

# *Best Practices*

## *Indirect Expropriation*

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## 1.0 Introduction

The concept of expropriation has always been surrounded by controversy, stretching right back to its origins in international law. Expropriation represents both the most serious infringement of private property rights and the manifest exercise of State sovereignty. In international investment law, it is defined as the formal withdrawal of property rights for the benefit of the State or for private persons designated by the State.<sup>1</sup> This definition covers direct expropriation or formal expropriation, which has long been recognized and regulated in national legislation. International investment treaties however, also recognise that where a State acts in a way that is detrimental to a foreign private investment, this may also be classified as expropriation, even if the investor formally retains its property rights over the investment.<sup>2</sup> This is known as indirect expropriation, or a “measure tantamount to expropriation.”

There are therefore two types of “expropriation.” The first involves direct expropriation and is usually formalized in an expropriation decree or law. Expropriation of this type is undertaken against one or several investments. Expropriation, or nationalization, can also be against several investments in one economic sector.<sup>3</sup> The second involves indirect expropriation. This type of expropriation may result from measures that a State takes to regulate economic activities within its territory, even where such regulation is not directly targeted at an investment. In this case, legal title to the investment is not affected.

Following a number of disputes in the past (discussion of which is outside the scope of this paper), the conditions under which a State may legally expropriate the property of a private foreign investor are now codified in general terms in international investment treaties. Under international investment treaties, a State has the sovereign right to expropriate private foreign investments located within its territory, provided that it complies with the following three conditions: the expropriation is designed to serve the public interest, the measure is not discriminatory and the investor is compensated for the losses suffered.

Although there is widespread consensus on the definition of direct expropriation, the definition of indirect expropriation remains much more problematic. The most crucial issue is to determine the clear conditions under which measures of a State may be considered as amounting to an indirect expropriation and, as such, require the State to compensate the investor for the damage caused. In other words, under what conditions may a State measure be deemed tantamount to expropriation? Indeed, several arbitral tribunals<sup>4</sup> recognise that not all State regulations that are harmful to investment activities constitute an indirect expropriation and, as such, not all actions of this nature give the injured party the right to pursue compensation.

<sup>1</sup> For definitions of direct expropriation, see the following arbitration awards (there is an abundance of case law on this matter): *Sempra Energy International v. Argentina* (ARB/02/13) award of September 28, 2007, para. 280; *Enron Corporation And Ponderosa Assets, L.P. v. Argentina* (ARB/01/3), award of May 22, 2007, para. 243. Available at: [www.worldbank/icsid.org](http://www.worldbank/icsid.org)

<sup>2</sup> As held by the Tribunal in the *Tippets v. Iran* case, indirect expropriation “may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected.” *Starrett Housing Corporation, Starrett Systems, Inc., Starrett Housing International, Inc., v. Iran, Bank Oman, Bank Mellat, Bank Markazi*, award of December 19, 1983, *Iran-US CTR*, vol. 4, p. 225.

<sup>3</sup> A range of studies have been conducted into nationalization in public international law. Examples include S. Friedman, *L'expropriation en droit international public*, Université de Paris, Faculty of Law, S.O.PRESS, Cairo, 1950, p. 1. (Extract from “l’Egypte contemporaine,” *Revue de la Société FOUAD 1er d’Economie politique, de Statistique et de Législation*, T. XLIIe pp. 203-433).

<sup>4</sup> See, *Tecmed v. Mexico* (ARB(AF)/00/2), award of May 29, 2003, 43 *ILM*, 2004, para. 119.

The definition of indirect expropriation is, without a doubt, presently one of the most important issues in international investment law. In the late 1990s, a number of investment disputes brought under the North American Free Trade Agreement (NAFTA), demonstrated the extent of the problems posed by the concept of indirect expropriation.<sup>5</sup> Since then, the sheer number of cases brought by investors making indirect expropriation claims demonstrates that this remains a major issue to this day.

The legal rules governing indirect expropriation are designed to protect investors in cases that fall outside formal and obvious infringements of their rights. Arbitrators and judges are required to look at “the substance of the measure and not its form,” as explained by the European Court of Human Rights in the case of *Sporrong & Lönnroth v. Sweden*.<sup>6</sup> A State may attempt to “hide” its intention to harm an investment behind a measure that is, on the surface, legitimate and seemingly innocuous. However, due to the fact that current international investment treaties offer substantial protection to private foreign investments, the outstanding uncertainty over the definition of indirect expropriation raises concerns over the ability of States that host such investments to retain their regulatory and policy space. There is good reason to believe that a State might decide not to take action in the public interest if it fears that such measures may qualify as indirect expropriation and, as such, require the State to pay substantial compensation.

This study will look only at the definition of indirect expropriation in international investment law, focusing on four key areas in particular. First of all, it would appear that existing investment treaties do not provide an explicit definition of the concept, despite several recent attempts of clarification (III). Due to this shortcoming, investment tribunals are required to devise their own criteria and definitions, each of which have their own strengths and weaknesses (IV). Further reflection is therefore required to attempt to provide a clear definition of the concept of indirect expropriation—one that respects the rights of both the host State and the private foreign investor (V). Before undertaking this exercise, it is first necessary to assess the risks that an ambiguous and/or excessively broad definition of indirect expropriation poses to the host State of investment (II).

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<sup>5</sup> Notable examples include the following cases: *Ethyl Corporation v. United States*, award of June 24, 1998. Available online at: <http://italaw.com>; *SD Myers Inc. v. Canada*, award of November 13, 2000; *Pope & Talbot Inc. v. Canada*, award of June 26, 2000. Available online at [www.naftaclaims.com](http://www.naftaclaims.com).

<sup>6</sup> *Sporrong & Lönnroth v. Sweden*, September 23, 1982, ECHR, Series A, No. 52, para. 63.

## 2.0 *Indirect Expropriation and the Policy Space of Host States*

Foreign private investors who hold an investment within the territory of another State are currently protected by a vast array of investment treaties that guarantee their rights, including the right to compensation in the event of direct or indirect expropriation. At the same time, a State might adopt public interest regulations that harm the economic interests of investors within its territory. This means that public interest measures that have harmful effects on a foreign investment may engage the host State's responsibility under international law. As cases have illustrated, investment treaties even provide a way for foreign investors to challenge the legitimacy of measures taken by governments in sensitive areas such as public health, human rights and environmental protection.

It is important to note in this respect that each State has, in principle, the right to expropriate. This is an internationally recognized sovereign right. Investment treaties do not, therefore, prevent States from taking expropriation measures. The only restrictions that apply are that any expropriation measure must not be discriminatory in nature, must be undertaken in the public interest and the investor must be compensated for the losses suffered.

Underlying that general rule on expropriation, however, are various complex tensions and difficulties for host States. They arise in three key areas.

Firstly, host States (especially developing countries, which have a particular need for foreign capital) do not always have the financial resources needed to compensate investors for the harmful consequences of public interest regulations. The fact that a State is unable to compensate investors for the harmful consequences of public interest regulations using its own public resources may, in turn, mean that the State in question is unable to amend its legislation when needed. This is especially true when one considers that, paradoxically, those States at the very earliest stages of economic development or suffering severe financial crises are those that require the most intensive regulation and the most frequent amendments and adjustments to economic policy. The most striking example of this situation is Argentina, which has been the subject of more than 40 cases brought before ICSID since it introduced drastic measures in response to the economic and financial crisis of 2001.

Secondly, the adoption of a broad definition of indirect expropriation may result in a situation where all State measures that harm an investor can be considered indirect expropriations, regardless of the reasons that underlie any such measure.<sup>7</sup> Under customary international law, however, host States have a recognized right to regulate, without any duty to compensate, in order to protect or promote the public interest (a broad concept that includes public order, public health, national security, human rights, public morals and environmental protection). A foreign investment may therefore be adversely affected by State measures that are not targeted directly at the investment and which do not affect the investor's legal title to the investment. In situations of this type, the investor will claim that the investment has been expropriated indirectly. The State, meanwhile, will argue that its regulation has been passed in the public interest and that it is not liable to compensate investors for any damages that may be caused unintentionally as a result of said regulation. The consequence is that the term "indirect expropriation" (in its broad sense) may cover all measures taken by authorities that have a negative impact on a private foreign investment, irrespective of any other consideration.

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<sup>7</sup> Excluding State measures taken in response to illegal acts by the investor.

Thirdly, States may take measures harmful to investors pursuant to the States' international obligations (e.g., obligations regarding human health, the environment and labour rights). A State may be bound to protect a forest, regulate the cross-border transportation of hazardous waste, impose stricter polluted water recycling standards or increase the level of social security contributions that companies are required to pay on behalf of their employees, as a result of its international obligations. At the same time, however, such measures may threaten the existence or profitability of a private foreign investment. Pursuant to its investment treaties, a State may therefore have to compensate an investor for fulfilling its international human rights, labour or environmental obligations.

In short, the host State needs to protect the public interest and meet its international commitments by maintaining a set of regulations under which it cannot be pursued for compensation. The challenge is therefore to identify a set of criteria governing indirect expropriation that enable the State to regulate without having to pay compensation for every single investment harmed by its actions. This does not, however, mean that the State should be given free rein to harm investments as it wishes and to justify such actions under the heading of "public interest." The target should be to achieve the right balance between public and private interests. Nevertheless, the expropriation clauses that appear in investment treaties do not provide a clear response regarding how to strike that balance.

### 3.0 Indirect Expropriation Provisions in Investment Treaties

The vast majority of investment treaties mention the concept of indirect expropriation and stipulate the same duty to compensate as for direct or formal expropriation. Article 1110 of the North American Free Trade Agreement (NAFTA) of December 17, 1992, for example, reads as follows:

No Party may **directly or indirectly nationalize or expropriate** [emphasis added] an investment (...) or take **a measure tantamount to nationalization or expropriation** [emphasis added] of such an investment (...), except: (a) for a public purpose; (b) on a non-discriminatory basis; (c) in accordance with due process of law (...); and (d) on payment of compensation (...).

The majority of these treaties do not provide a definition of indirect expropriation, although some more recent treaties do contain more explicit clauses.

### 3.1 Typical Indirect Expropriation Provisions

#### 3.1.1 The Lack of a Definition of Indirect Expropriation in Investment Treaties

According to recent official UNCTAD sources, there are at least 2,701 investment treaties in place worldwide.<sup>8</sup> Almost all of these treaties contains a clause on expropriation, covering both its direct and indirect forms. A review of these treaties—both bilateral investment treaties (BITs) and bilateral or regional free trade agreements (FTAs)—shows that the provisions that deal with expropriation can be divided into two main categories, based on the terminology used.

The first, and most common, type of provision makes a distinction between (1) (direct) expropriation or nationalisation, and (2) **indirect expropriation or equivalent measures or measures with similar/equivalent effects**. Treaties that fall into this category use just one of these three expressions to refer to indirect and informal expropriation, excluding the other two expressions. This category includes clauses that use the following terms:

- “expropriation, nationalisation and any other measure that has an effect tantamount to expropriation or nationalisation”<sup>9</sup>
- “measures that deprive the investor of their investment, either directly or indirectly”<sup>10</sup>
- “expropriation or nationalisation or similar measures”<sup>11</sup>
- “expropriation, nationalisation or measures with a similar effect”<sup>12</sup>
- “measures that deprive an investor of an investment or other measures that have a similar effect”<sup>13</sup>
- “dispossession measures, including nationalization or other measures having similar consequences.”<sup>14</sup>

<sup>8</sup> Source: UNCTAD, IIA Monitor No. 3 (2009), *Recent Developments in International Investment Agreements (2008–June 2009)*. Available at [www.unctad.org/jia](http://www.unctad.org/jia).

<sup>9</sup> Examples: Germany–Poland BIT, 1989, Article 4.2; Australia–Vietnam BIT, 1991, Article 7.1; Guinea–Egypt BIT, 1998, Article 5.1; Cameroon–Mali BIT, 2001, Article 6.1; Israel–Estonia BIT, 1994, Article 5.1.

<sup>10</sup> Examples: Mali–Netherlands BIT, 2003, Article 6; Panama–Netherlands BIT, 2000, Article 6; Chile–Egypt BIT, 1999, Article 6.1; Czech Republic–Hungary BIT, 1992, Article 4.1.

<sup>11</sup> Examples: China–Romania BIT, 1994, Article 4.

<sup>12</sup> Examples: Japan–China BIT, 1988, Article 5.4; Norway–Indonesia BIT, 1991, Article 6.1; Bahrain–Jordan BIT, 2000, Article 5.1.

<sup>13</sup> Example: Belgium–Burundi BIT, 1989, Article 4.1.

<sup>14</sup> Examples: Burkina Faso–Chad BIT, 2001, Article 5.1; France–Argentina BIT, 1991, Article 5.2; Gabon–Lebanon BIT, 2001, Article 4; Australia–Romania BIT, 1993, Article 5.1.

The second type of provision makes a clear distinction between three forms of expropriation: (1) direct expropriation or nationalization, (2) **indirect expropriation and (3) equivalent measures and/or measures with similar/equivalent effects**. This type of terminology is generally found in treaties signed by North American and Latin American countries and Switzerland. It is the terminology used in the NAFTA (Article 1110 cited above) and in recent FTAs between North American and South American countries, such as the Dominican Republic–Central America–United States Free Trade Agreement (U.S.–CAFTA–DR). Clauses that fall into this category use the following expressions:

- “direct or indirect expropriation or nationalisation, or any other equivalent measure having an effect similar to dispossession”<sup>15</sup>
- “shall not, directly or indirectly, expropriate or nationalise or take any measure with equivalent character or effect.”<sup>16</sup>

This type of clause explicitly distinguishes between two types of indirect expropriation. Is Indirect expropriation therefore treated as different from a measure tantamount to expropriation? Does this therefore mean that each of these terms is subject to a different set of criteria? If the answer to this question is “yes,” then arbitration tribunals will need to assess the evidence in three stages. Firstly, does the State measure effect a direct expropriation? Secondly, if the answer to the first question is “no,” does it constitute an indirect expropriation? Thirdly, if not, is it a measure tantamount to expropriation? In general, however, tribunals view the two expressions “indirect expropriations” and “measures tantamount to expropriations” as covering the same concept. In the case of *Feldman v. Mexico*, in its interpretation of Article 1110 of the NAFTA, the tribunal considered “the scope of both expressions to be functionally equivalent.”<sup>17</sup> The distinction created by this second type of clause is therefore artificial.

Some articles expressly state that a State measure may be deemed an indirect expropriation or “tantamount to expropriation” due to its effects or characteristics. Treaties may, for example, use language referring to “expropriation or nationalisation, or any other equivalent measure having an effect similar to dispossession,”<sup>18</sup> or “expropriation, nationalisation, or other measure having a similar effect.”<sup>19</sup> Treaties may also refer to measures “having the same character or the same effect,”<sup>20</sup> or “having a similar effect.”<sup>21</sup> These provisions are more explicit than those that simply mention the terms “indirect expropriation” or “measures tantamount to expropriation.” This is a clear indication designed to assist tribunals in their interpretation.

Furthermore, a small number of investment treaties mention “restrictive” measures or measures that “fully or partially deprive” the investor of its rights.<sup>22</sup> The majority of such treaties were signed before 1990. Articles of this type would seem to suggest that indirect expropriation may occur even when the losses caused are not substantial or severe.

<sup>15</sup> Examples: Burkina Faso–Chad BIT, 2001, Article 5.1; France–Argentina BIT, 1991, Article 5.2; Gabon–Lebanon BIT, 2001, Article 4; Australia–Romania BIT, 1993, Article 5.1.

<sup>16</sup> Example: Switzerland–Mozambique BIT, 2002, Article 6.

<sup>17</sup> § 100.

<sup>18</sup> Example: Burkina Faso–Chad BIT, 2001, Article 5.1.

<sup>19</sup> Example: Norway–Indonesia BIT, 1991, Article 6.1.

<sup>20</sup> See Switzerland–Russia BIT, 1990, Article 6.1; Switzerland–Peru BIT, 1991, Article 5.1; Central African Republic–Egypt BIT, 2000, Article 4.1; Cameroon–China BIT, 1997, Article 5.1; Sweden–Argentina BIT, 1991, Article 4.1.

<sup>21</sup> See e.g. Lebanon–Switzerland BIT, 2000, Article 4.1.

<sup>22</sup> For example, Article 4.1 of the BIT between Belgium and Burundi, signed in 1989, stipulates that “each Contracting Party hereby agrees not to undertake any measures to deprive or restrict the right to property, nor to undertake any measures having a similar effect (...).” A similar provision exists in Protocol 3 of the BIT between Germany and Côte d’Ivoire, signed in 1968: “the term ‘expropriation’ shall cover any measure that removes or limits the right to property.”

Despite these subtle variations in treaties' provisions on expropriation, as explained by the arbitration tribunal in the case of *LG&E v. Argentina*, the general fact remains that, "[g]enerally, bilateral treaties do not define what constitutes an expropriation—they just make an express reference to 'expropriation' and add the language 'any other action that has equivalent effects' [...] and do not establish which measures, actions or conduct would constitute acts 'tantamount to expropriation.'"<sup>23</sup>

### 3.1.2 Implicit Exclusion of Lawful Criteria in the Definition of Indirect Expropriation

Although treaty provisions generally do not explicitly state the factors relevant to determining whether a host State's measure constitutes an indirect expropriation, they do implicitly indicate which factors do not establish that an indirect expropriation has in fact occurred. Investment treaties commonly state that the State parties are not allowed to take indirect expropriation measures "unless," "except when" or "on condition that" the measures taken comply with all three of the following legality criteria: the measure is taken in the public interest, the measure is not discriminatory in nature, and the investor is compensated for the damage caused. These three factors establish whether an expropriation is legal, not whether it has in fact occurred. Consequently, arbitration tribunals have to first assess whether the measure constitutes an indirect expropriation and then, if so, whether the measure has been taken lawfully.<sup>24</sup> As the arbitration tribunal explained in the case of *Fireman's Fund Insurance Company v. Mexico*, to do otherwise would be "putting the cart before the horse (...)."<sup>25</sup>

This means that the criteria used to determine whether a measure effects an indirect expropriation are to be found outside these legality criteria. The two sets of criteria have been interpreted as being mutually exclusive. For example, when a tribunal is required to decide whether indirect expropriation has taken place, "it cannot be argued that because there is discrimination, there is expropriation."<sup>26</sup> The reverse also holds true. The same observation also applies to State regulations passed in the public interest. This distinction between criteria for determining whether there has been an expropriation and criteria for determining whether it was legal fuels the controversy that surrounds the concept of indirect expropriation. There are some who believe that, precisely because a measure is taken in the public interest (legality criterion), this same measure cannot be identified as an indirect expropriation.

Due to the fact that treaty provisions on expropriation seem to exclude the legality criteria from the initial process of determining whether indirect expropriation has occurred, some States have decided to insert new provisions into their recent treaties.

## 3.2 Current Practice in Recent Investment Treaties

Provisions containing a definition of indirect expropriation in recent investment treaties can be divided into three categories. Firstly, some provisions reaffirm the State's right to regulate. Secondly, other provisions exclude certain types of State regulation—even those that harm investments—from the definition of indirect expropriation. Thirdly, there are provisions inserted in explanatory annexes that provide a list of factors intended to help tribunals with their interpretation when assessing an indirect expropriation claim.

<sup>23</sup> Para. 185. See also the following awards: *Tecmed, S.A. v. Mexico*, (ARB(AF)/00/2), award of May 29, 2003, 43 *ILM*, 2004, para. 113, and *R. S. Lauder v. Czech Republic*, UNCITRAL award of September 3, 2001, para. 200. Available online at <http://italaw.com>.

<sup>24</sup> See e.g., *Parkerings-Company AS v. Lithuania* (ARB/05/8), award of September 11, 2007, para. 442. Available online at <http://italaw.com>.

<sup>25</sup> *Fireman's Fund Insurance Company v. Mexico* (ARB(AF)/02/1), award of July 17, 2006, para. 174. Available online at <http://italaw.com>.

<sup>26</sup> *Fireman's Fund Insurance Company*, para. 205. .

### 3.2.1 Reaffirmation of the Host State's Right to Regulate

#### *Content of the Provision*

Some recent investment treaties contain provisions that explicitly affirm that the State has the right to regulate to protect certain public interests.

These clauses, some of which are inspired by Article XX of the GATT of 1994,<sup>27</sup> generally state that none of the provisions in the treaty shall prevent any of the contracting States from taking measures that protect certain public interests (e.g., public health, the environment, national security, maintenance and improvement of labour rights, etc.). This is a general provision that applies to all articles in the investment treaty. As such, it applies also to the expropriation provision, unless otherwise indicated.<sup>28</sup>

General provisions of this type first appeared in regional free trade agreements signed in the early 1990s.<sup>29</sup> One such clause is in Article 1114.1, Chapter 11, of the NAFTA of December 17, 1992, entitled "Environmental Measures." It states:

Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

A number of recent BITs also contain provisions reaffirming the State's right to regulate.<sup>30</sup> This is the case with Article 12 of the BIT between Mauritius and Comoros in 2001, which states:

Nothing in this Agreement shall be construed to prevent a Contracting Party from adopting any measure whatsoever to protect its essential security interests or in the interest of public health or the prevention of diseases affecting animals and plants.

Similarly, some investment treaty models used by European and American countries contain clauses relating to protection of the environment, health and labour rights. This can be seen in the models used by the United States (2004, Articles 12 and 13), Canada (2004, Article 11), Belgium (2002, Articles 5 and 6), Finland (2004, Article 14) and Austria (2008, Article 4(5)).

<sup>27</sup> Article 10 (1) of the Canadian treaty model, for example, reads as follows: "Subject to the requirement that such measures are not applied in a manner that would constitute arbitrary or unjustifiable discrimination between investments or between investors, or a disguised restriction on international trade or investment, nothing in this Agreement shall be construed to prevent a Party from adopting or enforcing measures necessary: (a) to protect human, animal or plant life or health; (b) to ensure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement; or (c) for the conservation of living or non-living exhaustible natural resources." Also see Article 15 of the Japan-North Korea BIT (2002, Article 22 (1) of the COMESA CCA (2007) and Article 95 of the Japan-Switzerland BIT (2009).

<sup>28</sup> This is the case with the European Energy Charter, which contains a clause supporting measures "necessary to protect human, animal or plant life or health" (Article 24.2). Paragraph 1 of this same Article, however, is careful to exclude certain articles from its scope of application, including expropriation.

<sup>29</sup> Similar clauses appear in regional treaties, such as the European Energy Charter treaty of December 17, 1994 (Articles 18 and 19), the Economic Community of West African States (ECOWAS) Energy Protocol of January 31, 2003 (Articles 19 and 24) and the Dominican Republic-Central America-United States Free Trade Agreement (U.S.-CAFTA-DR) of August 5, 2004 (Articles 16.2.2 and 17.2.2).

<sup>30</sup> Examples: Chad-Lebanon, 2005, Article 8; Madagascar-South Africa, 2003, Article 3; Switzerland-Mexico, 1995, Protocol Ad Article 3; Egypt-Canada, 1996, Article 17; Mauritius-Burundi, 2001, Article 12; Mauritius-Cameroon, 2001, Article 11; Mauritius-Guinea, 2001, Article 12; Mauritius-Benin, 2001, Article 11.

### *Scope of the Provisions*

The scope of these provisions is extremely limited. Although the majority of them are entitled “general exceptions,” they do not really do much to narrow States’ potential liability for expropriations. Rather, they merely recognize and affirm the State’s sovereign right to regulate in the public interest, which is already recognized in customary international law. While there is no harm in reaffirming a rule of customary international law in a treaty, it is unclear what impact such provisions will have on other obligations contained in the treaty. In fact, these general provisions would seem to have no impact whatsoever on the expropriation provision, which does not prohibit a State from enacting regulations that effectively expropriate investors’ property, but demands compensation in return. These clauses that reaffirm the State’s right to regulate do not stipulate whether the State is relieved of its obligation to compensate in the event that the exercise of its sovereign right harms the investor.

This analysis is supported by the use of the expression “otherwise consistent with this Agreement” in certain texts such as the NAFTA. There is an important observation to make in this respect. As several authors have already noted,<sup>31</sup> Article 1114(1) is written in tautological language that renders the provision meaningless. By stating that the State parties to the treaty may adopt any measure necessary to protect the environment, but which is otherwise consistent with the treaty, this article arguably does not set forth any real exceptions. Compliance with the treaty may therefore be interpreted as an obligation to pay compensation in the event that the regulation constitutes an indirect expropriation. This provision thus seems to effectively repeat what is already implied in the expropriation clause: the right to expropriate (“nothing (...) shall be construed to prevent a Party from adopting (...) any measure”), provided that the investor is compensated, the measure is not discriminatory and the measure is taken in the public interest (“otherwise consistent with this Agreement”).

In the end, the reaffirmation of the right to regulate—at best—gives greater legitimacy to certain State measures intended to protect human rights or the environment. It is not, however, sufficient to prevent a tribunal from finding that any such measure constitutes an indirect expropriation.

### **3.2.2 Exclusions**

#### *Content of the Provision*

There are very few investment treaties that contain provisions that directly and specifically stipulate exceptions to or carve-outs from indirect expropriations. Some recently signed treaties do, however, explicitly exclude certain types of State regulations from the definition of an indirect expropriation. This means that these regulations may not be said to constitute an indirect expropriation and that the State will not be obliged to pay compensation irrespective of any harmful effects the regulations may have had on an investment.

The first examples of such clauses appeared in the treaty models used by the United States (2004) and Canada (2004). Paragraph C of the Annex to the Canadian model reads as follows:

<sup>31</sup> Valérie Dermedjan, “Le droit de l’Alena et la protection de l’environnement.” in S. MALJEAN-DUBOIS (dir.), *L’Outil économique en droit international et européen de l’environnement*, CERIC, 2002, p. 176. Also see A. Lemaire, “Le nouveau visage de l’arbitrage entre État et investisseur étranger : le chapitre 11 de l’Alena.” *Revue de l’arbitrage*, 2001, n°1, pp. 79-80; and T. Weiler, “A First Look at the Interim Merits Award in *SD Myers, Inc. v. Canada*: It is Possible to Balance Legitimate Environmental Concerns with Investment Protection?” *Hastings International & Comparative Law Review*, vol. 24, 2001, p. 182.

Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.<sup>32</sup>

A more recent example of exclusion can be found in Article 20(8) of the Investment Agreement for the COMESA Common Investment Area (COMESA CCIA) of 2007:

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.

The same applies to Annex 2, Paragraph 4 of the Association of Southeast Asian Nations (ASEAN) Comprehensive Investment Agreement of 2009, which states that:

Non-discriminatory measures of a Member State that are designated and applied to protect legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an expropriation of the type referred to in sub-paragraph 2(b) [indirect expropriation].

These new provisions therefore state that measures taken by a State with a legitimate objective, in good faith and without discrimination cannot be construed as acts of indirect expropriation. In other words, arbitration tribunals cannot conclude that indirect expropriation has occurred if the regulation concerned is designed to meet a legitimate public interest, except where the measure is discriminatory and has been adopted or applied in bad faith. The term “legitimate objective” can cover a wide range of governmental aims, including those relating to public health, security and the environment. The article cited from the COMESA CCIA explicitly refers to the customary international law principles on police powers to aid in the interpretation of this provision.

### ***Scope of the Exclusions***

According to these provisions, covered State measures cannot be construed as indirect expropriations requiring compensation due to that fact they are taken in the public interest and that they are non-discriminatory in nature. Does this therefore mean that investment treaties that contain such provisions undermine the key distinction between criteria for legality and criteria for qualification mentioned above? In other words, does this mean that these criteria for legality may be used to determine whether or not a measure constitutes an indirect expropriation?

In terms of the similar provisions that appear in the Canadian and American treaty models, the answer to this question cannot be “yes.” A close analysis of these articles would appear to suggest that, in “rare cases,” the measures that they explicitly exclude may nevertheless be construed as indirect expropriation. Furthermore, the Canadian model provides

<sup>32</sup> Annex B(13)(1)(c). Annex B(4)(c) of the American model is written in similar terms but does not provide an example. Also see Article 5(4) of the Austrian investment treaty model.

an example of such an exceptional situation, where the measure may be deemed “excessively rigorous.” The effect of these articles, therefore, is simply to create a presumption in favour of legitimate regulations, which may be excluded from the definition of an indirect expropriation. This type of clause does not, however, constitute a genuine exception.

As for the examples cited from the COMESA and ASEAN texts, the exclusion would seem to be more effective. It remains to be seen, however, how these clauses will be interpreted in practice by an arbitration tribunal. By deliberately excluding the expression “except in rare circumstances,” this clause explicitly creates a definitive, impenetrable barrier between indirect expropriation and certain types of State regulation. Furthermore, State regulations that do not require payment of compensation are attached to the specific concept of police powers. The clause does not set up a relationship of the “communicating vessels” type between police powers and indirect expropriation. In other words, once a State regulation is deemed to fall under within a State’s police powers, it may no longer be construed as an indirect expropriation. The reference to customary international law (in the COMESA text) also specifies a framework within which the provision is to be interpreted.

### 3.2.3 Explanatory Annexes to the Expropriation Provision

#### *Content of the Annexes*

Explanatory annexes to the expropriation clause first appeared in some investment treaties in the 2000s. These annexes provide a list of factors that arbitration tribunals will need to consider when assessing whether a State measure constitutes an indirect expropriation.

Such a list first appeared in the American and Canadian BIT models published in 2004. Annex B.4.a of the American model and B.13(1) of the Canadian model are almost identical. The Canadian model reads as follows:

The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:

- (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
- (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
- (iii) the character of the government action.

Three factors must be used on a cumulative basis, although these factors are not exhaustive, as evidenced by the use of the phrase “among other factors” in the text. Firstly, the investor must have suffered an adverse impact to the investment concerned. This is the economic impact of the measure. Secondly, reasonable investment-backed expectations are taken into account when assessing whether there has been expropriation. Thirdly, and finally, the character of the measure must be taken into consideration.

Annex 2 of the ASEAN Comprehensive Investment Agreement of (ASEAN CIA) 2009 also contains a list of factors that tribunals are required to consider:

- (a) the economic impact of the government action, although the fact that an action or series of actions by a Member State has an adverse effect on the economic value of an investment, standing alone, does not establish that such an expropriation has occurred;
- (b) whether the government action breaches the government's prior binding written commitment to the investor whether by contract, licence or other legal document; and
- (c) the character of the government action, including, its objective and whether the action is disproportionate to the public purpose (...).

This article is different from those that appear in the Canadian and American models. Although these differences are slight, they widen the scope of this article by comparison with the American and Canadian models.

### ***Scope of the Clause***

The fact that such elements of clarification are being provided for arbitrators is a positive step towards achieving a more accurate definition of indirect expropriation.

By taking the investor's defined and reasonable expectations, also known as "legitimate expectations," into account, however, the protection offered by the expropriation clause can thus be widened to include purely economic interests. In fact, "legitimate expectations" is a controversial concept that can encompass expectations resulting from the current legal framework along with assurances—formal or not—given to the investor at the time of making the investment, and on which it may have based the decision to invest in the host country. However, only legally protected rights can be expropriated. By preferring the term "binding commitments," the ASEAN Investment Agreement thus avoids having to take into account frustrated "legitimate expectations" that do not derive from the host State's legal obligations.

Moreover, in the Canadian and American models, the "nature" of the measure is not defined. Yet this is an important and innovative factor when considering indirect expropriation. Here, too, the ASEAN Agreement has the advantage of specifying that the nature of the measure relates to its objective and its proportionality vis-à-vis the intended public interest.

By way of conclusion with regard to indirect expropriation provisions, it should be noted that a relatively small number of investment treaties have included provisions on the right to regulate, exclusions or explanatory annexes. The majority of BITs, particularly those concluded prior to 2000, do not contain such articles, thus leaving the arbitrators entirely free to apply their own interpretation.

## 4.0 The Criteria for Identifying an Indirect Expropriation as Derived from Tribunal Case Law

Three main criteria are used by arbitration tribunals to identify whether there has been an indirect expropriation: detrimental effect, proportionality and legitimate public interest. The criterion of “appropriation” is also a criterion, but only in a minority of cases. These criteria are examined below.

### 4.1 Injurious Effect of the Measure

The exclusive criterion of injurious or adverse effect on the investment, sometimes known as the “sole effect doctrine”<sup>33</sup> has been described as making the adverse effect of the State measure on the investor “a major factor, or even the sole factor, in determining whether or not a Taking has occurred.”<sup>34</sup> In this regard, the terms “measure tantamount to expropriation” or “measure with a similar effect to expropriation” simply mean “measure having the same injurious effect on the investment as expropriation.”

#### 4.1.1 An Exclusive Criterion

The injurious effect criterion has been applied in numerous arbitration awards. It has become known as the “*Tippetts-Biloune-Metalclad* line,”<sup>35</sup> after the three principle cases often cited in support of this approach.

The *Tippetts v. Iran* award clearly illustrates the sole effect doctrine. In fact, the arbitrators explicitly rejected all other conceivable criteria before concluding that the damage suffered by the investor alone was relevant: “[T]he government’s intention is less important than the effects of the measures on the owner of the assets [...], and the form of the measures of control or interference is less important than the reality of their impact.”<sup>36</sup> The tribunal in the case of *Biloune v. Ghana* only took into account the fact that the measure had “the effect of causing the irreparable cessation of work on the project”<sup>37</sup> due to the order to stop work, the demolition of the works, and the arrest and then deportation of Mr. Biloune. Finally, in *Metalclad v. Mexico*, the tribunal unambiguously defended the sole effect doctrine in the following terms: “The Tribunal need not decide or consider the motivation or intent of the adoption of the Ecological Decree (...).”<sup>38</sup> It added that indirect expropriation could occur “even if not necessarily to the obvious benefit of the host State.”<sup>39</sup>

The sole effect doctrine is thus an exclusive criterion that disregards all other parameters in the process of determining whether an indirect expropriation has occurred, particularly the intention of those in government to do harm to the investor (or not), the public interest aim being pursued by the measure and the beneficial effect (or not) that the lost investment may have on the State’s assets. It is only the damage suffered by the investor that counts when deciding whether or not a State measure constitutes an indirect expropriation.

<sup>33</sup> See R. Dolzer, “Indirect Expropriation, New Developments?” *Environmental Law Journal*, vol. 11, 2002, p. 65. This doctrine has also been described as “orthodox” by A. Newcombe, “The Boundaries of Regulatory Expropriation in International Law,” in P. Kahn, T. W. Wälde (Eds.), *New Aspects of International Investment Law*. Leiden/Boston, Martinus Nijhoff Publishers, 2007, pp. 392-449.

<sup>34</sup> R. Dolzer, “Indirect Expropriation, New Developments?” p. 78.

<sup>35</sup> Expression used by R. Dolzer, F. Bloch, “Indirect Expropriation: Conceptual Realignment?” *International Law Forum*, vol. 5(3), 2003, p. 161.

<sup>36</sup> *Tippetts, Abbott, McCarthy, Stratton (Tams) v. Tams-Affa Consulting Engineers of Iran v. Iran, and others*, award of June 29, 1984, *Iran-U.S. CTR*, 6, 1986, pp. 225-226.

<sup>37</sup> *Biloune and Marine Drive Complex Ltd v. Ghana Investments Centre and the Government of Ghana*, ad hoc award of October 27, 1989, *ILR*, vol. 95, 1990, p. 209.

<sup>38</sup> *Metalclad Corporation v. Mexico (ARB (AF)/97/1)*, award of August 30, 2000, para. 111. Available online at <http://italaw.com>.

<sup>39</sup> Para. 103.

## 4.1.2 The Requirement for Serious and Irreversible Damage

In order to define any State measure as indirect expropriation, the tribunals require proof that the measure has caused serious and irreversible damage to the investment.

In terms of the severity of the damage suffered by the investment, this must be “substantial,” “serious” or “severe.” In other words, the rights held over the investment must have lost all economic interest for the investor. In the *Starrett Housing* case, the tribunal thus spoke of rights “rendered so useless that they must be deemed to have been expropriated.”<sup>40</sup> For this reason, minor restrictions, simple administrative inconveniences or other interferences of a lesser nature cannot be considered as constituting indirect expropriation. Similarly, an economic activity that is rendered more difficult but not made impossible will not be deemed to have been the object of indirect expropriation. Nonetheless, some tribunals have ruled that mere interference in the investor’s enjoyment of rights can represent serious damage,<sup>41</sup> or have admitted in theory that partial damage could be sufficient.<sup>42</sup>

As to the irreversible nature of the adverse measure, this implies that the investor’s situation will be compromised over a long period of time. The tribunals thus require that damage is “not merely ephemeral,”<sup>43</sup> or is a “deprivation [...] enduring.”<sup>44</sup> For the tribunal in *LG&E v. Argentina*, “the expropriation must be permanent, that is to say, it cannot have a temporary nature.”<sup>45</sup> How long does such a measure therefore have to last? The tribunals do not set a standard period of time<sup>46</sup> but assess situations on a case-by-case basis. As stated by the tribunal in the case of *RFCC v. Morocco*, “a temporary measure must [...] have substantial consequences equivalent to a permanent loss. The recovery of the property right or access to it does not replace ownership in its initial situation (...).”<sup>47</sup> Consequently, it is not a matter of how long the measure itself lasts but of how long the adverse effects endure on the investment, in other words, their irreversible nature.

In order to assess the severity of the damage suffered by the investor, the tribunals generally have recourse to certain factors. This set of verification factors can be called the *Pope & Talbot* test, after the principle award that formalized it. In order to determine the extent to which the investment had been compromised, the arbitration tribunal in this case considered a number of factors in the following terms:

<sup>40</sup> *Starrett Housing Corporation, Starrett Systems, Inc., Starrett Housing International, Inc., v. Iran, Bank Oman, Bank Mellat, Bank Markazi*, award of December 19, 1983, p. 154.

<sup>41</sup> *Metalclad*, para. 111.

<sup>42</sup> *SD Myers Inc. v. Canada*, award of November 13, 2000, para. 283.

<sup>43</sup> *Tippetts, Abbott, McCarthy, Stratton (Tams) v. Tams-Affa Consulting Engineers of Iran v. Iran, and others*, award of June 29, 1984, *Iran-U.S. CTR*, 6, 1986, p. 225.

<sup>44</sup> *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentina (ARB/02/1)*, award of October 3, 2006, *ICSID Rev.-FILJ*, vol. 21, pp. 203 et seq., para. 190.

<sup>45</sup> *LG&E Energy Corp.*, para. 193.

<sup>46</sup> A mere four-month import ban following the revocation of a licence was deemed sufficient to be termed an expropriation measure in *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt (ARB/99/6)*, award of April 12, 2002, *ICSID Rev.-FILJ*, vol. 18, 200, pp. 602 et seq. In contrast, an eight-month export ban was not deemed sufficient to conclude indirect expropriation in the case of *SD Myers Inc. v. Canada*, award of November 13, 2000. Here, the Tribunal considered that the temporary closure of the borders to imports of a product used by the investor had, in fact, only “delayed an opportunity” (para. 287).

<sup>47</sup> *Consortium R.F.C.C. v. Kingdom of Morocco (ARB/00/6)*, award of December 22, 2003, *ICSID Rev.-FILJ*, vol. 20, 2005, pp. 391 et seq, para. 68. [Translated]

... the Investor remains in control of the Investment, it directs the day-to-day operations of the Investment, and no officers or employees of the Investment have been detained by virtue of the Regime. Canada does not supervise the work of the officers or employees of the Investment, does not take any of the proceeds of company sales (apart from taxation), does not interfere with management or shareholders' activities, does not prevent the Investment from paying dividends to its shareholders, does not interfere with the appointment of directors or management and does not take any other actions ousting the Investor from full ownership and control of the Investment.<sup>48</sup>

It is therefore generally accepted that, in order to be able to claim to have suffered an indirect expropriation, the investor must have lost control of the investment and enjoyment of the benefits thereof. If the investor still has, for example, a free choice in the company's economic strategies and in its day-to-day running, access to the profits generated, and the freedom for both investor and staff to come and go as they please then the expropriation claim will be rejected. These elements of assessing the severity of damage are used by the majority of arbitration tribunals.<sup>49</sup> The extent to which they can be satisfied by regulations of general applicability could, however, be questioned as these latter are not aimed directly at the investor but simply modify the general economic or legal conditions in which the investment is being made.

Although applied by most tribunals, the criterion of injurious effect does have some significant limitations. Firstly, the severity of the damage that must have been suffered remains unclear. Secondly, no consideration is given to the host State's public interest. The damage suffered by the investor alone is decisive. Strict application of the "sole effect" doctrine may therefore result in any State measure that is detrimental to the investor being considered indirect expropriation, regardless of the justification for implementing said measure. Such an outcome may have consequences for the host State's policy space, as seen previously. The sole effect doctrine has been criticized by States, investment law specialists and civil society for a number of years now as insufficient to establish the existence of indirect expropriation when "legitimate" public regulations are at issue. Consequently, new approaches to the concept of indirect expropriation have been proposed, some of which have been favourably received by the tribunals, even in cases where the language used in the treaties offers no precise definition.

## 4.2 Proportionality of the Measure

The principle of proportionality is defined as that of finding a balance between two contradictory interests, in this case the public and the private. Its aim is to ensure that, when pursuing a public interest, the sacrifice imposed on private interests is "proportionate." While it is a relatively unfamiliar concept in international investment law, focused as it is on protecting investments, this principle has already been significantly developed in other dispute resolution forums.<sup>50</sup> The transposition of this principle into indirect expropriation litigation was first advocated by doctrine, before finding a favourable response in some recent arbitration cases.

<sup>48</sup> Pope & Talbot Inc. v. Canada, award of June 26, 2000, para. 100. Available online at <http://italaw.com>.

<sup>49</sup> Such was the case, to give but a few examples, of the tribunal in CMS v. Argentina (ARB/01/8), award of May 12, 2005, para. 263; LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentina (ARB/02/1), award of October 3, 2006, ICSID Rev.-FILJ, vol. 21, para. 188; Sempra Energy International v. Argentina (ARB/02/13) award of September 28, 2007, para. 284; Enron Corporation And Ponderosa Assets, L.P. v. Argentina (ARB/01/3), award of May 22, 2007, para. 245; Suez, Sociedad General de Aguas de Barcelona S.A., and InterAgua Servicios Integrales del Agua S.A. v. Argentina (ARB/03/17), award of July 30, 2010, para. 129. Awards available online at <http://italaw.com>.

<sup>50</sup> Such as the European Court of Human Rights, some of the decisions of which will be examined hereafter.

In *Tecmed v. Mexico*, regarding the State's refusal to renew an operating licence for a hazardous waste treatment plant, the tribunal deemed that the criterion of proportionality was a necessary criterion in establishing a case of indirect expropriation: "The Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments."<sup>51</sup>

The tribunal took three factors into account when assessing whether the regulatory measure taken to protect the public interest was proportional to the damage suffered by the investor.

Firstly, the damage has to be substantial. To assess this, the arbitrators took into account the sole effect doctrine.<sup>52</sup> Hence, as applied in *Tecmed v. Mexico*, the principle of proportionality is not intended to replace the criterion of injurious effect but to balance it against the public interest being pursued by the measure. It is therefore a complementary criterion. This means that if the criterion of injurious effect cannot be conclusively established then the proportionality test becomes superfluous.

Secondly, the *prima facie* existence of a public interest has to be verified. This criterion is left to the State's sovereign judgement, barring any obvious and gross abuse of power. In *Tecmed v. Mexico*, the arbitrators did, however, deem it necessary to verify whether the public interest invoked by the State was, in fact, the reason behind the measure, not in order to scrutinise the legitimacy of the measure but to test its proportionality in terms of the real public interest at issue.

Thirdly, at least one tribunal, the tribunal in *Tecmed v. Mexico*, has demanded that the authorities' response be necessary to achieve the intended public interest. This means that the measure taken by the State has to be the only measure available to achieve the objective, or the least detrimental if a number of effective solutions exist.<sup>53</sup> It is in the light of this condition that the damage caused to the investor must be proportional. In this case, the tribunal concluded that the decision not to renew the operating licence was not necessary to achieve the intended goal, which was to resolve the complaints from people living in the vicinity of the factory regarding the health and environmental consequences of its operations. Other less detrimental solutions were conceivable, such as relocation of the treatment plant to a more appropriate site. The measure had thus imposed an excessive burden on the investor.<sup>54</sup>

Since the award in *Tecmed v. Mexico*, the relevance of the criterion of proportionality has been recognized as applicable to expropriation litigation in other treaty-based investor-State disputes.<sup>55</sup>

While being more balanced than the criterion of injurious effect, the proportionality criterion is not perfectly suited for importation into the investor-State context. The arbitrators in *Tecmed v. Mexico* referred explicitly to European Court of Human Rights (ECHR) case law when interpreting Article 1 of the Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms of 1952 (hereinafter Protocol 1). Transposing this principle from the case law of a dispute settlement body that derives from a specific legal system, however, raises a problem. The European Union currently represents the most advanced form of regional integration process. Its legal corpus is therefore not

<sup>51</sup> *Tecmed v. Mexico* (ARB(AF)/00/2), award of May 29, 2003, 43 ILM, 2004, para. 122.

<sup>52</sup> *Tecmed*, para. 116.

<sup>53</sup> The "necessity" test is a controversial element and a source of much discussion in WTO law.

<sup>54</sup> *Tecmed*, para. 151.

<sup>55</sup> See, for example, *LG&E v. Argentina*, and *Azurix Corp. v. Republic of Argentina* (ARB/01/12), award of July 14, 2006. Available online at <http://italaw.com>. However, in these two cases, the tribunals did not have the opportunity to put their statements of principle into practice. In fact, the prior criterion of substantial damage was not fulfilled.

easily transposable into international investment law, which is based on a dense and complex network of bilateral investment treaties and a dispute settlement system that lacks harmony and in which the arbitrators do not enjoy the same legitimacy as the European judges. As one author observed, the consideration of highly subjective elements such as proportionality may be accepted when it is a question of “internal judicial institutions and international jurisdictions such as the European Court of Human Rights but [...] may be surprising when it is a question of an arbitral tribunal composed of private individuals and with no mechanism for appeal.”<sup>56</sup> Moreover, in contrast to many investment treaties, the human rights system demands that all local recourse has first been exhausted. Finally, the investment treaties themselves do not seek a balance between opposing rights. On the contrary, they have a “congenital” imbalance in favour of investors’ rights (which has often been denounced). Overall, therefore, Article 1 of Protocol 1 is more sensitive to the State’s policy space than a typical expropriation clause in investment treaties. Despite some notable developments, the current state of international investment law hardly lends itself to such a transposition.

### 4.3 Legitimate Objective of the Measure

In lieu of the criterion of the injurious effect of the State’ measure on the investment, some tribunals have applied the criterion of the legitimate objective the measure is designed to serve. This criterion has various applications, but what they have in common is postulating that certain legitimate host State measures with specific characteristics cannot be considered as indirect expropriations, even when they are seriously and irreversibly detrimental to an investment. These specific regulations are commonly referred to as “police power measures” or “legitimate public regulations.” They are not compensable.

It has also been argued that although these types of legitimate measures may indirectly expropriate an investor’s property, they do not give the investor the right to full compensation. Thus, the investor may not be entitled to full compensation at the market value of the property, due to the overriding interest that necessitated the devaluation of the asset. The main justification put forward for this balancing of the amount of compensation is that it makes public interest regulations financially sustainable for the State, while not completely discouraging private initiative.

One of the first cases to distinguish the non-compensable police power measure from indirect expropriation was the *Too v. USA* award, in which the tribunal stated:

[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 (...).<sup>57</sup>

One more recent award to have applied the distinction is the *Methanex v. USA* case under NAFTA. At issue was a measure prohibiting the use of a petrol additive considered carcinogenic. In this case, the tribunal rejected the definition of indirect expropriation on the grounds that it was a bona fide general regulation designed to serve a public interest, on a non-discriminatory basis: “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

<sup>56</sup> C. Leben, “La liberté normative de l’État et la question de l’expropriation indirecte,” in *Le contentieux arbitral transnational relatif à l’investissement: Nouveaux développements*. Louvain-la-Neuve, Artémis, 2006 p. 179.

<sup>57</sup> Emmanuel Too v. Greater Modesto Insurance Associates and the United States of America, award of December 29, 1989, *Iran-US CTR*, vol. 23, 1989-II, p. 378.

is not deemed expropriatory and compensable (...).<sup>58</sup> It thus concluded that “from the standpoint of international law, the California ban was a lawful regulation and not an expropriation.”<sup>59</sup> Such measures cannot therefore be considered indirect expropriations, regardless of any adverse effects on the investment.

In the *Saluka v. Czech Republic* award, an arbitration tribunal also recognized that:

[i]t is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.<sup>60</sup>

In the *Suez InterAgua v. Argentina* award, the tribunal ruled that:

... in evaluating a claim of expropriation it is important to recognize a State’s legitimate right to regulate and to exercise its police power in the interests of public welfare and not to confuse measures of that nature with expropriation.<sup>61</sup>

It may be noted here that the criteria used by tribunals to determine the legitimacy of the Californian regulation are very similar to the conditions governing whether indirect expropriation is lawful: non-discrimination action in pursuit of public interest (in addition to the application of due process).

In fact, several arbitration awards have recognized the existence of a principle of distinction between indirect expropriation and a non-compensable police power measure.<sup>62</sup> But while the statement of principle is straightforward, implementation is problematic. Aside from the first two cases cited above, few tribunals completely dismiss the criterion of adverse effect on the investor in favour of the legitimate public interest the measure is designed to serve. In other words, although some measures are recognized as legitimate police power measures, tribunals nevertheless verify that they have not been significantly detrimental to the investment before ruling for or against indirect expropriation. This was the case in the *Tecmed v. Mexico* award, in which the tribunal, after stating that it was “undisputable” that a State in the exercise of “its police power may cause economic damage ... without entitling [those harmed] to any compensation whatsoever” (§ 119), nevertheless stated that “regulatory actions and measures will not be initially excluded from the definition of expropriatory acts.”<sup>63</sup> This means that, as some arbitral tribunals are interpreting and applying investment agreements, police power measures are State measures like any other State measures, and may therefore result in indirect expropriations where their injurious effects are substantial.

Some tribunals have, moreover, decisively rejected the existence of a category of State measures that cannot constitute indirect expropriations because they are designed to serve a legitimate public interest and are not discriminatory. Thus, in the *Santa Elena v. Costa Rica* award, an arbitration tribunal ruled that:

<sup>58</sup> *Methanex v. USA*, award of August 9, 2005, Part IV, Ch. D, para. 7. Available online at <http://italaw.com>.

<sup>59</sup> *Methanex*, Part IV, Ch. D, para. 15.

<sup>60</sup> *Saluka Investments BV v. The Czech Republic*, award of May 17, 2006, para. 255. Available online at <http://italaw.com>.

<sup>61</sup> *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAgua Servicios Integrales del Agua S.A. v. Argentina* (ARB/03/17), award of July 30, 2010, para. 128.

<sup>62</sup> See, for example, *CME (Czech Republic) BV v. The Czech Republic*, award of September 13, 2001, para. 603; *Marvin Roy Feldman Karpa v. The United Mexican States* (ARB(AF)/99/1), award of December 16, 2002, ICSID Rev.-FILJ, vol. 18, 2003, pp. 488 et seq., para. 103; *Azurix Corp. v. The Argentine Republic* (ARB/01/12), award of July 14, 2006, para. 310. Available online at <http://italaw.com>.

<sup>63</sup> *Tecmed v. Mexico* (ARB(AF)/00/2), award of May 29, 2003, 43 ILM, 2004, para. 122.

[e]xpropriatory environmental measures — no matter how laudable and beneficial to society as a whole — are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state’s obligation to pay compensation remains.<sup>64</sup>

The principle of distinction between indirect expropriation and police power measures is cited in a number of non-binding texts,<sup>65</sup> and the majority of tribunals afford it a customary international law value. However, this distinction is not explicitly provided for in the majority of investment treaties, whose expropriation clauses do not expressly exclude the legitimate general regulations of their scope of application. As already discussed, exclusions such as that of Annex B.13(1) of the Canadian investment treaty model text are not sufficient to create a true exception for legitimate public interest regulations. On the contrary, the exclusion imposed by clauses such as that of Article 20(8) of COMESA CCA gives more weight to the principle of distinction, because it creates a real exclusion. But by referring to customary international law, the COMESA text merely defers the difficulty in providing a precise definition of the concept of police power measure.

Indeed, the difficulty of applying the principle of distinction between police power measures and indirect expropriation measures is primarily due to the fact that police power measures are difficult to identify. A police power measure is, in simple terms, all measures “essential to the effective functioning of the State.”<sup>66</sup> However, there is no precise definition of this functional concept in customary international law. As the tribunal bemoaned in the *Saluka v. The Czech Republic* award, although supportive of this principle, “international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered ‘permissible’ and ‘commonly accepted’ as falling within the police or regulatory power of States and, thus, noncompensable.”<sup>67</sup> Indeed, police power measures may be confused with all legitimate public regulations enacted by a State, due to the fact that they are all a priori designed to serve a more or less essential public interest. Thus, no precise and unanimous list of legitimate interests specific to the concept of police power measure exists, even if there is consensus around certain values. These include those that are the subject of protection under international law, or those that come under the regulatory functions of the State. This applies to issues of public policy, sanitation, taxation and monetary policy, environmental protection and labour rights. Moreover, it is difficult to verify that a State measure with an essential public interest objective has been enacted and implemented in accordance with due process, and on a non-discriminatory and reasonable basis. These terms refer to standards of conduct that are difficult for tribunals to assess in practice. Nevertheless, the State, by enacting the police power measure, must be seen to act with the utmost impartiality and objectivity in achieving the stated public interest objective. It must therefore be to some extent inevitable that, in pursuing public interest objectives, there may be some adverse impact on foreign private investments.

<sup>64</sup> *Compañía del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica (ARB/96/1)*, award of February 17, 2000, ICSID Rev.-FILJ, vol 15, 2000, pp. 169 et seq, para. 72.

<sup>65</sup> See, for example, commentary g under §712 of *Restatement of the Law, (Third), The Foreign Relations Law of the United States*, American Law Institute Publishers, St. Paul, Minnesota, 1987, vol. 2; or Article 10.5 of the 1961 Harvard project, reproduced in L. B. Sohn et R. R. Baxter, “Responsibility of State to injuries to Economics Interests of Aliens,” *AJIL*, 1961, vol. 55(3), pp. 545-584.

<sup>66</sup> Expression used by M. Sornarajah (2010), *The International Law on Foreign Investment*, 3rd ed., Cambridge: Cambridge University Press, p. 374.

<sup>67</sup> *Saluka Investments BV v. The Czech Republic*, award of May 17, 2006, para. 264.

Given the still uncertain definition of non-compensable police power measures, some tribunals take the view that a “blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation.”<sup>68</sup> They fear that any public interest measure detrimental to the investor may benefit from the exception of police power measures and not be compensable. Nevertheless, even if difficult to apply in practice, accounting for the public interest of the State when defining indirect expropriation cannot now be simply overlooked, however this public interest is considered.

#### 4.4 State Appropriation

The State appropriation criterion means that there can be no indirect expropriation when the State does not derive economic benefit from the adverse impact on the investor. In other words, the injurious effect on the investment must have resulted in economic benefit to the State. The economic effects of the *bona fide* measure on the investor and on the State must therefore be considered. Here, the appropriation or economic benefit derived by the State fulfils the role of an additional criterion to the injurious effect criterion.

The appropriation criterion has been advocated by a number of authors,<sup>69</sup> yet its application by tribunals remains marginal.<sup>70</sup> Its advocates argue that in direct expropriation, there is always appropriation of the asset by the State, due to the withdrawal of the ownership title. It would be this transfer of wealth from one entity to another that would justify the compensation obligation. It should therefore also be required in a compensable indirect expropriation. Appropriation may involve, for example, the State terminating a concession contract in order to resume economic activity on its behalf or to the benefit of a third party.

However, public interest measures that are detrimental to the investor do not always result in economic benefit to the State. The State may not derive economic benefit from the destruction of an investment where it regulates to protect human health or the environment. Sometimes, it may even suffer a loss due to its new laws. A ban on importing a substance deemed hazardous may result in reduced tax revenues on imports. In such cases, compensation would not be due.

Although it enables a rebalancing of the private and public economic interests at issue, the majority of tribunals and academics reject the appropriation criterion. This rejection is reinforced by the clauses of the BITs which do not make reference to the consideration of the economic benefit derived by the State in an indirect expropriation.

<sup>68</sup> Pope & Talbot Inc. v. Canada, award of June 26, 2000, para. 99.

<sup>69</sup> A. Newcombe, “The Boundaries of Regulatory Expropriation in International Law,” in P. Kahn, T. W. Wälde (Eds.), *New Aspects of International Investment Law*, Leiden/Boston, Martinus Nijhoff Publishers, 2007 pp. 441-445.

<sup>70</sup> See R. S. Lauder v. Czech Republic, UNCITRAL award of September 3, 2001, para. 203, available at <http://italaw.com>; Eudoro A. Olgún v. The Republic of Paraguay (ARB/98/5), award of July 26, 2001, ICSID Rev.-FILJ, vol. 18, 2003, pp. 143 et seq., para. 84.

## 5.0 Recommendations and Conclusions

The definition of indirect expropriation remains vague in international investment law. Approaches differ and arbitration awards can vary. There is, therefore, a problem of consistency, certainty and foreseeability.

To address this, there are some possible solutions through the redrafting of clauses in investment treaties and through their interpretation by arbitration tribunals.

Regarding the treaty provisions, it would be advisable for States signatory to the investment treaties to establish, by agreement, more precise details on the definition of indirect expropriation, particularly when legitimate regulations of general applicability are at issue. Indeed, it is because the definition of indirect expropriation is not clearly established that such differing interpretations are possible. It is certainly not easy to find a fixed definition of this concept, whose potential applications are endless. However, it is possible to redraft provisions which specify the role and place of the criterion of injurious effect and the role and place of other criteria. States may also envisage introducing the criterion of State appropriation along with that of injurious effect. Whether States choose to develop criteria for qualification or create exceptions, the new provisions should be more explicit and effective than those included in some recent treaties.

For example, simply recognizing the State's sovereign right to regulate may not be sufficient to address the definition of indirect expropriation. The latter does not prohibit regulation, but requires compensation in the event of substantial damage. Similarly, it is not enough to create a presumption in favour of certain regulatory measures; it should be specified that some measures, such as police power measures, are not expropriatory, whatever their adverse impact on the investments. If it is well defined, this exclusion of police power measures will provide more certainty for States and for foreign investors. To this end, it would be helpful to define the concept of police power measures more clearly, by drafting a clause on its criteria. Developing a list of factors to be taken into account by tribunals to define indirect expropriation is a positive step, provided the extremely vague reference to the "legitimate/reasonable expectations" of the investor is avoided, and what the "nature" of the measure means is explained. It would also be beneficial to introduce a hierarchy between criteria that may be irreconcilable, such as the economic impact and the nature of the measure.

Ideally, investment treaties as a whole would be renegotiated to incorporate these new clarifications and exclusions. To this end, the examples of the COMESA CCA (2007) and ASEAN CIA (2009) treaties may be a modern basis for discussion. The possibility of mutual or even unilateral interpretation may also serve to clarify the vague terms used to address indirect expropriation in the treaties already signed.

Pending the possible emergence of a new generation of provisions in investment treaties, it falls to arbitration tribunals to adapt their case law to the current challenges of defining indirect expropriation. Tribunals could, for example, distinguish measures that directly target the investment from those that do not, and whose negative impact on the investment are more collateral in nature. It is possible, at least for this second category of general measures, to depart from criterion of the injurious effect, and incorporate factors that take into account the needs and public interests of the host State. These factors, whether the criterion of proportionality or the criterion of legitimate public interest (or police power measures exclusion), once adapted to the context of international investment law and strictly enforced, may help to achieve a better balance.

Ultimately, the assessment of whether a State measure is an indirect expropriation should be a process that takes into account the private rights of foreign investors as well as the sovereign rights of the host State. The investor does have the right to protect its assets, but the State must retain the ability to protect the public interest of which it is guarantor within its territory. A universal panacea probably does not exist, but it is possible to move towards a better balance between the interests at issue.

International investment law has been interpreted via a number of disputes to favour private investors' rights over host States' regulatory discretion. As the field develops, however, it is increasingly apparent that the law needs rebalancing, and must now be receptive to the public interest considerations of the investment's host State along with the economic interests of investors.

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