁸¹⁹ and 'effectively and

⁸¹⁹ *Metalclad* (n 285) para 109.

permanently prevented the use by Metalclad of its investment'.⁸²⁰ If the deprivation of property rights or interests becomes irreversible, the exercise of the police power causing such a deprivation will become excessive and constitute a regulatory expropriation. In a similar vein, a temporary measure can 'ripen into an expropriation',⁸²¹ giving rise to an irreversible deprivation. In *Sabine G Helbig*, the United States Foreign Claims Settlement Commission accepted this concept when it identified what was once a temporary seizure of property as an expropriation. In this case, subsequent to the temporary seizure of property, governmental authorities had issued a return order. However, the execution of the return order failed and the seized property was never returned to the owner.⁸²² This case indicates that if property is seized in circumstances where an expropriation does not initially occur, it may be later rendered as an act of expropriation if the final taking ripens into an expropriation.⁸²³

3.2 The Development of Principles and Rules of International Law on Regulatory Expropriation

A general source of challenges for the international law on expropriation is the lack of detail and precision of the concept of indirect expropriation set out in international legal instruments and the awards of arbitral tribunals. Consequently, the most imminent issue is how to discern a normal legitimate regulation that does not incur the obligation of compensation from a compensable expropriation. The main function of the concept of regulatory expropriation is to assist in discerning the above. The concept of regulatory expropriation serves as a medium through which a more precise analysis can be conducted of a state's regulatory act of interfering with foreign-owned property which is alleged to constitute indirect expropriation. The

⁸²⁰ *ibid* para 96.

⁸²¹ Christie (n 807) 322.

⁸²² *ibid* 323, citing *Sabine G Helbig*, Decision No Hung – 941 (1958) Tenth Semi-Annual Report 51.

⁸²³ *ibid*.

analysis identifies certain characteristics that turn an ordinary regulation into indirect expropriation, in order to verify in practice whether indirect expropriation has occurred. It has been observed above that there exist certain conditions that characterise the existence of such a regulatory expropriation.

The US and Canada Model BITs' adoption of the three-part *Penn Central* test is notable. By concentrating on the three decisive factors of economic effect, the character of a regulation, and legitimate expectation, they effectively provide guidance as to where to put focus and special attention in order to identify an indirect expropriation. It seems desirable that the three-part *Penn Central* test adopted by these model BITs is also employed by subsequent BITs and FTAs. It may also be desirable that the test is used as a model for other international legal instruments. The conditions for establishing a regulatory expropriation, which have been identified above, can be considered in the same vein. Additionally, there are also certain common factors shared by these conditions, in order to establish regulatory expropriation, and the *Penn Central* test. These conditions can contribute to the finding of an indirect – and especially, a regulatory – expropriation.

The US Takings Clause doctrine, the NAFTA expropriation rule, and the European Convention on Human Rights expropriation rule were chosen for analysis because they have long employed and developed rules and principles dealing with the expropriation of private or foreign-owned property. Furthermore, these rules and principles exhibit strong similarities in terms of key concepts as well as formulations in provisions concerning both the protection of private property against expropriation and a state's right to expropriate.

As noted, a comparative analysis of the US Takings Clause doctrine, the NAFTA expropriation rule, and the European Convention on Human Rights expropriation rule reveals that they operate within the framework of the ends-means and the cause-effect. These rules and doctrine adopt the test that seeks a reasonable balance

or a proportionality⁸²⁴ between means and aims; in other words, a governmental measure and public objectives. The US Takings Clause doctrine and the European Convention expropriation rule especially employ the test that pursues a fair balance between the needs of public interests and the protection of property interests. In the matter of finding an indirect expropriation or a regulatory expropriation, the US Takings Clause doctrine and the NAFTA expropriation rule do not appear to include elaborated principles that are conducive to identifying which type of expropriation occurred in a case. They have relied on the consideration of the grave economic effect of the measure at issue on a private property and the doctrine of police powers. The European Convention on Human Rights expropriation rule, on the other hand, goes a step further by conceptually differentiating the deprivation of a property (or possession) and the control of use of property. The deprivation naturally constitutes an expropriation, whereas the control of use, as a lesser regulatory interference, cannot. This differentiation can make it easier to circumscribe the scope of the notion of expropriation. Even so, the European Convention on Human Rights expropriation rule allows for compensation to be accorded in the case of a control of use, from the fair balance consideration, where a foreign investor has borne a disproportionate burden as a result of the regulatory interference.

The doctrine of police power may prove effective for the finding of a regulatory expropriation, rather than finding itself as the determinant that denies the existence of expropriation. For the doctrine of police power to fulfil its role, it has been noted that certain steps are required. Firstly, in order to differentiate indirect expropriation from an ordinary regulatory measure, one must increase the reliance on the multifactor, rather than concentrating on the depriving effect of the regulatory measure in issue. Then, if arbitral scrutiny has identified that the police power was excessively exercised, the principle of proportionality can be applied to aid in finding regulatory expropriation. The principle of proportionality can function within the framework of the ends-means and cause-effect. What specially

⁸²⁴ *Fireman's Fund* (n 697) para 176(j).

differentiates an expropriation issue from other investment protections is that an expropriation is a state's inherent and sovereign right. This is definitively recognised by customary international law and also by significant international investment agreements, while other investment protections have no direct bearing on a state's substantive sovereignty. A state is entitled to expropriate a private property, whether it is owned by its domestic citizen or a foreigner, in the exercise of its sovereign right. The role of international law with regard to the right to expropriate is merely to restrain it within an international standard. On the other hand, a state has no sovereign right to unreasonably discriminate against a foreign investor and his or her investment. An expropriation issue in international law prompts the question as to when a regulatory interference with private property that falls within sovereign jurisdiction turns into an international legal concern.

The doctrine of police power is a traditional concept that has long been relied upon in international law to demarcate the line where a regulatory interference can be safeguarded by the doctrine from international legal consequences. In order to further develop the rules of international investment law on regulatory expropriation, it appears necessary to improve the use of the doctrine, based on an elaboration of more specific principles and rules, for its use in finding regulatory expropriation.

Chapter 4: The Standard of Compensation for Regulatory Expropriation

4.0 Introduction

In relation to the compensation rules for expropriation, it seems to be accepted that the Hull formula requiring ‘prompt, effective and adequate’ compensation in the event of nationalisation or expropriation generally applies. ‘Adequate’ compensation usually denotes the full market value of an expropriated property. Even so, in practice, the full market value has not been universally accepted in scholarly literature and arbitral jurisprudence in the field of international investment law. Law on the standard of compensation for expropriation is called upon to address the increasingly diversified indirect forms of expropriatory regulations in a way that adequately balances the public and private interests involved in investment treaty claims. In particular, an indirect expropriation that exhibits a regulatory nature and pursues legitimate public interests takes a central place in connection to the request and brings about a challenging issue of how to discern compensable expropriation from ordinary regulations that do not incur the obligation to compensate. Furthermore, an important question can also arise regarding regulatory expropriation, as to whether the full compensation rule is always applicable to the case when a regulatory expropriation has occurred. This is because regulatory expropriation can be evaluated as being placed between ordinary regulation, which does not incur the obligation to compensate, and a type of expropriation, which may entail the full market compensation, and where the less-than-full or minimum level of compensation can be conceivable. The current practice of the law on the standard of compensation will be considered below. In relation to it, significant issues will be explored, such as the Hull doctrine, the Calvo doctrine, and the full compensation rule, including the deviation from it.

4.1 The Standard of Compensation for Expropriation

4.1.1 Introduction

In relation to the amount of compensation in an event of nationalisation or expropriation, widespread and frequently used terms are, for example, ‘appropriate’, ‘fair’, ‘adequate’ and ‘just’ compensation. ‘Appropriate’ compensation appears in Article 2 of the Charter of Economic Rights and Duties of States⁸²⁵ as well as in Part 1 of the 1962 UN General Assembly Resolution on Permanent Sovereignty over Natural Resources.⁸²⁶ ‘Just’ compensation can be found in the *Norwegian Shipowners’ Claims* case⁸²⁷ and also in the 5th Amendment to the United States Constitution.

The traditionally recognised Hull doctrine, requiring prompt, effective, and adequate compensation for expropriation, has exerted a long prevailing influence on the understanding and interpretation of ‘just compensation’. However, the law on the standard of compensation in the event of expropriation has taken shape not only under the influence of the Hull doctrine, but also in circumstances where the interests of developed and developing countries have conflicted. This has also been accompanied by the adoption of other international legal instruments, for instance, the UN General Assembly’s resolutions and the Charter of Economic Rights and Duties of States.

With reference to the amount of compensation in the event of nationalisation or expropriation, the *Chorzów Factory* case delivers the basic principle, based on

⁸²⁵ Article 2 provides in para 2(c) that ‘each State has the right to nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures’.

⁸²⁶ The General Assembly declares in Part 1, paragraph 4 that ‘nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation’.

⁸²⁷ *Norwegian Shipowners’ Claims* (n 421).

international practice and the awards of arbitral tribunals, requiring that reparation must intrinsically eliminate all of that which the illegal act created and restore the original situation as if the illegal act had not been committed.⁸²⁸ Alternative remedies such as restitution-in-kind or pecuniary compensation are not conceivable until the intrinsic goal of the reparation becomes impossible to achieve. In *Chorzów Factory*, one of the arbitrators, M Rabel, clarified the basic rationale underlying the judgment's determination of compensation, by explaining that it resulted from the unlawful nature of the expropriation. The rationale, he added, 'is applicable in practice whenever the damage caused appears greater than the compensation which would be due if the expropriation is lawful'⁸²⁹ and that the responsible state should bear the burden of 'damage caused in so far as such damage exceeds the amount' of the due compensation. In this respect, the legality of the expropriation is to be taken into account in determining the amount of compensation and the extent to which the amount may exceed the amount of a lawful expropriation.⁸³⁰

Therefore, despite the significant influence of the Hull doctrine, the fact that other influential factors have affected the law on the standard of compensation for expropriation may give rise to questions as to whether the Hull doctrine is in fact the completely controlling principle of the law on the standard of compensation for expropriation. Also, the *Chorzów Factory* case draws attention to the issue of the substantive roles of the legality of expropriation in relation to the standard of compensation. This chapter will seek answers to these questions, beginning with a consideration of nationalisation, from which contemporary as well as traditional expropriations have originated.

4.1.2 The Doctrines and Rules for the Standard of Compensation

4.1.2.1 The Calvo Doctrine and the Hull Doctrine

⁸²⁸ *Chorzów Factory* (n 48) para 125.

⁸²⁹ *ibid* para 189.

⁸³⁰ *ibid* para 193.

The Calvo doctrine is aimed at achieving equality not only among countries but also between foreigners and domestic citizens.⁸³¹ This doctrine basically means that ‘the responsibility of governments toward foreigners cannot be greater than the responsibility of governments toward their own citizens’. The doctrine has appeared in the ‘Additional and Explanatory Convention to the Treaty of Peace, Amity, Commerce and Navigation’,⁸³² which states:

It is mutually understood, that the Republic of Chile is only bound by the aforesaid stipulation to maintain the most perfect equality in this respect between American and Chilean citizens, the former to enjoy all the rights and benefits of the present or future provisions which the laws grant to the latter in their judicial tribunals, but no special favors or privileges.⁸³³

During the nineteenth century, developing countries advocated the national treatment as reflected in the Calvo doctrine. However, during the twentieth century, countries began to move towards the adoption of a new law of expropriation that reaches beyond national treatment. This is the principle of no obligatory compensation for expropriation.⁸³⁴ Mexico manifested its stance in a note, stating:

My government maintains, on the contrary, that there is in international law no rule universally accepted in theory nor carried out in practice, which makes obligatory the payment of immediate compensation nor even of deferred compensation, for expropriation of a general and impersonal character like those which Mexico has carried out for the purpose of redistribution of the land.⁸³⁵

⁸³¹ Montt (n 40) 38.

⁸³² *ibid* 43. This Convention clarified the meaning of the ‘full protection and security’ clause contained in Article 10 of the Friendship, Commerce and Navigation (FCN) Treaty.

⁸³³ *ibid* 44.

⁸³⁴ *ibid* 56.

⁸³⁵ *ibid* 56; ‘Translation of note from the Minister of Foreign Affairs of Mexico to the American Ambassador at Mexico City (3 August 1938)’ (1938) 32 AJIL 186, 186.

The US Secretary of State Cordell Hull responded to this statement by creating the Hull doctrine. The doctrine, deemed to reflect customary international law, required that compensation be prompt, adequate, and effective. After the advent of the Calvo doctrine, the principle of no obligatory compensation for expropriation asserted that international law could not obligate a state to pay compensation. The Hull doctrine, in contrast, maintained that international law imposed an obligation on the state to pay adequate compensation in a prompt and effective way. Thereafter, the Calvo clause came into play, requiring that foreigners be regarded as domestic citizens and be exclusively subject to domestic regulation, giving up diplomatic protection. This type of clause appeared in the provisions of investor-state contracts, as demonstrated in the *North American Dredging* case.⁸³⁶ Here, in a contract with the Mexican government, the clause functioned as a legally binding requirement that domestic law applied to compensation matters.

Thus, is the task of determining compensation merely reduced to a choice between the Hull and the Calvo doctrine? Before reaching such a conclusion on this issue, it is necessary to delve into how the Hull doctrine, specifically the requirement of full or adequate compensation, operates in practice and to develop further considerations as to how rules of compensation for expropriation can adequately work in regulatory expropriation.

4.1.2.2 The Full Compensation Rule and Exceptions to the Hull Doctrine

⁸³⁶ Article 18 of the contract provides that ‘the contractor and all other persons who, as employees or in any other capacity, may be engaged in the execution of the work under this contract either directly or indirectly, shall be considered as Mexicans in all matters, within the Republic of Mexico, concerning the execution of such work and the fulfillment of this contract. They shall not claim nor shall they have, with regard to the interests and the business connected with this contract, any other rights or means to enforce the same than those granted by the laws of the Republic of Mexicans, nor shall they enjoy any other rights than those established in favor of Mexicans. They are consequently deprived of any rights as aliens, and under no conditions shall the intervention of any foreign diplomatic agents be permitted, in any matter related to this contract’; AH Feller, ‘Some Observations on the Calvo Clause’ (1933) 27(3) AJIL 461, 462. This is the Spanish text, as reproduced by the American Commissioner in *USA (International Fisheries Co) v United Mexican States* Opinions of Commissioners (1931) 206, 260. See also Montt (n 40) 45.

In relation to the standard of compensation for expropriation, the positions taken by states tend to diverge specifically over whether expropriation should result in full compensation. By and large, capital importing states have maintained a national treatment standard or a standard of less-than-full fair market value compensation.⁸³⁷ Capital exporting states, however, have advocated a full fair market value compensation standard, as reflected in the Hull doctrine.⁸³⁸ The Hull doctrine, requiring prompt, adequate, and effective compensation, was claimed to reflect customary international law.⁸³⁹ According to this doctrine, under customary international law, an expropriating state has the obligation to pay full compensation corresponding to the fair market value of the expropriated property.⁸⁴⁰ This view was also reflected in the ILC's Articles on State Responsibility, which provided that the responsible state, for its international wrongful act, should pay compensation which 'shall cover any financially assessable damage including loss of profits'.⁸⁴¹ The commentary to the Articles prescribes that 'compensation reflecting the capital value of property taken or destroyed as the result of an internationally wrongful act' is generally assessed on the basis of the 'fair market value of the property lost'.⁸⁴²

Even though the Hull doctrine has been recognised as the traditional rule, it can be identified that the term 'full', used in conjunction with compensation for an expropriation, has not been adopted in certain legal instruments and investment arbitral awards. For instance, with regard to the compensation for expropriation, the tribunal in the *Chorzów Factory* case provided solely for 'fair compensation', whereas the tribunal in the *Norwegian Shipowners' Claim* case provided for 'just compensation'. The UN General Assembly Resolution 1803 of 1962 provides that the owner of the expropriated property is entitled to 'appropriate compensation'.⁸⁴³

⁸³⁷ Newcombe (n 1) 377.

⁸³⁸ *ibid.*

⁸³⁹ Montt (n 40) 56.

⁸⁴⁰ Newcombe (n 1) 378.

⁸⁴¹ *ibid.*

⁸⁴² *ibid.*; 379 ILC's Articles on State Responsibility, UN GAOR, 56th Sess, Supp No 10, UN Doc A/56/10 2001 YBILC, vol II, p 2.

⁸⁴³ The UN General Assembly Resolution 1803 of 1962 (XVII) Permanent Sovereignty over Natural Resources provides that 'nationalization, expropriation or requisitioning shall be

The Charter of Economic Rights and Duties of States (the Charter), adopted in 1974 by the UN General Assembly, provides at Article 2(2)(c) that ‘appropriate compensation’ should be paid by the expropriating state.⁸⁴⁴ In the *Aminoil* case, the tribunal held that the nationalisation of an oil concession was lawful and provided for appropriate compensation that was affirmed in the UN General Assembly Resolution 1803.⁸⁴⁵ In addition, Section 712 of the Draft Articles of the American Institute’s Restatement (Third) of the Foreign Relations Law of the United States requires ‘just compensation’, and the comments affirm that the United States has maintained the position that ‘just compensation’ indicates ‘prompt, adequate, and effective compensation’.⁸⁴⁶ No reference to ‘full’ compensation is made and the use of alternative terms such as ‘fair’, ‘just’, or ‘appropriate’ is consistently observable. While the tendency may be towards an uncertainty concerning the intentions behind the use of such terms, the view that full compensation is required for every expropriation case has been vigorously challenged by scholars.⁸⁴⁷ Furthermore, certain arbitral cases have denied that full compensation is required in every case of expropriation and, instead, less-than-full compensation has been determined to be appropriate.

In the *Libyan American Oil Company Arbitration* case, the sole arbitrator Mahmassani stated that the nationalisation of the claimant’s oil concession was lawful and that the compensation should contain, as a minimum, the *damnum emergens*, ie the ‘full value of the nationalised property, including all assets, installations, and various expenses incurred’, which was regarded as the market

based on grounds or reasons of public utility ... in such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law’.

⁸⁴⁴ The Charter of Economic Rights and Duties of States, art 2(2)(c).

⁸⁴⁵ *Aminoil v Kuwait* (1982), (1984) 66 ILR 518.

⁸⁴⁶ Restatement of the Foreign Relations Law of the United States (Revised) §712 (Tent. Draft No 3, 1982), comment e; Oscar Schachter, ‘Compensation for Expropriation’ 78 AJIL vol 78 No 1 (1984) 121, 122.

⁸⁴⁷ Even though US government has long advocated that the Hull doctrine requiring ‘prompt, adequate and effective’ compensation is required by international law, scholars have objected that the Hull doctrine is a general rule of international law applicable to all cases of expropriation; Schachter (n 846) 121.

value.⁸⁴⁸ He, while objecting to the ‘full’ compensation approach, affirmed that ‘convenient and equitable’ compensation should be accorded, which reflected part of the loss of profits, but not the full loss.⁸⁴⁹ According to the arbitrator, the ‘classical doctrine’ requiring the payment of ‘prompt, effective and adequate’ compensation functions, rather than as a requisite general rule, as a technical rule for the evaluation of compensation and as a guide in negotiating settlement agreements, being for instance a criterion of the maximum level.⁸⁵⁰

In the *INA Corporation* case, the tribunal acknowledged the probable deviation from full or adequate compensation. The tribunal, while recognising that full compensation could be accorded to the foreign owner, affirmed as follows:

The taking might be characterised as a formal and systematic nationalisation by decree of an entire category of commercial enterprises of fundamental importance to the nation’s economy ... In the event of such large-scale nationalisation of a lawful character, international law has undergone a gradual reappraisal, the effect of which may be to undermine the doctrinal value of any ‘full’ or ‘adequate’ (when used as identical to ‘full’) compensation standard as proposed in this case.⁸⁵¹

This statement indicates a change or development of law, being particularly influenced by two main characteristics: the scale of nationalisation and its lawfulness. In addition, Judge Lagergren, the chairman, in a separate opinion, maintained as follows:

An application of current principles of international law, as encapsulated in the ‘appropriate compensation’ formula, would in a case of lawful large-scale

⁸⁴⁸ CF Amerasinghe, ‘Issues of Compensation for the Taking of Alien Property in the Light of Recent Cases and Practice’ [1992] *International & Comparative Law Quarterly* 22.

⁸⁴⁹ *ibid.*

⁸⁵⁰ *ibid.* 8.

⁸⁵¹ *ibid.* 43, citing *INA Corporation v The Government of the Islamic Republic of Iran* (1985) 8 Iran-USCTR 161, 373.

nationalizations in a state undergoing a process of radical economic restructuring normally require the ‘fair market value’ standard to be discounted in taking account of ‘all circumstances’.⁸⁵²

This opinion implies that the consideration of relevant circumstances can yield a deviation from the ‘fair market value’ standard. It is correct to say that case law in international law is merely a ‘subsidiary means for the determination of rules of law’.⁸⁵³ Thus, arbitral cases cannot exercise a dominant effect, such as reshaping or modifying current rules of international law. Also, the Charter is a programmatic instrument and is not designed to declare current principles of international law.⁸⁵⁴ Article 2.2(c) of the Charter does not reflect current rules of international law, but instead declares a goal to be fulfilled for the advent of a new international economic order.⁸⁵⁵ This is revealed from the *travaux préparatoires* and the General Assembly members’ discussion that deemed the Article as only indicating an objective.⁸⁵⁶ Thus, it can hardly be concluded that a firmly-established deviation from full compensation or less-than-full compensation has been introduced. Nonetheless, further discussions that will be helpful in shedding light on the desirable direction of the development of international law on the standard of compensation for expropriation, especially regulatory expropriation, can be conducted.

4.2 Rules on the Standard of Compensation for Regulatory Expropriation

4.2.1 The Hull Doctrine and its Exceptions

⁸⁵² *ibid* 390; Judge Holtzman, the US judge, however, disagreed, maintaining that ‘whatever “reappraisal” of customary international law may have occurred in recent years, it has not led courts or arbitral tribunals to adopt a standard of partial compensation’. See Amerasinghe (n 848) 43–44.

⁸⁵³ Article 38 1(d) of the Statute of the International Court of Justice.

⁸⁵⁴ See Amerasinghe (n 848) 36–37.

⁸⁵⁵ *ibid*.

⁸⁵⁶ *ibid*.

The Hull doctrine has been recognised as the classical rule that requires full or adequate compensation, exercising a predominant effect in shaping international law on the compensation for expropriation. It is, nonetheless, true that its universal applicability in all circumstances has been questioned, as witnessed by the contrasting positions among developed and developing countries, the UN General Assembly's legal instruments, and investment awards. More specifically, deviations from the Hull doctrine or the full compensation rule have been articulated in a range of positions, such as the Calvo doctrine and the Calvo clause, both of which indicate that the determination of compensation is within a state's domestic jurisdiction, out of reach of international legal regulation. Additionally, further deviation is demonstrated by the support of certain investment case tribunals of the exceptional application of the less-than-full compensation principle for expropriation. Furthermore, whether an expropriation was lawful or unlawful can be a conceivable factor to be taken into account when determining the standard of compensation to be awarded. The tribunal in the *Chorzów Factory* case stated that it is significantly meaningful to distinguish between lawful and unlawful expropriations in terms of their financial outcomes,⁸⁵⁷ and clarified that the fundamental principle underlying an 'illegal act' is that 'reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed'.⁸⁵⁸ Also, as a result of the study on the awards of the Iran-US Claims Tribunal, Bowett drew the conclusion that the tribunal was approaching a position that would accept three different standards of compensation for an unlawful expropriation, a lawful *ad hoc* expropriation, and a lawful, general act of nationalisation, among which the third standard is the lowest.⁸⁵⁹ The sole arbitrator in the *Libyan American Oil Co* case asserted that in the situation of lawful nationalisation, 'convenient and equitable'

⁸⁵⁷ *Chorzów Factory* (n 48) para 124.

⁸⁵⁸ *ibid* para 125. The PCIJ asserted that this principle would be 'established by international practice and by the decisions of arbitral tribunals'.

⁸⁵⁹ DW Bowett, 'State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach' (1988) 59 BYIL 49–74, 67. Bowett stated that there is no explanation in the jurisprudence in differentiating those standards. See Subedi (n 8) 128.

compensation should be accorded, which consisted of only part of the loss of profits, in opposition to ‘full’ compensation.⁸⁶⁰ As can be observed from the discussion above, it can be judicially meaningful that different standards of compensation may apply, depending on whether the expropriation was lawful or unlawful, and also depending on the different characteristics of expropriations among lawful ones.

If the classification technique could be used in a more refined way to reflect clear and diverse circumstances that identify the availability of different standards of compensation, on the basis of rules and principles of law for expropriation within the spectrum of legality to illegality, it could be helpful in the formation of exceptions in relation to the Hull doctrine. In particular, in the case of regulatory expropriation, the question may arise as to whether the exceptions to the Hull doctrine or any different standards of compensation could apply, if conducted in a *bona fide* way without discrimination for the purpose of legitimate public interests, and also if the conditions for lawful regulatory expropriation were met.

4.2.2 The Fair Balance Test in Determining Exception for Compensation for Regulatory Expropriation

An exception to the Hull doctrine could be described, in a regional context, as being the common outcome resulting from the application of a specific test devised by a regional tribunal. If this specific test was identifiable then it could potentially contribute, in depth and detail, to the formation of exceptions to the Hull doctrine. It may also be used to examine how the standard of compensation operates under the regional legal system and to consider whether the standard is effectively applicable on an international level.⁸⁶¹

⁸⁶⁰ *Libyan American Oil Co* (n 501); see *Amerasinghe* (n 848) 41.

⁸⁶¹ Determining exceptions for compensation for regulatory expropriation should not be confused with the necessity of differentiating the standard of compensation for lawful expropriation with that for unlawful expropriation. In the former, the goal is to establish exceptions to the Hull doctrine. In the latter, the necessity comes from the demand for a ‘general preventive function of law’, which will be marred if lawful and unlawful behaviour result in the same financial evaluation. See Sergey Ripinsky and Kevin Williams, *Damages*

Under the ECHR, the ECtHR employs the fair balance test⁸⁶² for the determination of compensation, which permits a flexible, refined consideration of a wide range of relevant factors involved in the case. The fair balance test seeks to find a fair balance between the demands of the general interest of the community and the protection of the individual's fundamental rights.⁸⁶³ The test involves both the means-aim sub-test and the cause-effect sub-test.⁸⁶⁴ One noticeable difference which the European Convention expropriation rule demonstrates in comparison to customary international law on expropriation relates to how compensation is processed. Under customary international law, it is a condition that a foreign owner must be awarded compensation for a lawful expropriation to be recognised. On the other hand, even though the fair balance test takes into account compensation, it also considers whether the foreign owner has borne an 'excessive'⁸⁶⁵ or a 'disproportionate'⁸⁶⁶ burden consequent to the regulatory deprivation. If this is the case, then the deprivation cannot be justified. In *Holy Monasteries v Greece*, the court held as follows:

Compensation ... is material to the assessment whether the contested measure respects the requisite fair balance and notably, whether it does not impose a disproportionate burden on the applicants. In this connection, the taking of property without payment of an amount reasonably related to its value will normally constitute a disproportionate interference and a total lack of compensation can be considered justifiable under Article 1 only in exceptional circumstances.⁸⁶⁷

The court's adoption of the fair balance test when addressing the control of use of private property means that a state's regulatory interference, in the general interest

in International Investment Law (British Institute of International and Comparative Law, London 2008) 65.

⁸⁶² *Sporrong and Lönnroth* (n 726).

⁸⁶³ *ibid.*

⁸⁶⁴ *ibid.*

⁸⁶⁵ *ibid* 28.

⁸⁶⁶ *Erkner & Hofhauer v Austria* (1987) Series A No 117 ECtHR 39, 66–67.

⁸⁶⁷ *Holy Monasteries v Greece* (n 722). See Freeman (n 714) 187–88.

of the rights of the community, must be balanced against the protections owed to a property owner, so that the owner does not bear an unreasonably excessive burden.⁸⁶⁸ In this respect, a stark difference between deprivations and regulatory interferences, concerning the control of the use of property, exists. In the latter, the state is not obliged to make a payment of compensation if the burden borne by the property owner is not unreasonable.⁸⁶⁹ In applying the fair balance test, the court also takes into account the level of legitimacy involved in the purpose of a regulatory interference when determining compensation. In *James*, the court held as follows, ‘Legitimate objectives of public interest, such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value’.⁸⁷⁰

Considering the way in which the ECtHR has employed the fair balance test in dealing with expropriation cases, the noticeable features of the test are not only that it involves an in-depth contemplation of private and public interests, but also that the test focuses on the outcome that would result from expropriation. In this scenario, the court readjusts the balance between the state’s interest and the property owner’s interest. Also, the court appears to place priority on the affirmative presumption that a state normally has the right to expropriate. The subsequent consideration is whether a property owner has had to bear an excessive burden consequent to the expropriation. When considering expropriation in international law, unlike direct expropriation or nationalisation, it is almost always challenging to differentiate between a compensable indirect expropriation and a legitimate regulation; while the differentiation can determine whether the claimant property owner does or does not receive compensation. If the fair balance test was adopted, it could be used to produce a more flexibly balanced compensation level between the limited options of no compensation or full compensation. Furthermore, regulatory expropriation is usually more likely to involve the legitimate regulatory purpose of public interest, not expropriatory intent, than direct expropriation and other types of

⁸⁶⁸ Mountfield (n 721) 136, 137; Freeman (n 714) 188.

⁸⁶⁹ *ibid.* See also Freeman (n 714) 188.

⁸⁷⁰ *James and Others* (n 541) 36.

indirect expropriation. The fair balance test can provide due regard to a state's legitimate regulatory purpose, which regulatory expropriation may deserve.

4.3 Conclusion

As clearly indicated in the *Chorzów Factory* case, the objective of compensation for unlawful expropriation is that the reparation must intrinsically eliminate all of that which the illegal act created and restore the original situation as if the illegal act had not been committed. However, the objective of the compensation for lawful expropriation may be different. In this scenario, it may be that priority is afforded to balancing interests rather than placing an emphasis on cancelling out the original act and restoring the original situation.

When a legal dispute involves conflicting interests, with both interests deserving of some degree of effective protection or justification, it can be doubtful as to whether the dispute system operates effectively by permitting only one party to win. This proposition is truer in investment treaty cases. In this situation, a state's regulatory act stems from the exercise of sovereignty, but investment treaty law is basically designed to protect foreign-owned property. Bearing in mind these problems, when a case is brought to an investment arbitral tribunal, which involves a potential regulatory expropriation issue, it is necessary that special care be taken. It has been doubted that the Hull doctrine, requiring adequate or full compensation, is capable of providing suitable legal consequences in relation to all the various types of indirect expropriation. Thus, efforts have been made to establish exceptions to the Hull doctrine in order to find an enhanced method of reaching a proper balance between a state's interest and a foreign investor's interest, one example of such being the less-than-full compensation process. Both the finding of regulatory expropriation and the determining of the legal consequences of regulatory expropriation are ultimately directed at distributing international legal protections equitably between a state and a foreign investor. In this respect, the fair balance test

provides flexibility in striking a balance between the interests of both parties to a regulatory expropriation dispute.

Chapter 5: A Recent Expropriation Claim: The *Lone Star* Case

5.0 Introduction

*Lone Star*⁸⁷¹ is an on-going case. Proceedings were initially commenced in May 2015. It is the first investor-state arbitration case under the ICSID with which the Republic of Korea has been confronted. This case involves an expropriation claim based on the allegation that certain tax-related measures taken by the Republic of Korea constituted expropriation. This case is very worthy of close attention because it addresses the claim that a state's taxation, which is usually deemed to be a normal exercise of a state's public authority, constituted expropriation.

Even though the award has not yet been decided, it will be beneficial to analyse this case in the context of regulatory expropriation as it will provide the opportunity for this thesis to consider creeping expropriation. Creeping expropriation is distinct as a type of regulatory expropriation. The inquiry into creeping expropriation takes the collective view in identifying and evaluating what is alleged to be an expropriation, by investigating a series of regulatory measures in-group, each of which does not necessarily constitute an international wrongful act. An analysis of the facts in the *Lone Star* case will assist in understanding the concepts of regulatory expropriation and of creeping expropriation, in the context of concrete factual details.

Lone Star, a Belgian investor, represented the interests of six Belgian investors in this case.⁸⁷² These Belgian investors were LSF-KEB Holdings SCA, Star Holdings SCA, HL Holdings SCA, LSF SLF Holdings SCA, Kukdong Holdings I SCA, and Kukdong Holdings II SCA.⁸⁷³ The investors began their investment activities in

⁸⁷¹ *LSF-KEB Holding SCA and others v Republic of Korea* (ICSID Case No ARB/12/37).

⁸⁷² Notice of Arbitration on the *LSF-KEB Holding SCA and others* case.

⁸⁷³ *ibid.*

Korea in 2003 and approximately owned a 64.62% stake in the Korea Exchange Bank (KEB).⁸⁷⁴ Post 2003, two sets of circumstances occurred. Firstly, after Lone Star purchased 51% of the shares in KEB and merged with the Korea Exchange Bank Credit Service Co Ltd (KEBCS), it attempted to sell its stakes in KEB on a number of occasions.⁸⁷⁵ The attempted sales were unsuccessful. Lone Star alleged that this was because the Financial Supervisory Commission (FSC) had continuously delayed processing the approval of Lone Star's transactions with other parties.⁸⁷⁶ Secondly, the Korean National Tax Service (NTS) imposed taxes on several share transactions between Lone Star and other companies.⁸⁷⁷ On 21 May 2012, Lone Star filed an arbitration claim under the terms of the Agreement Between the Government of the Republic of Korea and the Belgium-Luxembourg Economic Union for the Reciprocal Promotion and Protection of Investments (Korea-Belgium BIT), on the grounds that the FSC's acts of delaying approval and the NTS's taxations were so 'arbitrary and discriminatory' that they 'substantially and materially impaired the ability of Lone Star to dispose of its investment in KEB'.⁸⁷⁸ Lone Star claimed that the Korean government violated the prohibition of expropriation in the absence of compensation⁸⁷⁹ and other standards of treatment, such as the obligation of fair and equitable treatment⁸⁸⁰ provided for by the Korea-Belgium BIT.

The notice of arbitration was submitted on 10 December 2012 and three arbitrators were appointed. In this chapter, the two sets of circumstances will be explored respectively. This case is on-going and awaits long-term proceedings; thus, the goal

⁸⁷⁴ *ibid.*

⁸⁷⁵ 'Memorandum Required by Article 8.1 of the Agreement between the Government of the Republic of Korea and the Belgium-Luxembourg Economic Union for the Reciprocal Promotion and Protection of Investment with respect to the Dispute between Lone Star and the Republic of Korea (*Lone Star Arbitration Memorandum*)' <www.businesswire.com/news/home/20120805005041/en/Lone-Star-Funds-Update-Dispute-South-Korean> accessed 6 November 2015.

⁸⁷⁶ *ibid.* See Korean Banking Act (2012) art 15(3).

⁸⁷⁷ '*Lone Star Arbitration Memorandum*' (n 875).

⁸⁷⁸ *LSF-KEB Holdings* (n 871) Memorandum.

⁸⁷⁹ The Korea-Belgium BIT, art 5.

⁸⁸⁰ *ibid* art 2.2.

of this chapter is to explore Lone Star's claim specifically in relation to the expropriation violation and to examine whether its claims are tenable. This will be done by scrutinising the FSC's acts of delay and the NTS's taxations. As the arbitration ruling has yet to be released, the chapter will attempt to show how an expropriation claim can be addressed in consideration of a government's administrative delays and taxations, thus not providing a complete review of the arbitral award and the case.

5.1 The FSC's Alleged Acts of Delay of Approval of Lone Star's Transactions and Other Conducts

5.1.1 Facts

Under the Korean Banking Act, any entity seeking to obtain a substantial stake, of over 10 per cent of voting shares, in a Korean commercial bank must first receive approval from the Financial Supervisory Commission (FSC).⁸⁸¹ Without FSC approval, any entity is seriously limited in obtaining such a substantial stake.⁸⁸² Pursuant to the Act, Lone Star submitted the required application to the FSC for approval shortly after entering into the binding agreement to recapitalise KEB.⁸⁸³ On 26 September 2003, the FSC approved Lone Star's acquisition of 51% of the outstanding shares of KEB,⁸⁸⁴ as well as Lone Star's right to exercise call options to acquire additional shares from Commerzbank and KEXIM within the limit of 65.23% of total shares issued and outstanding voting shares.⁸⁸⁵ On 20 November 2003, KEB, with Lone Star's acquiescence, purchased the shares of KEBCS held by

⁸⁸¹ Korean Banking Act, art 15(3).

⁸⁸² *ibid* 15(1).

⁸⁸³ 'Lone Star Arbitration Memorandum' (n 875) 3.

⁸⁸⁴ According to the Korean Banking Act, Article 16-2, the FSC could only approve such an investment if the FSC was satisfied that the potential acquirer was not a non-financial business operator (NFBO) (otherwise, the NFBO investor could hold no more than 4% of the bank's total issued and outstanding voting shares).

⁸⁸⁵ 'Lone Star Arbitration Memorandum' (n 875) 3.

the other major shareholder in KEBCS, Olympus Capital, and then merged KEBCS into KEB.⁸⁸⁶

It was alleged that the sale of a majority share in KEB to Lone Star was illegal due to the negligence of the Korean government, KEB, and the Lone Star personnel involved. Therefore, Korean government agencies conducted a number of investigations, including an audit of Lone Star's acquisition of KEB by the Board of Audit and Inspection at the request of the National Assembly on 3 March 2006; a criminal investigation of Lone Star by the Supreme Prosecutor's Office in response to complaints filed by, *inter alia*, the Finance and Economy Committee of the National Assembly on 7 March 2006 and an activist group called Spec Watch Korea on 14 September 2005; and an investigation by the Financial Supervisor Service, an executive branch of the FSC.⁸⁸⁷

Lone Star claimed that following the initiation of these investigations, it attempted to sell its shares; however, the FSC delayed its review for the approval of Lone Star's transactions with other parties. The reason provided for the delay was that the FSC believed that it should refrain from proceeding with the review process whilst investigations and legal proceedings were still pending in relation to the former head of Lone Star Advisors Korea, Mr Paul Yoo, who was charged with manipulating the stock price in connection to the KEBCS merger. A timeline of the events demonstrates the repeated delays of the FSC in its review process.

On 19 May 2006, Lone Star entered into a Share Purchase Agreement (SPA) with the Kookmin Bank for the sale of Lone Star's 64.62% stake in KEB.⁸⁸⁸ Kookmin filed its application for the approval of the acquisition with the FSC in late May 2006.⁸⁸⁹ The FSC refused to process Kookmin's application for the reason that legal

⁸⁸⁶ *ibid* 4.

⁸⁸⁷ *ibid* 7.

⁸⁸⁸ *ibid* 6.

⁸⁸⁹ *ibid*.

investigations were on-going.⁸⁹⁰ After Lone Star's attempts to sell were frustrated, it sold 13.6% of KEB's shares on the open market for ₩ 1.2 trillion (about €1 billion).⁸⁹¹ Therefore, Lone Star was forced to sell the shares at a discounted price – compared to the figure it could have obtained if it had been able to sell a controlling block.⁸⁹²

On 3 September 2007, Lone Star and HSBC entered into a SPA.⁸⁹³ On 17 December 2007, HSBC submitted its application to the FSC for the approval of the acquisition.⁸⁹⁴ The FSC declined to approve HSBC's application by reason of the on-going legal proceedings, relating to allegations that Mr Yoo had manipulated the stock price of KEBCS in connection with its merger into KEB.⁸⁹⁵ On 1 February 2008, the FSC announced that it would not approve HSBC's acquisition of KEB until all legal disputes would be settled.⁸⁹⁶ On 18 September 2008, with the FSC still refusing to proceed, HSBC terminated the SPA.⁸⁹⁷ Thereafter, Lone Star and the Hana Financial Group (Hana) entered into a SPA and, on 13 December 2010, Hana filed an application for approval with the FSC.⁸⁹⁸ The Fair Trade Commission, the Korean antitrust authority, approved the sale on 9 March 2011.⁸⁹⁹ The FSC announced that Hana's application, along with Lone Star's status as an NFBO, would be reviewed at its meeting on 16 March 2011.⁹⁰⁰ During this course of events, the Supreme Court vacated the Seoul High Court's 'not guilty' verdict against Mr Yoo for stock price manipulation related to the KEBCS merger, and remitted the case to the lower court.⁹⁰¹ Unsurprisingly, on 16 March 2011, the FSC reaffirmed that Lone Star was not an NFBO, but confirmed that it would not approve Hana's

⁸⁹⁰ *ibid* 8.

⁸⁹¹ *ibid*.

⁸⁹² *ibid*.

⁸⁹³ *ibid* 9.

⁸⁹⁴ *ibid*.

⁸⁹⁵ *ibid*.

⁸⁹⁶ *ibid*.

⁸⁹⁷ *ibid* 10.

⁸⁹⁸ *ibid*.

⁸⁹⁹ *ibid*.

⁹⁰⁰ *ibid*.

⁹⁰¹ *ibid*.

application on the basis of the Supreme Court's ruling.⁹⁰² Under Article 16–4(3) of the Bank Act and Article 215 of the repealed Securities and Exchange Act, the FSC would be entitled to order that Lone Star must sell its shareholding in excess of 10% of KEB's shares if the courts determined that Lone Star had violated a finance-related law or regulation as part of the merger of KEB and KEBCS.⁹⁰³

On 6 October 2011, the Seoul High Court issued a ruling in the KEBCS stock manipulation case, finding Lone Star vicariously liable due to its alleged wrongdoing during KEB's merger with KEBCS.⁹⁰⁴ On 17 October 2011, the FSC informed Lone Star that it would be issuing a compliance order based on the Seoul High Court decision in the KEBCS case.⁹⁰⁵ The FSC issued the Compliance Order on 25 October 2011, obliging Lone Star to sell its shareholding in excess of 10% of KEB's shares.⁹⁰⁶ On 18 November 2011, the FSC issued a Disposition Order, which ordered Lone Star to dispose of its shares in KEB in excess of 10% by no later than 18 May 2012.⁹⁰⁷ Under the time pressure of the approaching deadline of the disposition order, Lone Star accepted Hana Financial Group's demands to drop the sale price for its shares.⁹⁰⁸ Hana submitted the second application with the FSC on 5 December 2012, which set out the reduced price.⁹⁰⁹ The FSC approved the sale to Hana on 27 January 2012.⁹¹⁰

5.1.2 Can the FSC's Alleged Acts of Delay of the Approval of Lone Star's Transactions with Third Parties and Other Acts Constitute Expropriation?

⁹⁰² *ibid.*

⁹⁰³ *ibid.*

⁹⁰⁴ *ibid.* 11.

⁹⁰⁵ *ibid.* 11–12.

⁹⁰⁶ *ibid.*

⁹⁰⁷ *ibid.* 12.

⁹⁰⁸ *ibid.*

⁹⁰⁹ *ibid.* 13.

⁹¹⁰ *ibid.*

When exploring an expropriation claim under international investment law, two questions should be addressed. The first is whether a property interest existed that falls within the concept of investment as provided for in the international investment agreement concerned. The second is whether the property interest was expropriated in violation of the relevant provision in the international investment agreement. According to Article 1.1(a) of the Korea-Belgium BIT, ‘investment’ is defined as follows:

Every kind of asset owned or controlled, directly or indirectly, by an investor of one Contracting Party in the territory of the other Contracting Party and in particular, though not exclusively, includes movable or immovable property or any other property rights such as mortgages, liens or pledges.⁹¹¹

Accordingly, in connection to the FSC review of approval, Lone Star’s property right to transact shares, from which it would be able to obtain economic gain, falls within the scope of investment to be protected under the BIT.

Thus, was Lone Star’s right to transact shares expropriated? As for expropriation, Article 5 of the BIT provides:

Investments of investors of one Contracting Party shall not be nationalised, expropriated or otherwise subjected to any other measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as ‘expropriation’) in the territory of the other Contracting Party except for public purposes and against prompt, adequate and effective compensation. The expropriation shall be carried out on a non-discriminatory basis and under due process of law.⁹¹²

⁹¹¹ Article 1 (Definition) 1(2) of the Korea-Belgium BIT.

⁹¹² Article 5 of the BIT, para 1.

The Banking Act allows the FSC to exercise its authority to review a transaction application for approval and also gives it a wide discretion when doing so. The FSC is entitled to afford the approval of transactions ‘only when it can admit itself that it is necessary’, by considering factors such as whether the acquirer can contribute to the ‘efficiency and soundness of banking business’, the distribution of share-ownership of the shareholders of the bank concerned, and so forth.⁹¹³ The list of considerations is not exhaustive and it is likely that the FSC can exercise extra discretion when deciding whether approval is necessary, even though the extent of this extra discretion is not definitively known. While the review processes allegedly lingered, the SPAs were given up or terminated by the transaction counterparts. The FSC based its halt of the review processes on the reason that it had to wait while investigations and legal proceedings were still pending with regard to the former head of Lone Star Advisors Korea, Mr Paul Yoo, who was charged with manipulating the stock price in connection to the KEBCS merger. If the arbitral tribunal considers the FSC’s decision to halt the review processes as legitimate, it will decline Lone Star’s claims with regard to the FSC’s acts. However, if the arbitral tribunal views the delay as an abuse of authority, then the FSC’s administrative acts can be described as unjustifiable; *de facto* inaction. Because, in this case, no nationalisation or direct expropriation occurred, in light of Article 5 of the BIT, a question may arise. This is whether the inaction can be deemed as ‘any other measures’⁹¹⁴ that can give rise to the effect of nationalisation or expropriation. Arbitral tribunals’ views diverge on whether inaction can constitute an indirect expropriation. The Iran-US Claims Tribunal denied the potential of inaction to become such a measure:

A claim founded substantially on omissions and inaction in a situation where the evidence suggests a widespread and indiscriminate deterioration in management,

⁹¹³ Korean Banking Act, art 15(3).

⁹¹⁴ Article 5 of the Korea-Belgium BIT.

disrupting the functioning of the port of Bandar Abbas, can hardly justify a finding of expropriation.⁹¹⁵

On the other hand, the tribunal in *CME Czech Republic* contended that when a *de facto* or indirect expropriation claim arises, it does not matter whether the effect of expropriation was caused by actions or by inaction.⁹¹⁶

Therefore, it will need to be decided by the arbitral tribunal in *Lone Star* whether inaction can constitute an indirect expropriation, and the existence of the ‘effect equivalent to expropriation’ will be a factor of high importance, possibly the decisive factor, from a number of factors which will be considered, for a finding of expropriation. The sole effect doctrine, though once recognised as predominant, is no longer universally accepted. However, in this case it is very likely that the economic effect could be the sole decisive factor, in view of the BIT expropriation provisions.

The Korea-Belgium BIT embraces the concept of indirect expropriation on the basis that the measure in question gives rise to an ‘effect equivalent to nationalisation or expropriation’.⁹¹⁷ The formulation of indirect expropriation in the BIT shows particular differences to those provided for by NAFTA and other BITs. Article 1110 of NAFTA conceives of indirect expropriation when ‘a measure tantamount to nationalisation or expropriation’ occurs. This may indicate that a NAFTA tribunal could find an indirect expropriation by taking into account a number of considerations in addition to the economic effect. For instance, the tribunal in *Fireman’s Fund Insurance Company* put forward several relevant factors, beside the economic effect factor, for the finding of an indirect expropriation, such as ‘whether the measure at issue is within the recognised police powers’; the ‘proportionality between the means employed and the aim sought to be realised’; and the ‘investor’s

⁹¹⁵ *Sea-Land Service Inc v Republic of Iran* (1984) 6 Iran-USCTR 149; McLachlan and others (n 4) 291.

⁹¹⁶ *CME* (n 7) paras 604–05; McLachlan and others (n 4) 291.

⁹¹⁷ Article 5 of the Korea-Belgium BIT.

reasonable investment-backed expectations’.⁹¹⁸ The US and Canada Model BITs of 2004 also provide for additional factors to be considered, such as the ‘extent to which the government action interferes with distinct, reasonable investment-backed expectations’ and ‘the character of the government action’.⁹¹⁹ It is thus reasonable to conclude that the existence of an indirect expropriation under the Korea-Belgium BIT requires the actual ‘effect equivalent to nationalisation or expropriation’ to be considered as the most significant factor.

When a case involves a series of regulatory acts, for the finding of an indirect expropriation, an arbitral tribunal can examine either each regulatory act or the collection of all the acts together. In the context of *Lone Star*, besides examining each act of the FSC halting the review process, the arbitral tribunal can scrutinise all the FSC’s acts of halting the review processes plus the FSC’s orders and the governmental investigations in the collective sense for a potential finding of an indirect expropriation. This is because the notion of ‘creeping expropriation’ is recognised as a type of indirect expropriation. Creeping expropriation denotes the situation where an indirect expropriation occurs through a gradual process over a long period of time. The tribunal in *Pope & Talbot* defined creeping expropriation as ‘a process that has the effect of taking property through staged measures’.⁹²⁰ The tribunal in the *Fireman’s Fund* case also recognised creeping expropriation by stating that the taking can occur through ‘a series of related or unrelated measures over a period of time’.⁹²¹ The Restatement (Third) of the Foreign Relations Law of the United States describes creeping expropriation as a situation where the state seeks ‘to achieve the same result [as with formal expropriation] by taxation and regulatory measures designed to make continued operation of a project uneconomical so that it is abandoned’.⁹²²

⁹¹⁸ *Fireman’s Fund* (n 697) para 176.

⁹¹⁹ US Model BIT (2004), Annex B Expropriation, 4(a)(ii)~(iii) and Canadian Model BIT (2004), Annex B.13(1) Expropriation, (b)(ii)~(iii).

⁹²⁰ *Pope & Talbot* (n 135) para 83.

⁹²¹ *Fireman’s Fund* (n 697) para 176(d).

⁹²² American Law Institute, Restatement (Third) Foreign Relations Law of the United States (1987) vol 1, s 712, comment g.

The final question in this task of finding an expropriation is whether Lone Star's right to transact shares in KEB was subjected to an expropriatory effect as a result of the FSC's halting acts and orders, and the governmental investigations, viewed either respectively or collectively in light of creeping expropriation. Lone Star attempted to sell its shares in KEB to Kookmin Bank, DBS Bank, and HSBC to no avail; it finally sold them to Hana. Lone Star claimed that the FSC created the situation where it was indirectly forced to sell shares at a reduced price to Hana. It is likely that the tribunal will consider that Lone Star suffered a loss of some degree of the value of its property, whether it could be justifiable or not. Even so, Lone Star did not lose its right to transact because it was ultimately able to sell its shares to Hana. Neither did Lone Star go through a situation where all or a substantial part of its shares became economically meaningless. This is true even when all of FSC's acts of halting and orders, and the governmental investigations, are examined collectively in light of creeping expropriation. Therefore, the FSC's acts of halting the review process and orders, and the governmental investigations, did not constitute an indirect expropriation under the Korea-Belgium BIT. Nevertheless, it remains to be seen whether the FSC's acts violated other BIT obligations such as the FET, the prohibition of impairment by arbitrary and discriminatory measures, and non-discrimination. Those issues are not addressed in this thesis because they are beyond the ambit of its topic.

5.2 The NTS Taxation on Lone Star's Transactions

5.2.1 Facts

The NTS imposed taxes on Lone Star's share transactions on the basis of its interpretation of the Convention between the Republic of Korea and the Kingdom of

Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Korea-Belgium Tax Treaty).⁹²³

Firstly, Star Tower Corporation was owned by Star Holdings SCA, a Lone Star investment holding company organised under Belgian law.⁹²⁴ The NTS assessed ₩ 112 billion (almost €92 million) in capital gains taxes in relation to the sale of the shares of Star Tower Corporation.⁹²⁵ The Korea-Belgium Tax Treaty expressly provides that Korea may not impose tax on the sale of shares of a Korean entity where the seller or ‘alienator’ of the shares is a Belgian resident.⁹²⁶ However, the NTS asserted that Star Holding SCA was not the true beneficial owner of the shares of Star Tower Corporation.⁹²⁷ In declining the status of Star Holdings SCA as the seller of the shares of Star Tower Corporation, the NTS based its decision on the fact that the ultimate investors, ie the investors in the US and Bermuda partnerships that indirectly owned Star Holdings SCA, were the authentic owners of Star Tower Corporation.⁹²⁸ The NTS also asserted that the proceeds were taxable in Korea under Korea’s domestic law, regardless of the provisions of the treaty, because the gains in question engendered from the sale of a Korean company whose primary asset was real estate.⁹²⁹ Accordingly, the NTS assessed taxes against the US and Bermuda partnerships that had invested indirectly in Star Tower Corporation.⁹³⁰

The NTS imposes taxes against these partnerships under Korea’s personal income tax, not under Korea’s corporate tax.⁹³¹ In January 2012, the Korean Supreme Court found that it was inappropriate to impose taxes under Korea’s personal income tax

⁹²³ The Convention between the Republic of Korea and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Korea-Belgium Tax Treaty) was signed on 20 April 1994 and came into force on 31 December 1996.

⁹²⁴ ‘*Lone Star Arbitration Memorandum*’ (n 875) 14.

⁹²⁵ *ibid.*

⁹²⁶ *ibid.* 15.

⁹²⁷ *ibid.*

⁹²⁸ *ibid.*

⁹²⁹ *ibid.*

⁹³⁰ *ibid.*

⁹³¹ *ibid.*

and ordered that the NTS cancel the personal income tax imposed on Lone Star.⁹³² Accordingly, the NTS imposed corporate tax on Lone Star.⁹³³

Secondly, in 2007, five Belgian investment holding companies affiliated with Lone Star sold shares in three Korean companies.⁹³⁴

In July 2008, the NTS assessed and imposed taxes of ₩153 billion (about €93 million).⁹³⁵ The NTS, having no regard for each of the Belgian entities that had sold the shares, asserted that the upstream US and Bermuda partnerships had permanent establishments in Korea (and a portion of gains from the sale of the shares can, therefore, be taxed in Korea) due to business activities conducted by employees of LSAK and Hudson Advisors Korea Inc, an affiliated asset management company in Korea.⁹³⁶

Thirdly, in February 2012, Lone Star was permitted to sell its majority stake in KEB to Hana Financial Group.⁹³⁷ Then, the NTS directed Hana to withhold taxes in relation to the transaction of the KEB shares.⁹³⁸ Lone Star argued that the NTS's direction to withhold taxes in this case indicated that the NTS had inconsistent views of the tax assessment.⁹³⁹ This was because the order to withhold taxes indicated that the NTS viewed Lone Star as having no permanent establishment in Korea, while the exemption from withholding taxes under the Korea-Belgium Tax Treaty (or embracing for the purpose of discussion the NTS's position that the ultimate fund investors were the true taxpayers with respect to this investment, under the treaties with the countries of residence of those ultimate investors) in the case of the proceeds of the 2012 sale indicated that the NTS did in fact view that

⁹³² *ibid.*

⁹³³ *ibid.*

⁹³⁴ *ibid* 16.

⁹³⁵ *ibid.*

⁹³⁶ *ibid* 16–17.

⁹³⁷ *ibid* 17.

⁹³⁸ *ibid.*

⁹³⁹ *ibid.*

Lone Star had a permanent establishment in Korea.⁹⁴⁰ In accordance with the NTS's direction, Hana withheld taxes of ₩ 431 billion (almost €292 million) from the sale proceeds and paid it to the Seoul Regional Tax Office and the Namdaemun District Tax Office on 5 March 2012 and 7 March 2012, respectively.⁹⁴¹

5.2.2 The State's Right to Tax under International Law and Double Taxation

According to basic principles of international law, a state exercises the power to tax on the basis that it has sovereignty over a 'defined territory' and a 'permanent population'.⁹⁴² States tend to prefer bilateral treaties as the legal instruments imposing limitations on their fiscal sovereignty, where the principle of reciprocity can operate.⁹⁴³ Multilateral treaty regimes have been declined by developed countries.⁹⁴⁴ The authority to tax is also exercised subject to constraints formed by general principles of international law.⁹⁴⁵ International taxation regimes operate upon two foundations: (i) the identification of the taxation basis and (ii) the international allocation of taxable income or properties between tax authorities.⁹⁴⁶ A taxation basis can be established on the basis of predominately two main tax principles: the residence principle and the source principle.⁹⁴⁷ The residence principle involves taxing income, without regard for where it originated from, based on the residence of the natural or legal person who obtains the income.⁹⁴⁸ In contrast,

⁹⁴⁰ *ibid.*

⁹⁴¹ *ibid* 18.

⁹⁴² The 1933 Montevideo Convention on the Rights and Duties of States provides in Article 1 that the state as a person of international law should possess the following qualifications: (a) a permanent population; (b) a defined territory; (c) a government; and (d) the capacity to enter into relations with other states.

⁹⁴³ Fiona C Beveridge, *The Treatment and Taxation of Foreign Investment under International Law: Toward International Disciplines* (Juris Publishing, Manchester University Press 2000) 78.

⁹⁴⁴ *ibid.*

⁹⁴⁵ Wolfgang Schon, 'Persons and Territories: on the International Allocation of Taxing Rights' [2010] *British Tax Review* 1.

⁹⁴⁶ *ibid* 79.

⁹⁴⁷ *ibid* 79–80.

⁹⁴⁸ *ibid* 79.

according to the source principle, tax is imposed on income in the jurisdiction within which income-generating business activities take place.⁹⁴⁹ In a situation where these two principles intersect each other, double taxation becomes a potential issue.⁹⁵⁰

In relation to the potential for double taxation, a large amount of double taxation treaties exists; more than 1,500 treaties at a minimum. Even though some variances exist in the relevant provisions of these agreements, most of them pursue the general approach adopted in the OECD Model Tax Convention on Income and on Capital 2010 (OECD Model Tax Convention).⁹⁵¹

In determining whether to tax an enterprise from state A, the taxing authorities in state B confront two questions, as follows:

1. Do the enterprise's business activities fall within the scope of state B's domestic tax law?
2. If so, is it protected from such taxation by the provisions of a double tax treaty between state A and state B?⁹⁵²

The OECD Model Tax Convention basically employs the residence principle, but allows deviations from it by taking into account the 'permanent establishment'.⁹⁵³ Therefore, suppose that the business is *prima facie* taxable and that the tax treaty between the two relevant states follows the OECD Model Tax Convention, the question of taxation leads onto whether the enterprise has a permanent establishment in state B.⁹⁵⁴ Paragraph 3 of the Commentary to Article 7 of the OECD Model Tax Convention provides that:

⁹⁴⁹ *ibid* 80.

⁹⁵⁰ *ibid*.

⁹⁵¹ Beveridge (n 943) 83.

⁹⁵² Paul Williams, 'Websites and Servers – Double Tax Treaties and Permanent Establishments' [2000] CTLR 147.

⁹⁵³ Beveridge (n 943) 84.

⁹⁵⁴ Williams (n 952).

It has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

The definition of 'permanent establishment' is articulated in Article 5(1) of the OECD Model Tax Convention, according to which, it is 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. Paragraph 2 of the Commentary to Article 5 expounds details of the definition, as follows:

1. the existence of a 'place of business', ie a facility, such as premises, or in certain instances, machinery or equipment;
2. the place of business must be 'fixed', ie it must be established as a distinct location with a certain degree of permanence; and
3. the carrying on of the business of the enterprise is through this fixed place of business. This means, traditionally, that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the state in which the fixed place is situated.

Article 5(5) of the OECD Model Tax Convention provides an alternative method of recognising permanent establishment. An enterprise is deemed to have a permanent establishment in a state where there is a person – other than an independent agent – (a dependent agent) who is 'acting on behalf of and has, and habitually exercises, in a Contracting state, an authority to conclude contracts in the name of the enterprise'.⁹⁵⁵ However, Article 5(4) of the OECD Model Tax Convention provides a general carve-out provision for cases where business activities performed through a fixed place of business or a dependent agent are characterised as being preparatory or auxiliary for the enterprise, because 'such a place of business' only affords 'the

⁹⁵⁵ Article 5(5) of the OECD Model Tax Convention.

services so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business (or dependent agent) in question'.⁹⁵⁶

5.2.3 Taxation Claims and Investment Treaty Arbitration

Governmental taxation measures normally meet four conditions: it must be exercised (i) for something other than a certain benefit (service, right or performance); (ii) to a public body; (iii) with the aim of raising revenue; and (iv) based on a liability in law or regulations.⁹⁵⁷ International investment agreements do not usually contain express provisions that directly address such governmental taxation measures. Even so, can a foreign investor bring a claim before investment treaty arbitration in relation to a tax measure? Investment treaties are not intended to afford foreign investors with rights concerning taxation and tax calculation.⁹⁵⁸ A taxation measure as such, thus, cannot be a subject matter about which to raise a complaint under international investment agreements. However, when a tax measure can be construed as a type of treatment which has been afforded to a foreign investor, the investor would be able to raise an investment treaty claim for a violation of standards of treatment afforded by the treaty.⁹⁵⁹ In this regard, international investment agreements become applicable to taxation matters; only in a different way to that of double taxation treaties.⁹⁶⁰ For a taxation claim to be brought to investment treaty arbitration under the ICSID, there are additional conditions to be met.

First of all, the ICSID Convention provides in Article 25 that 'the jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment'.

⁹⁵⁶ Paragraph 23 of the Commentary to Article 5 of the OECD Model Tax Convention.

⁹⁵⁷ Edwin Vanderbruggen, 'Investment Arbitration in Tax Matters: Some Thoughts on Selected International Case Law' (2013 Tax Conference of the New Zealand Institute of Chartered Accountants) 8 <www.nzica.com/Training-and-events/CPD-policy-and-online-log/~media/NZICA/Docs/Resources%20and%20publications/2013%20Tax%20Conference/TC13%20E%20Vanderbruggen%20paper.ashx> accessed 27 August 2014.

⁹⁵⁸ *ibid* 7.

⁹⁵⁹ *ibid*.

⁹⁶⁰ *ibid* 5.

Although there is no indication that a tax dispute related to an investment is a ‘legal dispute’ over which the ICSID tribunals have jurisdiction, the early jurisprudence of the ICSID has recognised that tax disputes related to an investment are indeed ‘legal disputes arising directly out of the investment’.⁹⁶¹ In *Kaiser Bauxite v Jamaica*, a case relating to an investment treaty which contained a tax-stabilisation clause, the tribunal acknowledged that a dispute over a tax increase would fall within the scope of the jurisdiction of the ICSID Convention because ‘the dispute concerned the alleged rights and obligations stemming from the particular provisions in the agreements between Kaiser and Jamaica and was therefore a legal dispute’.⁹⁶² In *Goetz v Burundi*, where the investor claimed that the revocation of a duty free zone constituted the expropriation of his mining operation, the tribunal made an award on the basis that the issues of reparation for damage to a foreign investor are invariably legal disputes, irrespective of the types of governmental measures involved.⁹⁶³ In *Feldman v Mexico*, the tribunal concluded that the failure of the tax authorities to refund excise tax for exported cigarettes brought about a violation of the national treatment of the investment treaty.⁹⁶⁴

Secondly, unique to taxation matters under international investment agreements is the limited ability that foreign investors have to file a taxation-based investment claim, due to the existence of a ‘taxation carve-out clause’ in all contemporary international investment agreements.⁹⁶⁵ Taxation carve-out clauses first appeared in international investment agreements in the late 1960s. Previously it seemed that taxation matters in general were not been covered by international investment agreements because they had been recognised as being covered in bilateral tax treaties.⁹⁶⁶ A taxation carve-out clause can be understood as circumscribing either the ‘admissibility of a claim’ or the ‘host state’s consent to arbitration’, and

⁹⁶¹ *ibid* 6.

⁹⁶² *Kaiser Bauxite v Jamaica* [1999] ICSID Case No ARB/74/3 Reports 296.

⁹⁶³ *Goetz et al* (n 804) para 83.

⁹⁶⁴ *Feldman v Mexico* (n 321).

⁹⁶⁵ Matthew Davie, ‘Taxation-Based Investment Treaty Claims’ [2015] *Journal of International Dispute Settlement* 1, 9.

⁹⁶⁶ *ibid* 10.

therefore the ‘jurisdiction of the tribunal’.⁹⁶⁷ In this respect, a taxation carve-out clause can function as a procedural limitation to the arbitral judgment of a taxation-based investment claim.⁹⁶⁸ For instance, Article 16(1) of the Canada Model BIT of 2004 provides at Article 16(1):

Except as set out in this Article, nothing in this Agreement shall apply to taxation measures. For further certainty, nothing in this Agreement shall affect the rights and obligations of the Parties under any tax convention. In the event of any inconsistency between the provisions of this Agreement and any such convention, the provisions of that convention shall apply to the extent of the inconsistency.⁹⁶⁹

Article 16(4) of the Canada Model BIT provides, in particular to a taxation-based expropriation issue, as follows:

The provisions of Article 13 shall apply to taxation measures unless the taxation authorities of the Parties, no later than six months after being notified by an investor that the investor disputes a taxation measure, jointly determine that the measure in question is not an expropriation. The investor shall refer the issue of whether a taxation measure is an expropriation for a determination to the taxation authorities of the Parties at the same time that it gives notice under Article 24 (Notice of Intent to Submit a Claim to Arbitration).⁹⁷⁰

Article 16(4) renders the arbitral acceptance of a taxation-based expropriation claim conditioned on the joint veto of the tax authorities of both the home state and the host state.⁹⁷¹ When a foreign investor files a notice of arbitration, it should also refer its taxation-based expropriation claim to the tax authorities of both its home state

⁹⁶⁷ *ibid* 9.

⁹⁶⁸ *ibid*.

⁹⁶⁹ Article 16.1 of the Canada Model BIT of 2004 [Taxation Measures].

⁹⁷⁰ Article 16.4 of the Canada Model BIT of 2004 [Expropriation].

⁹⁷¹ *ibid* 11.

and its host state. Both tax authorities will determine whether a taxation measure in question constituted an expropriation in the period of six months. If the tax authorities jointly decide that it did not constitute an expropriation, the investor's claim will no longer be processed in the arbitration. Canada's Department of Foreign Affairs, Trade and Development clarified the purpose of the Canada Model BIT's taxation carve-out clause:

In general, taxation measures are outside the scope of a FIPA [Foreign Investment Protection Agreement]. Taxation matters are addressed through bilateral double taxation agreements ... Canada does, however, negotiate its FIPAs on the basis that tax measures will be subject to the disciplines of the FIPA with respect to expropriation and tax measures that form part of a private investment agreement or contract between an investor and host government.⁹⁷²

Article 21 of the US Model BIT of 2012 also provides that the BIT only applies exceptionally to taxation measures, as follows:

1. Except as provided in this Article, nothing in Section A shall impose obligations with respect to taxation measures.
2. Article 6 [Expropriation] shall apply to all taxation measures, except that a claimant that asserts that a taxation measure involves an expropriation may submit a claim to arbitration under Section B only if:
 - (a) The claimant has first referred to the competent tax authorities of both Parties in writing the issue of whether that taxation measure involves an expropriation; and

⁹⁷² *ibid* 12.

- (b) Within 180 days after the date of such referral, the competent tax authorities of both Parties fail to agree that the taxation measure is not an expropriation.⁹⁷³

The foreign investor, prior to submitting its taxation-based expropriation claim to arbitration, should refer to the authorities of both the home state and the host state. The matter should only be referred to arbitration if the tax authorities of both states cannot agree within 180 days, since the alleged expropriation was referred to the authorities, whether the taxation measure constituted an expropriation.

NAFTA provides in Article 2103(1) and (2) in relation to taxation:

- (1) Except as set out in this Article, nothing in this Agreement shall apply to taxation measures.
- (2) Nothing in this Agreement shall affect the rights and obligations of any Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the consistency.

Article 2103(6) of NAFTA also provides, concerning a taxation-based expropriation issue, that:

Article 1110 (Expropriation and Compensation) shall apply to taxation measures except that no investor may invoke that Article as the basis for a claim under Article 1116 (Claim by an Investor of a Party on its Own Behalf) or 1117 (Claim by an Investor of a Party on Behalf of an Enterprise), where it has been determined pursuant to this paragraph that the measure is not an expropriation.⁹⁷⁴

⁹⁷³ Article 21(1) and (2) of the US Model BIT of 2012.

⁹⁷⁴ NAFTA, art 2103(6).

NAFTA also provides for a joint veto mechanism whereby the tax authorities of both the home state and the host state can jointly decide the continuous arbitral judgment of a taxation-based expropriation claim in the period of six months.⁹⁷⁵ The Energy Charter Treaty (ECT) similarly contains the taxation carve-out and the joint veto clauses. Article 21 (1) provides that:

Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties. In the event of any inconsistency between this Article and any other provision of the Treaty, this Article shall prevail to the extent of the inconsistency.⁹⁷⁶

It is submitted that the version of the joint veto mechanism of the ECT is weak, in that the tax authorities of both the home state and the host state are obliged to ‘strive to resolve’⁹⁷⁷ whether an expropriation occurred and the tribunal may ‘take into account’⁹⁷⁸ conclusions made by the tax authorities.

5.2.4 Taxation-Based Expropriation Claims

Tax intrinsically involves a ‘partial confiscation’⁹⁷⁹ or an ‘appropriation of property’⁹⁸⁰ that incurs no compensation.⁹⁸¹ Thus, it is clearly a challenging task to differentiate a compensable expropriation from normal taxation measures. Since international investment agreements do not provide extra guidelines in order to helpfully conduct this task, it is almost inevitable that one has to rely on what can be derived from arbitral jurisprudence. Furthermore, what may render the issue more

⁹⁷⁵ *ibid.*

⁹⁷⁶ Article 21(1) of the ECT.

⁹⁷⁷ *ibid* art 21(5)(b)(ii).

⁹⁷⁸ *ibid* art 21(5)(b)(iii).

⁹⁷⁹ Arno E Gildemeister, ‘Case Comment: Burlington Resources, Inc. v. Republic of Ecuador. How Much is Too Much: When is Taxation Tantamount to Expropriation?’ (2014) 29 ICSID Review 1, 2.

⁹⁸⁰ Newcombe (n 1) 361.

⁹⁸¹ Gildemeister (n 979).

complicated is that wide disagreement exists between states within the global tax system on what constitutes a ‘legitimate exercise of the taxing power’.⁹⁸² For instance, states can apply differential tax treatment to a corporate group where its holding company, situated in a tax haven, ‘state A’, is the owner of an ‘operating subsidiary with valuable property’ in ‘state B’, which seeks to obtain a capital gain from the value of the assets by transacting its shares into the operating company.⁹⁸³ Western states deem that this share transaction brings about a capital gain, taxable only in state A.⁹⁸⁴ On the other hand, India and China view that state B has the right to tax the group in relation to the gain.⁹⁸⁵ Therefore, it is significant to pay close attention to specific bilateral tax treaties as well as relevant arbitral jurisprudence.

What can be observed from recent arbitral cases, to be explored below, which involve taxation-based expropriation claims, is that the most frequent reason for the rejection of claims has lain in the failure of proving substantial deprivation.⁹⁸⁶ In the case of *Archer Daniels Midland Company*, the amendment of the Mexican Congress, imposing a 20 per cent excise tax on soft drinks and syrups that used sweeteners other than cane sugar, such as high fructose corn syrup, was at issue.⁹⁸⁷ Even though the claimant argued that the excise tax was expropriatory, because it was ‘discriminatory and also interfered with their legitimate and reasonable expectations regarding the economic benefit to be obtained from the use and enjoyment of the investment’,⁹⁸⁸ the tribunal was not convinced. The tribunal advocated that the ‘effect test’,⁹⁸⁹ indicating that an expropriation occurs when the measure at issue causes the investor to lose control of the investment by losing the property rights, even if the legal title remains intact⁹⁹⁰ or ‘rendered useless the most

⁹⁸² Davie (n 965) 21.

⁹⁸³ *ibid.*

⁹⁸⁴ *ibid.*

⁹⁸⁵ *ibid.*

⁹⁸⁶ *ibid.* 5.

⁹⁸⁷ *Archer Daniels Midland Company* (n 462) para 2.

⁹⁸⁸ *ibid.* para 251.

⁹⁸⁹ *ibid.* para 240.

⁹⁹⁰ *ibid.* para 244.

economically optimal use of it'.⁹⁹¹ Furthermore, the tribunal recognised that the economic effect of deprivation was the factor of highest priority to be taken into account for the finding of an expropriation. The tribunal clarified its stance by citing the cases of *Norwegian Shipowners' Claims* (1922) and *Polish Upper Silesia* (1929), in which the tribunals admitted that an indirect expropriation could occur 'as a result of a government measure which results in the effective loss of management, use or control, or significant loss or depreciation of the value or the assets of the foreign investment'.⁹⁹² The *Archer Daniels Midland Company* tribunal also stated that the decisive element was whether the government measure interfered with property rights to an extent that these rights were rendered 'so useless that they must be deemed to have been expropriated'.⁹⁹³ The tribunal conclusively rejected the claim on the basis that the tax did not prevent the full operation of production activities.⁹⁹⁴

In *Feldman*, the Mexican government's refusal to afford rebates on exported tobacco products was at issue.⁹⁹⁵ The refusal resulted in a tax liability that made the claimant's tobacco export business unprofitable.⁹⁹⁶ The tribunal did not accept the claim as it felt that a tax that made 'certain activities less profitable or even uneconomic to continue' did not necessarily amount to an expropriation.⁹⁹⁷ In *EnCana*, the claimant contended that the denial of VAT credits and refunds, estimated to be 10 per cent of the value of its business transactions, constituted an expropriation under the Canada-Ecuador BIT.⁹⁹⁸ The tribunal denied this contention as the state measure in question did not impair the claimant's ability to maintain normal business activities, or render the economic profit from its investment 'so marginal or unprofitable as to effectively deprive them of their character as

⁹⁹¹ *ibid* para 246.

⁹⁹² *ibid* para 241.

⁹⁹³ *ibid* para 241.

⁹⁹⁴ *ibid* para 247.

⁹⁹⁵ *Feldman v Mexico* (n 321); see *Davie* (n 965) 5.

⁹⁹⁶ *ibid*.

⁹⁹⁷ *ibid* para 112.

⁹⁹⁸ *EnCana* (n 483) para 177.

investments'.⁹⁹⁹ In *Occidental Exploration and Production Company*, the tribunal concluded that the denial of VAT refunds did not constitute an expropriation under the US-Ecuador BIT because of the absence of a substantial deprivation of the value of the claimant's investment.¹⁰⁰⁰ In both *Burlington Resources* and *Perenco*, in relation to Ecuador's Law 42, heavy taxes were imposed on sales of oil exceeding certain amounts. In *Burlington*, the tribunal rejected the claimant's contention that taxation that occupied 50~90 per cent of profits constituted an expropriation under the US-Ecuador BIT and held that the taxes did not render the claimant's investment completely unprofitable.¹⁰⁰¹ In *Perenco*, the tribunal rejected the expropriation claim even though the taxes caused the claimant a loss of 99 per cent of windfall profits.¹⁰⁰² It held that:

The financial burden of paying 99% of the revenue above the reference price, while disadvantageous to Perenco, did not bring its operation to a halt or, to revert to the tests previously cited, effectively neutralise the investment or render it as if it had ceased to exist.¹⁰⁰³

Despite being rare, successful cases involving taxation-based expropriation claims have materialised; in particular, in the circumstances of the nationalisation of the Yukos oil company by the Russian government. Yukos' production companies sold oil to its affiliated trading companies in locations which were exempt from profits tax.¹⁰⁰⁴ The trading companies sold oil at market price to foreign purchasers.¹⁰⁰⁵ This oil was subject to VAT, but received a zero-rate benefit as it was on exported goods.¹⁰⁰⁶ In 2003, Khodorkovsky, Yukos' CEO, was prosecuted for corporate tax

⁹⁹⁹ *ibid* para 174.

¹⁰⁰⁰ *Occidental Exploration and Production Company* (n 300) para 89.

¹⁰⁰¹ *Burlington Resources Inc v Republic of Ecuador* (Decision on Liability) 14 December 2012 (ICSID Case No ARB/08/5) para 450.

¹⁰⁰² *Perenco Ecuador Limited* (n 479) para 684.

¹⁰⁰³ *ibid* para 685.

¹⁰⁰⁴ Davie (n 965) 3.

¹⁰⁰⁵ *ibid*.

¹⁰⁰⁶ P Stephan, 'Taxation and Expropriation – The Destruction of the Yukos Oil Empire' (2013) 35(1) *Houston Journal of International Law* 1, 15–16, cited in Davie (n 965) 3.

evasion.¹⁰⁰⁷ At this point, the Russian tax authorities re-examined Yukos' accounts for the period of 2000 through to 2003, and found that more than US\$24 billion in liabilities were overdue.¹⁰⁰⁸ The new assessments neglected the existence of Yukos' affiliated trading companies and removed Yukos' advantage of the exemption from profits tax.¹⁰⁰⁹ Besides the loss of the exemption of profits tax, Yukos was deprived of its zero-rated VAT benefit filed by its production companies, becoming subject to the full VAT rate.¹⁰¹⁰ In response, the state seized Yukos' properties and implemented a 'non-competitive' auction whereby Yukos' properties were sold at below-market price to Rosneft, a state oil company.¹⁰¹¹

Yukos' shareholders filed investment arbitration claims against Russia under the UK-USSR BIT,¹⁰¹² the Spain-USSR BIT¹⁰¹³ and the Energy Charter Treaty (ECT),¹⁰¹⁴ claiming that Russia had expropriated their investments. All the tribunals under these international investment treaties accepted the expropriation claims. In *RosInvestCo UK Ltd v Russia*, the tribunal established under the Stockholm Chamber of Commerce (SCC) Rules concluded that Yukos suffered from 'relentless and inflexible attacks' that could only be construed as 'steps under a common denominator in a pattern to destroy Yukos and gain control over its assets'.¹⁰¹⁵ In *Renta 4 SVSA v Russia*, the tribunal looking at the SCC Rules examined whether 'Yukos' tax delinquency was indeed a pretext for seizing Yukos' assets and transferring them to Rosneft'.¹⁰¹⁶ Yukos was liquidated through bankruptcy proceedings and the rest of its assets were sold in liquidation auctions.¹⁰¹⁷ The tribunal, while admitting that the claimants had failed to prove that the 'manner in

¹⁰⁰⁷ *ibid* 19, cited in Davie, (n 965) 3.

¹⁰⁰⁸ *ibid* 25, cited in Davie (n 965) 3.

¹⁰⁰⁹ Davie (n 965) 3.

¹⁰¹⁰ Stephan (n 1006) 21–22, cited in Davie (n 965) 3.

¹⁰¹¹ *ibid* 25, cited in Davie (n 965) 3.

¹⁰¹² *RosInvestCo UK Ltd v Russia* (Final Award) 12 September 2012 Stockholm, Sweden SCC Arbitration V (079/2005).

¹⁰¹³ *Renta 4 SVSA, et al v The Russian Federation* (Award) 20 July 2012 SCC No 24/2007.

¹⁰¹⁴ *Yukos Universal Limited v The Russian Federation* (Final Award) 18 July 2014 (PCA Case No AA 227).

¹⁰¹⁵ *RosInvestCo UK Ltd* (n 1012) para 621.

¹⁰¹⁶ *Renta 4 SVSA v Russia* (n 1013) 60.

¹⁰¹⁷ *ibid* para 129.

which the bankruptcy and liquidation proceedings were commenced or conducted violated Russian law',¹⁰¹⁸ concluded that:

Yukos' tax delinquency was indeed a pretext for seizing Yukos' assets and transferring them to Rosneft. As discussed above, this finding supports the Claimant's contention that the Russian Federation's real goal was to expropriate Yukos, and not to legitimately collect taxes.¹⁰¹⁹

In *Yukos Universal Ltd v Russia*, the tribunal concluded that an expropriation occurred, holding that:

The tribunal has earlier concluded that 'the primary objective of the Russian Federation was not to collect taxes but rather to bankrupt Yukos and appropriate its valuable assets' ... Among the many incidents in this train of mistreatment that are within the remit of this Tribunal, two stand out: finding Yukos liable for the payment of more than 13 billion dollars in VAT in respect of oil that had been exported by the trading companies and should have been free of VAT and free of fines in respect of VAT; and the auction of YNG at a price that was far less than its value. But for two actions, ...Yukos would have been able to pay the tax claims of the Russian Federation justified or not; it would not have been bankrupted and liquidated. ... Respondent has not explicitly expropriated Yukos or the holdings of its shareholders, but the measures that Respondent has taken in respect of Yukos, set forth in detail in Part VIII, in the view of the Tribunal have had an effect 'equivalent to nationalisation or expropriation'.¹⁰²⁰

From the examination of the above expropriation cases, it seems apparent that it is rarely likely for foreign investors to succeed in taxation-based expropriation cases. Expropriation cases involving the Yukos oil company represent a taxation-related example in which a state significantly abused its tax power and surreptitiously

¹⁰¹⁸ *ibid* para 159.

¹⁰¹⁹ *ibid* para 177.

¹⁰²⁰ *Yukos* (n 1014) paras 1579–80.

managed to bring about an indirect expropriation. As the tribunal in *Yukos Universal Ltd* clarified, in relation to the question as to when a taxation measure can constitute an indirect expropriation, the important core element is an effect ‘equivalent to expropriation’. The tribunal in *Archer Daniels Midland Company* introduced ‘substantial deprivation’, as follows:

Judicial practice indicated that the severity of the economic impact is the decisive criterion in deciding whether an indirect expropriation or a measure tantamount to expropriation has taken place. An expropriation occurs if the interference is substantial and deprives the investor of all or most of the benefits of the investment.¹⁰²¹

In articulating the concept of substantial deprivation, there are three conceivable approaches. The first approach is to calculate the tax rate. Although the tax rate is a key element in taxation, international law does not inhibit tax rates of 90 per cent or more.¹⁰²² Case law of international courts and tribunals does not specify the maximum tax rate that a state must abide by in accordance with international law.¹⁰²³ In fact, the tribunal in *Burlington* did not give much weight to a high tax rate.¹⁰²⁴ A second approach is to examine the variation in the tax rate. If an extremely wide variation gap or a sudden advent of a new tax at a high rate exists, it may create the implication of an indirect expropriation.¹⁰²⁵ However, because there can be occasions in which some part of the high tax burden is transferable to a foreign investor’s customers,¹⁰²⁶ then it cannot be guaranteed as an accurate criterion. A third approach is to focus on the ‘profitability of the investment’ and to determine whether a taxation measure has extinguished profitability, in order to find an indirect expropriation.¹⁰²⁷ The tribunal in *Burlington* expounded this approach:

¹⁰²¹ *Archer Daniels Midland Company* (n 462) para 240.

¹⁰²² *Gildemeister* (n 979) 3.

¹⁰²³ *ibid.*

¹⁰²⁴ *Burlington* (n 1001) paras 434–57.

¹⁰²⁵ *Gildemeister* (n 979) 3.

¹⁰²⁶ *ibid.*

¹⁰²⁷ *ibid.*

What appears to be decisive, in assessing whether there is a substantial deprivation, is the loss of the economic value or economic viability of the investment. ... What matters is the capacity to earn a commercial return. After all, investors make investments to earn a return. ... 'loss of benefits or expectation ... is not a sufficient criterion for an expropriation'.¹⁰²⁸ ... While losses in one year may indicate that the investment has become unviable and will not return to profitability, this is not necessarily so and a finding of expropriation would need to assess the future prospects of earning a commercial return. It must be shown that the investment's continuing capacity to generate a return has been virtually extinguished.¹⁰²⁹

Tax by nature involves the taking of a portion of property. With such an appropriation being justifiably allowed, arbitral jurisprudence does not put more emphasis on factors other than economic effect for the finding of an indirect expropriation. Thus, the substantial effect of economic deprivation is deemed as the most decisive factor. This means that in addressing a taxation-based expropriation claim for the finding of expropriation, rather than seeking to articulate other conditions than economic effect to establish taxation-based expropriation, it is necessary to maintain the focus on the notion of substantial deprivation. In connection to substantial deprivation, the tribunal in *Burlington* emphasised that as a result of the state's conduct, the 'investment's continuing capacity to generate a return has been virtually extinguished'. In fact, it is usually unlikely that a simple taxation measure alone can cause such an enormous impact on a whole investment. As is observable in the *Yukos* cases, the taxation itself was merely used as a pretext for the Russian government to deprive Yukos of its assets. Other tax enforcement measures, such as the seizure of Yukos' assets, an auction, the bankruptcy, and the liquidation collectively resulted in the effect amounting to expropriation. In this regard, a wider scope of taxation-related measures, beyond a simple tax rate or variation, should conceivably have the capability of bringing about an indirect

¹⁰²⁸ *Archer Daniels Midland Company* (n 462) para 251.

¹⁰²⁹ *Burlington* (n 1001) paras 397, 399.

expropriation. In other words, a series of taxation-related measures, when the scope of scrutiny is properly circumscribed, could be recognised as having a much higher potential of constituting an indirect expropriation; this possibly constituting a so-called creeping expropriation.

Creeping expropriation is recognised as a type of indirect expropriation. During investigation, the scope of the tribunals' scrutiny is directed at the state's series of acts. This concept was defined by the tribunal in *Generation Ukraine Inc*:

Creeping expropriation is a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the State over a period of time culminates in the expropriatory taking of such property.¹⁰³⁰

The tribunal in *RosInvestCo UK Ltd* highlighted the concept of creeping expropriation and, in doing so, concentrated its scrutiny on the sum of a series of state acts and the collective or cumulative effect of those measures, as follows:

In conclusion therefore, the Tribunal considers that the totality of Respondent's measures were structured in such a way to remove Yukos' assets from the control of the company and the individuals associated with Yukos. They must be seen as elements in the cumulative treatment of Yukos for what seems to have been the intended purpose. ... The Tribunal ... considers that this cumulative effect of those various measures taken by Respondent in respect of Yukos is relevant to its decision ... In the view of the Tribunal, they can only be understood as steps under a common denominator in a pattern to destroy Yukos and gain control over its assets.¹⁰³¹

¹⁰³⁰ *Generation Ukraine Inc* (n 284) para 22.

¹⁰³¹ *RosInvestCo UK Ltd* (n 1012) para 621.

Arbitral practice concerning taxation-based expropriation issues exhibits a strong adherence to the effect test that requires the substantial deprivation of property interest for establishing indirect expropriation. It has been demonstrated that expropriation claims simply based on some degree of loss of value or enjoyment of property interest are ultimately unsuccessful. If the notion of creeping expropriation is embraced by arbitral tribunals, it will increase the likelihood that a series of taxation-related measures could be recognised as constituting an indirect expropriation. The *Yukos* cases effectively represent this potential. In addition, it should not be neglected that the sole existence of substantial deprivation cannot guarantee the constitution of an indirect expropriation. There are other factors that must be taken into account, such as proportionality and legitimate expectation.¹⁰³²

5.2.5 Can the NTS Taxes on Lone Star's Transactions and the Withholding Taxes Constitute Expropriation?

Lone Star has disputed, in the Korean domestic courts, the jurisdiction of the Korean tax authorities, namely, the NTS, and permanent establishment. As previously mentioned, the appellate judgments have yet to be concluded. Despite this inconclusiveness, it is worth exploring the issue of expropriation on the supposition that Lone Star's contention concerning the NTS's tax jurisdiction and permanent establishment issues are accurate; meaning that the Korean government imposed taxes on Lone Star in violation of the Korea-Belgium Tax Treaty. Lone Star argued that the Korean tax authorities deprived it of its property interests by exercising its tax power despite Belgium retaining the power to tax Lone Star under the Korea-Belgium Tax Treaty. The NTS imposed taxes on the sale of Lone Star's holding company (Star Holdings SCA), in relation to the shares in Star Tower Corporation under the corporate tax regime, not a personal income tax regime. It also imposed taxes on the sale of shares in three Korean companies by five Lone Star holding companies. Further, it executed withholding taxes in respect of the sale by Lone Star of shares in KEB to Hana.

¹⁰³² *Archer Daniels Midland Company* (n 462) para 250.

According to Article 1.1(a) of the Korea-Belgium BIT, what falls within the scope of investment to be protected is, namely, ‘every kind of asset’. In this case, this would be Lone Star’s ownership of shares in the Korean companies. Additionally, as touched upon previously, Article 5(1) of the Korea-Belgium BIT requires that the actual effect be ‘equivalent to nationalisation or expropriation’. This is the most significant factor to be considered in establishing indirect expropriation. In view of recent arbitral practice, it is probable that, besides effect, other factors such as the proportionality and the legitimate expectation can be considered. With regard to economic effect, in the context of taxation-based expropriation issues, it is primarily necessary to articulate the existence of substantial deprivation, which encompasses such outcomes as the deprivation of all or most of the benefits of the investment,¹⁰³³ the demise of all profitability of the investment,¹⁰³⁴ or the removal of the assets from the control of the investor.¹⁰³⁵ All NTS taxes imposed on the sale of Lone Star’s shares, viewed either respectively or collectively in light of creeping expropriation, do not appear to have produced a substantial deprivation at such an enormous scale. Also, given that Lone Star ultimately sold its shares to Hana, it was not deprived of all or most of the benefits of the investment or of its control over its assets. Therefore, it is hard to conclude that the NTS taxes on Lone Star’s transactions constituted indirect expropriation. However, it remains to be further investigated whether the NTS taxes on Lone Star’s transactions violated other standards such as fair and equitable treatment and non-discrimination.

5.3 Conclusion

The *Lone Star* case is the first investor-state arbitration case that the Korean government has experienced and is experiencing. Since Lone Star filed its arbitration claim on 21 May 2012, under ICSID, the arbitration proceedings have been on-going. The outcome of the arbitration proceedings is still awaited. This case

¹⁰³³ *ibid* para 240.

¹⁰³⁴ *Burlington* (n 1001) paras 397, 399.

¹⁰³⁵ *RosInvestCo UK Ltd* (n 1012) para 621.

is special not only because it is the first arbitration case that the Korean government has faced, but also because it involves a taxation-based expropriation claim. A state's taxation power is the most ordinary type of police power and it may be very challenging for a foreign investor to succeed with such a claim because, from a theoretical perspective, the effect-oriented doctrine requires that the taxation measure in question bring about an extraordinary financial impact on a foreign investor's property. Another issue is whether the state's delay of approval of a foreign investor's business activities, as a series of administrative acts, can give rise to an accumulative effect of economic deprivation. The FSC's acts of halting the review processes and the NSC's taxation measures did not involve a high degree of interference with Lone Star's property interests. However, it seems likely that if Lone Star's claim would be raised in circumstances where creeping expropriation is deemed to occur, it would be successful.

While customary international law does not provide specific helpful guidelines in addressing this type of expropriation claim, the Korea-Belgium BIT offers some clues as to what the tribunal will rely on, this being indirect expropriation or creeping expropriation; requiring an actual effect equivalent to expropriation. In comparison with other indirect expropriation provisions, such as additional BITs and FTAs, the requirement can be construed as the effect-centred doctrine or possibly the sole effect doctrine. It is likely that the arbitral tribunal will take account of either doctrine. From the facts of the case, it can also be noted that the FSC halted its reviewing processes not only out of concern regarding Korea's banking business, but also due to concern in relation to the pending legal investigations and proceedings, the outcome of which would affect the FSC's decisions of subsequent administrative acts in relation to Lone Star. In this regard, it will be more likely that the arbitral tribunal may give deference to the FSC's regulatory discretion or rely on the presumption of legality.

Furthermore, among taxation-based expropriation claim cases, *Yukos* provides a good example of a viable taxation-based expropriation claim. A substantial number

of claims of a similar type have failed, but Yukos' expropriation claims have survived. In *Yukos*, it is clear that the Russian government's taxation authority was abused. This is because the taxation of Yukos' properties was merely a method by which to embark upon *de facto* expropriation. The measures that the Russian government took resulted in almost the same effect as nationalisation or expropriation. Thus, the circumstances indicate which type of taxation-based expropriation claims will likely be successful in the future.

Conclusion

International economic law has laid the foundations for economic interdependence in the globalised world. In the field of international trade, the World Trade Organisation (WTO) agreement and the General Agreement on Tariffs and Trade (GATT) have contributed to trade liberalisation through member states' negotiations and trade dispute resolutions. In the field of international investment, it is the international investment law regime, based on customary international law and international investment agreements, that has provided guidance and dispute resolution mechanisms for the purpose of protecting and promoting foreign investment. Most noticeable is the explosive growth of bilateral and regional investment agreements. These types of agreements have become almost a global trend.

At the dawn of international investment law, the protection of foreign-owned property was merely a matter between states. The principle of state responsibility for a state's international delinquency, concerning a breach of treatment to aliens, could only be invoked when the state of the injured national opted to exercise diplomatic protection on behalf of its injured citizen. In this scenario, the dispute resolution process was inevitably subject to the political and diplomatic influences of the states concerned. The growth of bilateral investment treaties (BITs) and regional free trade agreements (FTAs), which govern investment issues and disputes, is a double-edged sword. BITs and FTAs provide for dispute resolutions to be conducted by a tribunal, which is authorised to interpret international investment agreements in accordance with principles of international law, and accord a foreign investor the entitlement to file a legal claim directly against a state for violations of international investment agreements. This development could have strengthened the neutral and juridical nature of investment dispute resolution, contributing to an attenuation of political and diplomatic influence that could potentially hinder the operation of investment treaty arbitration. However, because BITs and FTAs are not

multilateral agreements, but bilateral or regional ones, they are unable to establish unified rules or principles of international investment law which could guarantee a certain degree of legal certainty and stability. Multilateral efforts have been made to establish a universal investment treaty, but these have been to no avail.

Furthermore, investment arbitral tribunals do not proceed under the legally binding force of precedents. Simply put, tribunals retain the autonomous authority to interpret international investment agreements in any manner that they so wish. In this respect, the international investment law regime is vulnerable in terms of legal certainty, stability, and consistency. Fortunately, on a more positive note is the fact that BITs and FTAs have the tendency of containing very similar or common terminology in their provisions concerning standards of treatment. This does not mean, however, that such a tendency could eradicate all the weaknesses that have been noted above. Instead, it is very likely that interpretations as to the standards of treatment and investment arbitral award-making decisions both could produce specific outcomes, which may help significantly to narrow the gaps or avoid inconsistencies if these are properly and effectively managed. In order not to miss the potential advantages resulting from the similarity of treaty languages, it may be both a conceivable and promising option to identify and elaborate certain rules or principles of international law which can achieve acceptable results in the resolution of investment disputes from an international legal perspective.

The research of this thesis is concentrated on exploring the question of how to establish and justify regulatory expropriation in international law. This task involves obtaining a fundamental understanding of international law on expropriation, drawing some useful guidance from other regional expropriation rules and jurisprudence, and considering their cross-applicability to investment issues and disputes. Current international law on expropriation, based on customary international law and international investment agreements, and supplemented by investment arbitral jurisprudence, does not provide a definitive answer to what can constitute an expropriation in international law. Alternatively, it clearly provides for

four conditions to be met for an expropriation to be lawful. The limited options available for finding expropriation and determining the legality of expropriation, and the lack of definition for expropriation under international investment law, cause difficulties in differentiating legitimate regulations from compensable expropriation. It may also appear that the advent of the concept of regulatory expropriation, besides indirect expropriation, can further add to these complexities.

It has been observed that the US Takings Clause doctrine, the NAFTA expropriation rule and the European Convention on Human Rights expropriation rule are worthy of comparison. It was shown that they operate within the framework of the ‘ends-means’ and the ‘cause-effect’. The scrutiny of those rules and the doctrine proves that they commonly pursue a reasonable balance or a degree of proportionality¹⁰³⁶ between the means and aims; in other words, a government measure and public objectives. To a degree, it appears that these principles or rules on expropriation are possibly open to a mutual transplantation when seeking more reasonable and balanced legal consequences in a regulatory expropriation situation. International law on expropriation, in an attempt to refine the rules and principles of regulatory expropriation, can develop by embracing rules and principles that are acceptable from the perspective of international law with the goal of achieving the aforementioned reasonable and balanced legal consequences. Especially in relation to the Transatlantic Trade and Investment Partnership (TTIP), the comparative analysis of those rules and doctrines becomes more significant. The TTIP, if concluded, will be one of the most comprehensive regional free-trade agreements that will geographically cover the United States and Europe. In the TTIP negotiations, relating to international investment law and policy on expropriation, one of the urgent goals will be to measure an appropriate and legitimate scope of a state’s regulatory interference with foreign-owned property on the basis of rules and principles that are compromised by TTIP member states. Further analytical exploration of the US Takings Clause doctrine, the NAFTA expropriation rule, and

¹⁰³⁶ *Fireman’s Fund* (n 697) para 176(j).

the European Convention on Human Rights expropriation rule will significantly aid in fulfilling such a mission.

Among a range of standards of treatment under international investment agreements, rules of international investment law on expropriation carry the strongest substantive nature. This is evidenced from the fact that the provision allows international legal scrutiny to interfere with a state's sovereign right to regulate while other standards of treatment do not directly intrude into matters of a state's sovereignty. Regulatory expropriation emerges from a broad concept of indirect expropriation and can serve to distinguish between a justifiable regulation and an expropriation that cannot be justified without compensation. Several conditions for establishing regulatory expropriation have been examined, such as the intent and motive of a state's measure, a state's measure's economic effect, the legitimate expectation, the principle of proportionality, and the doctrine of police power. These conditions are worthy of being incorporated within international investment agreements and of being relied upon by arbitral tribunals. Also, it is imperative to develop continuously elaborated and increased criteria. It has also been shown that the conditions to be met for lawful expropriation and the principles of necessity can be invoked to justify regulatory expropriation in international law.

Regulatory expropriation gives rise to the legal consequence of compensation, as is the case with other types of expropriations. Standards of compensation that are available for regulatory expropriation, on the other hand, need not be limited to full compensation. There exists the doubt as to whether the full compensation rule can reasonably encompass every case of expropriation. From the perspective of the equitable principle, deviation from the full compensation rule can be reasonable when an investment dispute involves both legitimate public interests and property interests that are entitled to be protected. Regulatory expropriation exerts a substantial impact on private property, which is also certainly directed at regulatory and public objectives. Thus, the proportionality principle or the fair balance test

needs to be used in order to produce a reasonable or equitable compensatory outcome.

Lone Star is yet to be decided; thus, it is not presently clear as to what the outcome of the arbitration will be. However, in relation to Lone Star's taxation-related claim, it is certainly expected that the outcome will be either that of the *Yukos* cases or the cases in which claims on taxation-based expropriation failed, such as *Archer Daniels Midland Company*, *Feldman*, or *EnCana*. Nonetheless, there are significant benefits to be derived from conducting a review of this case. It can be observed that the notion of creeping expropriation can assist in providing increased security for foreign-owned property by expanding the scope of arbitral scrutiny. The notion of creeping expropriation has the potential to prohibit a state measure involving the abuse of tax power. It appears that a taxation-based expropriation claim will not easily succeed under the current international investment law on expropriation. Thus, what can increase the likelihood of the success of taxation-based expropriation claims? One conceivable notion would be a shift of approach away from the effect-centred approach, giving less weight to the economic effect and conferring more weight to non-effect criteria, even though it remains to be seen how viable this approach could be in terms of international legal deference to state sovereignty. It would also be a challenge to achieve international consensus on how far the notion of creeping expropriation could or should extend the scope of scrutiny.

The expansive growth of international investment agreements since the end of World War II has been remarkable. According to the UN Conference on Trade and Development, as of January 2015, 2,924 BITs exist, of which 2,222 BITs have come into force. Another 345 other types of international investment agreements exist, of which 274 have come into force. Despite this noticeable growth across the world, no multilateral investment regime exists thus far. Efforts were made at negotiating a 'multilateral agreement on investment' (MAI) by governments at the Annual

Meeting of the OECD Council at Ministerial level in May 1995.¹⁰³⁷ It was envisioned that a MAI would provide a broad multilateral framework for international investment which could contribute to investment liberalisation and protection and to effective dispute resolution. However, negotiations were halted after April 1998. Since then, low expectations concerning the advent of a new multilateral investment agreement have been persistent.

Recently a number of regional comprehensive investment regimes have been conceived. They include the Trans-Pacific Partnership (TPP), the Regional Comprehensive Economic Partnership (RCEP), and the Transatlantic Trade and Investment Partnership (TTIP). The TPP is a regional free trade agreement that is currently negotiated among the United States, Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. The negotiators describe the TPP as a ‘comprehensive and high-standard’ FTA that purports to liberalise trade in almost every sector of trade and investment and involve a higher level of commitments than those stipulated in the World Trade Organisation (WTO).¹⁰³⁸ The membership of the TPP will be based on countries in the Asia-Pacific region. The RCEP is also a free trade agreement between ten ASEAN countries and six of ASEAN’s FTA partners: China, India, Japan, South Korea, Australia, and New Zealand. The RCEP is designed to facilitate deeper regional economic integration by removing tariff and non-tariff barriers and by maintaining consistency with the rules of the WTO.¹⁰³⁹ The RCEP negotiations were pursued to ‘establish an open trade and investment environment in the region to facilitate the expansion of regional trade and investment and contribute to global economic growth and development’.¹⁰⁴⁰

¹⁰³⁷ The OECD’s ‘Draft MAI Negotiating Text’ contains the text of the agreement negotiated until 1998 <www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf> accessed 13 August 2015.

¹⁰³⁸ The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress, Summary.

¹⁰³⁹ CSIS, ‘ASEAN and Partners Launch Regional Comprehensive Economic Partnership’ <<http://csis.org/publication/asean-and-partners-launch-regional-comprehensive-economic-partnership>> accessed 26 August 2015.

¹⁰⁴⁰ Joint Statement of the first RCEP Meeting, para 2(i).

The TTIP is a free trade agreement that has been negotiated between the United States and the European Union. The greatest and most immediate challenge that will confront these regional FTA negotiations will be the management of the varying positions held by states concerning the manner in which to establish a common international standard with regard to targeted subjects. If any regional FTA is to be successfully concluded, the FTA must achieve, at least to some extent, unified rules of international trade and investment law. When it comes to the investment protection standards afforded by international investment agreements and, in particular, the prohibition of expropriation without compensation, international investment agreements tend to exhibit a high degree of similarity in their provisional languages. Furthermore, as for the international law on regulatory expropriation, the doctrine of police powers, if further elaborated, can contribute to creating enhanced rules of international law on regulatory expropriation. In this respect, if the negotiations being pursued in the TPP, the RCEP, or the TTIP seek to narrow the gaps as much as possible in the interpretation of treaty languages with regard to expropriation and establish agreements on the operation of the doctrine of police powers and the principle of proportionality, there will be a greater likelihood that these regional FTA negotiations can achieve a compromise on the rules of international law on regulatory expropriation.

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