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Compensation for Expropriation

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Best Practices
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Introduction

The issue of compensation for foreign investors adversely affected by expropriation in their host State has always led to a profound divergence of views in international investment law centered on whether or not there existed an international obligation on the part of a host State to compensate foreign investors for expropriated investments. Major capital-exporting countries generally defended[1] the existence of such an obligation, while the newly independent countries and communist countries challenged the right of foreign investors to receive compensation in the event of expropriation on various legal grounds, such as national treatment,[2] or to address economic inequalities borne out of "colonial sin"[3] or excessive profits.[4] Controversies then arose as to the applicable standards for assessing the amount and methods of paying compensation.

Today, some of these controversies are no longer an issue. Investment protection treaties and customary international law now obligate host States to protect foreign investments such that any expropriation must be done according to certain rules. Thus, when a measure taken by a State is categorized as direct or indirect expropriation (using definition criteria), then it must meet at least three criteria of legality: (1) it must have been enacted in the public interest; (2) it must not be discriminatory and; (3) it must be accompanied by compensation for adversely affected investors. The award of compensation is, therefore, one of the conditions for any expropriation to be considered lawful under international law. However, while recognition of a foreign investor's right to compensation is one thing, agreement on the amount of compensation to be paid is another matter altogether.

Assessing the amount of compensation is a major current issue. Of course, every party to investment litigation first attempts, depending on their interests, to convince the tribunal that expropriation has happened or not. However, once it has been accepted that expropriation has taken place, it is the method of assessment of compensation that will significantly impact the amounts awarded. On this point, the determination of the applicable rules is often vague and incomplete. Moreover, the expropriation clause is the only provision in bilateral investment protection treaties (BITs) designed to address the method of calculation of compensation. In fact, it is often used in tribunal as a reference for the calculation of compensation for breach of other BIT obligations. It is therefore essential that States that are parties to BITs take extra care in drafting the expropriation compensation clause in order to guide the calculation of the amounts that will have to be disbursed from public funds in the event of an adverse award by a tribunal.

This study does not attempt to examine in detail the formulas for calculating amounts, which fall within accounting and economics expertise. Instead, the objective here will be to analyze, from a legal perspective, the principles governing compensation for expropriation, as well as the principal methods of calculating the amount. To reflect conventional arbitration practice in this regard, we will first consider the current state of customary international law before going on to examine the language contained in some BITs, as well as the interpretation of the various arbitral tribunals. The last part will feature the recommendations to States.

[1] It should be noted that some countries have not always upheld the obligation to pay compensation for expropriation, especially when they themselves were carrying out large-scale nationalizations on their territory. Britain, for example, argued in the early 19th century that in the context of large-scale expropriation, foreigners were entitled to the same treatment as nationals. See the 1927 report by A. Chamberlain to the League of Nations on Hungarian complaints against Romania. Quoted by Seidl-Hohenveldern, "Semantics of wealth deprivation and their legal significance," in D. C. Dicke (Ed.), *Foreign investment in the present and a new international economic order*. Freiburg Univ. Press, 1987.
[2] This argument was defended by the Soviet Union during the great waves of nationalization in the early 20th century. The federal government did not intend granting compensation to adversely affected foreign investors while there was no such right for nationals. National treatment only requires foreigners to be treated no less favourably than nationals.
[3] This argument was defended by southern countries in the wake of their independence. These countries carried out the nationalization of the colonial enterprises that exploited their natural resources, considering that by so doing they were only recovering what they had been despoiled of.
[4] This argument was mainly defended by Latin American countries, which felt that the expropriated companies had made excessive profits for many years to the detriment of nationals and that to pay compensation would, therefore, be unfair.

I. Compensation for Expropriation in Customary International Law

A. Review of the General Rules of International Responsibility of States

In customary international law, a distinction is made between primary rules and secondary rules for the responsibility of states for internationally wrongful acts. Primary rules are those whose violation is the responsibility of the state (primary obligations) and secondary rules are those governing the liability of the state for breaches of primary rules (secondary obligations). In other words, the primary rule defines "the content of the obligation it imposes" and the secondary rule sets "whether that obligation has been breached and what the consequences of this breach must be."[5]

Nonetheless, the legal regime of expropriation is unique. Indeed, in the event of expropriation, the primary obligation lies not in the act of expropriation, which is a recognized sovereign right of States, but in the conditions for its lawful implementation, which amount to State obligations. Therefore, a State does not incur any international liability by carrying out expropriation. Liability only attaches if the State fails to meet the conditions for said expropriation. This would be the case, for example, if the expropriating State failed in its primary obligation to compensate the investor for the expropriated investment. Therefore, "there is . . . a 'primary' obligation to compensate and, if this obligation is breached, a 'secondary' obligation to indemnify as a responsibility."[6] Compensation, which is a central issue in the matter of expropriation, can therefore have two distinct functions.

B. The Distinction Between Compensation for Lawful and Wrongful Expropriations in Customary International Law

Depending on whether the direct or indirect expropriation was carried out in compliance with the conditions for legality, it will be lawful or unlawful in international law. That said, considering the dual status of compensation, a central question arises. Since both lawful and wrongful expropriation give entitlement to compensation, how should one distinguish between the compensation to be awarded for lawful expropriation and that for wrongful expropriation?

The response of customary international law to that concern was developed in the *Chorzów Factory Case*,[7] which, despite some controversy, remains the seminal decision on this matter. In this case, the Permanent Court of International Justice (PCIJ) stated that in the case of a wrongful act (wrongful expropriation in this case):

> 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 the restitution in kind or payment in place of it—such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.[8]

[5] Until the election of Special Rapporteur R. AGO, the distinction between primary rules and secondary rules had not been clearly made. On this distinction, see Yearbook of the International Law Commission, 1970, vol. II, p. 327, par. 66 c.
[6] K. Zemanek (1987–1988). "The responsibility of States for internationally wrongful acts, as well as for internationally lawful" in *International Responsibility*. Lectures and Readings of the Institut des Hautes Etudes Internationales de Paris. Paris, Pedone.
[7] The Chorzów Factory Case (Germany/Poland), September 13, 1928, Series A, No. 17 (substantive issue).
[8] Ibid., p. 47.

For lawful expropriation, compensation is limited "to the value of the company at the time of dispossession, plus interest to the date of payment."[9]

For certain theorists and tribunals[10], this verdict highlighted the following principle. In the case of lawful expropriation (including when the granted compensation amount is disputed), the adversely affected investor is entitled only to "compensation" equating to the *damnum emergens*, or losses suffered upon the date of expropriation. These losses are limited to the static value of the investment's assets. In the case of wrongful expropriation, the adversely affected investor shall have the right, beyond "compensation," to "reparation." Indemnification in this case includes not only losses, but also *lucrum cessans*, or lost earnings/loss of profits. Losses, then, include loss of earnings due to expropriation, calculated from the profits the investment generated. The principle of reparation is also provided in the International Law Commission (ILC) Draft Articles on the Responsibility of States for Internationally Wrongful Acts, considered a codification of customary rules: "The compensation shall cover any financially assessable damage including loss of profits insofar as it is established."[11]

It should be noted, however, that there is some division on the aforementioned interpretation of the *Chorzow Factory* decision. For some writers, the *Chorzow Factory* decision must be interpreted to mean that the adversely affected foreign investor is entitled to compensation for the "value of investment" in cases of lawful expropriation, that is to say losses and lost profits. Reparation in the case of unlawful expropriation would include losses, lost profits, plus indirect damages.[12]

[9] Ibidem.

[10] See, for example, Amoco International Finance Corp. v. Iran, 15 Iran-US CTR (1987-II), pp. 189 et seq.

[11] *Draft Articles on Responsibility of States for Internationally Wrongful Acts,* ILC, 2001, section 36.2.

[12] See, for example, the concurring opinion of Judge Brower in the Amoco International Finance Corp. v. Iran, 15 Iran-US CTR (1987-II), verdict, especially, pp. 300–301: "(...) Chorzów Factory presents a simple scheme: if expropriation is lawful, the dispossessed party should be awarded damages equal to "the value of the undertaking" it has lost, including any potential future profit, from the date of dispossession; in the case of wrongful expropriation, however, the injured party must either regain effective enjoyment of its property, or if that is impossible or impracticable, it should be awarded damages equal to the greater of (i) the value of the company at the date of injury (again, including lost profits), assessed on the basis of information available at that date, and (ii) its value (also including lost profits), as illustrated by its likely performance after the date of injury and before the date of the award, based on actual post-expropriation experience, and (in either alternative) any indirect damages."

II. The BIT Terms of Compensation for Expropriation

Before we turn to examining various BIT provisions on compensation for expropriation, it should be noted that there used to be a practice of flat-rate compensation (lump sum settlement agreements). During the large-scale nationalizations that characterized the 1950s to 1980s, host States and the investors' home States reached numerous lump sum settlement agreements. Under these agreements, the claimant State received a fixed sum from the expropriating respondent State, which the claimant State adjudicated and distributed to its injured nationals in proportion to the losses suffered through a special domestic tribunal or claims commission. This practice made it possible to take into account the financial capacity of the newly independent countries that wanted to exercise their permanent sovereignty over their natural resources through nationalizations. The conclusion of these agreements was aided by the fact that at that time, the investors' only recourse in cases of an expropriation or nationalization was the diplomatic protection of their home State. Now, with direct access to arbitration against the host State through BITs, investors may make direct claims against the host State for the full amount of compensation to which they believe they are entitled.

A. The Legal Principles Governing Compensation for Expropriation

Several questions concerning the principles governing compensation for expropriation are not addressed in the provisions of BITs. When such answers do exist, they are then subject to different doctrinal interpretations before the arbitral tribunals.

1. A Single Standard for Direct and Indirect Expropriation

Observation

A common observation is that expropriation clauses in BITs do not distinguish between the modes of assessment of compensation for direct and indirect expropriation. Indeed, although both forms of expropriation are covered, the treaties do not take into account the peculiarities and challenges inherent in indirect expropriation. The definition of direct expropriation poses less of a challenge. According to international investment law, direct expropriation is defined as a State measure (statute or regulation) that expressly withdraws legal title of ownership over an investment for the benefit of the State or a third party designated by the State. In contrast, the definition of indirect expropriation remains problematic. Indirect expropriation is generally defined as a State measure which causes serious injury to an investment without legal title to the investment being affected. Thus, the investor still retains legal title over the investment, but its investment no longer has any financial value or no longer effectively exists. In theory, every state regulation could, thus, be classified as indirect expropriation, depending on the definition in the BIT or the criteria used by the tribunals, which are often varied and sometimes contradictory.[13]

Problem

The fact that BITs do not provide specific rules for each type of compensation for expropriation poses a problem. Based on most BITs, it is difficult to know what types of State measures can be categorized as indirect expropriation. As such, legitimate general regulatory measures undertaken in the public interest, such as the enactment of health or

[13] For more details see S. H. Nikiema (2012, March). *Best Practices: Indirect expropriation*. International Institute for Sustainable Development. Available at http://www.iisd.org/pdf/2012/best_practice_indirect_expropriation.pdf.

environmental legislation, though not targeted at investors, but that turn out to create a financial injury for investors could be determined by tribunals to be regulatory takings amounting to indirect expropriation.

At first glance, it may seem unfair that the State should have to offer maximum compensation for legislating in the public interest or in order to implement its international obligations to respect human rights, or to safeguard health and the environment. Let us take the example of two domestic laws which are currently being challenged by foreign investors before arbitral tribunals. The first case involves a Uruguayan law on cigarette packaging, requiring health warnings on 80 per cent of the front and back of cigarette packages and reducing therefore the space for logos.[14] Phillip Morris consequently filed a notice for arbitration before ICSID, alleging among other things, indirect expropriation of its investment. The second illustrative case concerns the amendment in 2011 to the German Atomic Energy Act by the German Parliament in order to accelerate the abandonment of the use of nuclear energy by 2022 in the aftermath of the Fukushima nuclear disaster.[15] In May 2012, the Swedish energy company Vattenfall filed a request for arbitration against Germany in response to the closure of two Vattenfall-run nuclear plants. It is very likely that Vattenfall alleged indirect expropriation as the basis for its claim in its request for arbitration. Should an arbitral tribunal consider the enactment of these laws as a "taking" amounting to indirect expropriation, a question arises as to whether the respondent host State would have to provide full compensation for the loss suffered by an investor, despite the fact that its investment would have continued to cause serious harm to public health or could have led to a catastrophe if an accident occurred, had the law not been enacted? Should the respondent host State in such a situation be subjected to the same standard of compensation in the case of a State that decided to nationalize the investment of a private foreign investor?

Moreover, it should be noted that in direct expropriation, the host State acquires an economic gain. There is, indeed, a transfer of ownership over private property to the public, and therefore an enrichment of the State. In such circumstances then, it is only right that the State should pay for what it has taken. However, in indirect expropriation through a general regulatory measure, the State does not normally make any financial profit out of the measure in question. Instead, as illustrated by the examples below, it may even result in a loss of tax revenue due to the closure of a business or decrease in the consumption of a product. The standard of full compensation, therefore, becomes difficult to justify.

Finally, in the case of indirect expropriation, one could ask whether a State would be less inclined to take certain measures in the public interest if, as a consequence of these measures, it would unexpectedly be made to compensate the foreign investor. In such a case, the State would have to make a disbursement of public funds not originally earmarked for this purpose. The situation is different in the context of nationalization. Here, a State decides to lawfully nationalize an investment only after a balancing of interests and the allocation of funds in its budget for the implementation. But, does a State have the capacity and means to anticipate and meet the possible financial costs of full compensation for foreign investments injured by the least of its regulations at a national or local level? This question has led some authors to fear that States might develop "extremely timid behaviour when adopting measures to implement human rights," leading them "to subordinate collective choices in the general interest to the rights of private foreign investors,"[16] or again that they might "not regulate to the extent that they should, or will modify or remove regulations when threatened with investor claims."[17] In reality, the problem is already upstream, as it falls to the States to specify in their BITs that certain

[14] See Philip Morris Brand Sàrl, Philip Morris Products S.A. and Abal Hermanos S.A. v. Uruguay, ICSID ARB/10/7. The request for arbitration is available at http://italaw.com/sites/default/files/case-documents/ita0343.pdf.
[15] See N. Bernasconi-Osterwalder (2009). *Background paper on Vattenfall v. Germany arbitration.* Winnipeg: International Institute for Sustainable Development. Available at http://www.iisd.org/pdf/2009/background_vattenfall_vs_germany.pdf.
[16] R. Bachand, M. Gallie, S. Rousseau (2003). "Investment Law and Human Rights in the Americas" AFDI, 2003, respectively p. 592 and pp. 601-602.
[17] N. Bernasconi-Osterwalder et al. (2011). *Investment Treaties and Why They Matter to Sustainable Development: Questions and answers.* Winnipeg: International Institute for Sustainable Development. Available at http://www.iisd.org/pdf/2011/investment_treaties_why_they_matter_sd.pdf.

types of regulations are immune from being classed as indirect expropriation. Otherwise, once qualified as such, it is difficult to defend non-compensation when an expropriation has occurred.

2. A Common Standard for Lawful and Wrongful Expropriations

Observation

Clauses in BITs explicitly provide a standard for compensation for lawful expropriation. These clauses, however, are unclear if the same standard is applicable in cases of unlawful expropriation. This lack of distinction may be interpreted to mean that the compensation standards provided for in BITs are identical for internationally lawful acts (lawful expropriation) and internationally wrongful acts (wrongful expropriation). Were this so, the expropriation and compensation provisions of BITs would literally bring about a contradiction with the customary international law of state responsibility. Indeed, regardless of differences over the content of compensation for lawful and unlawful expropriation, customary rules differentiate between reparation for wrongful acts and compensation for lawful ones. Nevertheless, even if this gap in the BITs were interpreted to mean that recourse must be made to customary international law for compensation for unlawful expropriations, the result would be the same. In fact, the compensation standards for lawful expropriation provided for in BITs are at least as high as those in customary law for wrongful expropriation.

In practice, when it comes to direct expropriation, an allegation which is increasingly rare in international investment disputes, the arbitral tribunal can easily distinguish between lawful and unlawful expropriation and calculate the amount of compensation on the basis of this dichotomy. But in the case of indirect expropriation, most tribunals do not take the trouble to state whether it is lawful or unlawful expropriation, and neither do they calculate the compensation accordingly. And even when the tribunals admit that the distinction is relevant, they still fail to continue to take account of this when calculating compensation. In essence, calculating compensation is based on another criterion, which is the profitability (ongoing business) or non-profitability of the expropriated investment. In other words, and as one author empirically stated, "for compensation, the criterion relating to the profitability of the assets expropriated has gradually substituted for that of the legality of the expropriation. (…) In assessing the quantum of compensation, performing assets have taken the place of the wrongful expropriation and non-performing assets have taken the place of lawful expropriation."[18]

Problem

First, the absence of a distinction in the method of calculating compensation depending on the lawfulness or wrongfulness of the expropriation poses an ethical problem. One cannot really conceive that a State that expropriates in accordance with its international obligations should have to pay the same compensation as a State which commits an unlawful act by expropriating, for example for the private interest of a government official, in a discriminatory manner and/or without compensation. In this regard, it should be noted that an arbitral tribunal before which a suit for wrongful expropriation has been brought may reclassify the state action as lawful expropriation if the difference between the parties is restricted to the amount of compensation awarded.[19] Secondly, it also bears mentioning that

[18] Y. Nouvel (2003). "Compensation for indirect expropriation." *Forum du droit international/International Law Forum*, Vol.5, n° 3, p. 199. Author's translation.

[19] This means that the state has agreed to indemnify the foreign investor in accordance with its international obligations, but the sum offered or payment schedule is disputed. In this case, the court will only recalculate the amount due in accordance with the standards set out in the BIT and, failing this, by customary law.

any direct or indirect expropriation may be wrongful. But in practice, indirect expropriation is more likely to be unlawful expropriation, because the State does not consider or even fails to realize that the general requirements of a law or regulation may be regarded as the indirect expropriation of a foreign investment. So the paradox is that in the case of indirect expropriation, the host State *accidentally* triggers the exercise of a right it is recognized to have, but with significant financial costs, from its carrying out wrongful expropriation when it did not judge that it was expropriating anything. That said, whether the unlawfulness of the indirect expropriation is the result of good or bad faith by the government, the ambiguous terminology of BITs can require the State to indemnify the injured investor on the basis of the same criteria as lawful expropriation.

3. The Obligation of Immediate Compensation

Observation

The majority of BITs do not state the exact date compensation is due for payment, but require payment "immediately,"[20] or "without undue delay."[21] Some BITs provide explicit expectations, for example that "provisions for the determination and payment of compensation shall be made in a timely manner and at the time of expropriation at the latest."[22] This means that the host State must anticipate and assess the injury that its act of expropriation will cause the foreign investor, and indemnify it in advance or at the time of adopting the measure in question. This requirement is understandable, but it may be unrealistic, or even absurd in certain situations.

Problem

With regard to direct expropriation, a state may compensate the injured foreign investor before the application of the law of nationalization or expropriation decree. But this solution is not always feasible for every country, especially in the case of developing countries whose financial resources are limited. It may, then, be more appropriate for the State to be able to adopt staged payments in line with its financial resources. Insofar as indirect expropriation is concerned, the obligation to pay before or at the time of expropriation may not be feasible. If we take the case of general measures to protect or deal with a health or environmental risk, the speed required to resolve whether or not the measure amounted to a regulatory taking may not allow the host State to calculate, budget and compensate the potential injured parties before acting. And even if it were possible, the State would still have to be aware of or accept the fact that it is indirectly expropriating a foreign investment. Compounding the problem is that the definition of indirect expropriation is still so widely debated that no one can predict with certainty whether this type of measure may or may not be classed as indirect expropriation by a tribunal.

Some of the problems raised are currently addressed in recent texts introducing flexibility into the timeframe for payment of compensation. This is the case in Section 6.4 of the SADC Model Bilateral Investment Treaty: " Awards that are significantly burdensome on a Host State may be paid yearly over a three-year period or such other period as agreed by the parties to the arbitration, subject to interest at the rate established by agreement of the parties to the arbitration or by a tribunal failing such agreement."[23]

[20] See, for example, section 1110.3 of NAFTA
[21] See, for example, section 4.2 Netherlands–Senegal BIT
[22] See, for example, United Kingdom–Swaziland BIT, section 5.1. Author's translation.
[23] Translation of the author.

4. The Obligation to Pay Interest

Observation

The provisions of several BITs clearly indicate that compensation for expropriation "shall include the payment of interest at a normal commercial rate until the date of payment."[24] The due date of compensation is also the date on which interest begins to accrue.

The payment of interest in cases of expropriation is recognized by the tribunals as customary international law,[25] even though some national laws prohibit interest for religious reasons. While it is commonly accepted that interest is an integral part of compensation, the method of calculating this interest is still subject to debate. Indeed, BITs do not always give useful guidance to the tribunals, thus leading to multifaceted and unpredictable methods of calculation. At best, BITs require the application of "normal commercial rates" until the date of payment of compensation.[26] BITs generally do not specify the type of interest applicable (simple or compound), the annual rate of interest (fixed rate applicable to the host country's sovereign debt or market rates) and, where relevant, the reference period for conversion into foreign currency.

In practice, three main methods for calculating interest rates are applied by the tribunals. One method commonly used by tribunals is that of the rate corresponding to the cost of the investor's loss of opportunity. This method reflects the idea that expropriation without prompt compensation has deprived investors of the opportunity of profitably reinvesting their resources. In this case, the rate is calculated on the basis of what a hypothetical reinvestment of the principal compensation would have brought. Another method is to use a rate at the cost that the investor would have had to pay to raise additional funds, usually by borrowing, to cover the lack of compensation by the state. Finally, an approach that is common to the tribunals is to determine the interest rate based on a market-based index, such as the London Interbank Offered Rate (LIBOR). Several tribunals have held that the payment of compound interest is now the international standard applicable and is justified to grant full compensation for the harm suffered.[27]

Problem

The obligation to pay interest from the due date of compensation and the absence of any indication of the type of interest raises problems at two levels. On the one hand, a long period of time may pass between the date of expropriation or of contesting the payment of compensation and the date of actual payment of the compensation due. If payment is made after arbitration proceedings, it may even be several years before the award is made or before the State would be in a position to pay the amount awarded. This is even more difficult when it comes to indirect expropriation arising from a general measure that the host State did not in good faith believe constituted indirect expropriation. In this particular case, a question may arise as to whether it is appropriate to fix the date of adoption of the measure as the key date from which the State should pay interest or if another date is more appropriate.

On the other hand, the type of interest chosen, the rate applicable, and the foreign currency conversion rates are crucial issues. When the delay is spread over several years and compound interest is applied at a high rate, the

[24] See, for example, United Kingdom–Swaziland BIT, section 5.1; Tanzania–Netherlands BIT, section 6.
[25] See section 38 of the ILC draft articles on the International Responsibility of States for Internationally Wrongful Acts.
[26] See, for example, Comoros–Mauritius BIT, section 7.1
[27] See Middle East Cement v. Egypt (ARB/99/6), Ruling of 12 April 2002, § 174-175."

amount of interest may exceed the principal.[28] For example, for a sum of 100 Euros with the principal due in 15 years, with the addition of interest at 6 per cent, the amount payable is 190 Euros in the case of simple interest and 239.65 Euros for annually capitalized compound interest.[29] It should be noted that several countries do not specify the type of interest applicable in their BITs, while prohibiting or strictly delimiting the capitalization of interest in their domestic legislation.[30] Section 38.1 of the ILC Draft Articles on State Responsibility does not make compound interest mandatory, but states that it is appropriate "to the extent necessary to ensure full reparation." But does interest necessarily have to be compounded for compensation to be complete? And regardless of circumstances of the case? In addition, for an act of direct expropriation with a value of 100 Euros in 2008, to be paid in U.S. dollars in 2010, the tribunal may decide to calculate interest on the 100 Euros before converting them into dollars, or to convert the 100 Euros directly into dollars before calculating the interest rate. The result will be different in each case and will also fluctuate depending on the exchange rate chosen between the date of expropriation and the arbitration award. Through being generally silent on the type of interest applicable, BITs allow each arbitral tribunal the latitude to choose the rule that seems best to them. To address this uncertainty, States could use more precise language in their treaties and require, for example the use of simple interest. This is the case in section 6.3 of the SADC Model BIT which provides that "(...) payment shall include simple interest [LIBOR] [current commercial rate in the host State] from the date of expropriation until the date of effective payment . . . ."

B. The Legal Standards for Assessing Compensation

The assessment of compensation by the host State (or, failing this, by an arbitral tribunal) must be according to specific rules. This is what is termed the standards of compensation.

1. The Extent of Compensation

a. The Classic Provisions in BITs

The first question that arises in any assessment of compensation is that of its scope. Should the injured investor be compensated for the full extent or for a portion of the harm suffered? It is vital to answer this question before determining the total or partial value of the investment expropriated.

A significant number of BITs adopt the standard of "prompt, adequate and effective" compensation. This is the so-called Hull formula,[31] which was first claimed by the United States in 1917. "Prompt, adequate and effective" compensation means that the investor should be granted, as soon as the investment is made (prompt), an amount equal to the total value of its expropriated investment (adequate) in a freely transferable and exchangeable currency (effective). For some, the Hull formula refers to full compensation; that is to say, full compensation for losses suffered and lost profits. Typically, BITs adopting this standard do not make a distinction between lawful and unlawful expropriation.

[28] This was what happened, for example, in Wena Hotel v. Egypt (ARB/98/4), award of December 8, 2000, where the amount of interest amounted to US$11.43 million, exceeding the capital amount which was US$8.06 million. Similarly, in the Santa Elena v. Costa Rica award in 2000, the investor was awarded US$4.15 million in compensation and US$11.85 million in interest from the date of direct expropriation in 1978.
[29] Simple interest is calculated only on this capital, while compound interest consists of adding the interest generated to the capital at the end of each period to generate new interest. Interest is then said to be capitalized.
[30] This is the case with Egyptian law and Swiss law, which prohibit compound interest. Other legal systems prohibit compounding unless expressly agreed otherwise by the litigants (Germany), or strictly regulates the capitalization of interest (France). Anyway, as international law has prevailed over domestic law, it is up to states to precisely state their choice directly into the BIT.
[31] From the famous formula of U.S. Secretary of State Cornell Hull in his note of July 21, 1938 in response to the Mexican nationalizations of 1917.

However, this formula is rarely inserted into BITs as a stand-alone standard. In fact, a great number of BITs state as a standard, prompt, effective and adequate compensation of the expropriated investment equivalent to its fair market value. Accordingly, Section 6.1 and 6.2 of the United States - Uruguay BIT states in part:

> "1. Neither Party may expropriate or nationalize a covered investment (...), except (...) (c) against payment of prompt, adequate and effective compensation (...).
>
> 2. The compensation referred to in paragraph 1(c) shall: (...) (b) be equal to the fair market value of the expropriated investment (...)."

Some BITs only require that compensation for the expropriated investment be pegged "to the fair market value" of the investment. Thus, Section 1110.2 of the North American Free Trade Agreement (NAFTA) provides that: "compensation shall be equivalent to the fair market value of the expropriated investment (...)." Due to the frequent assimilation between the Hull formula and the fair market value formula, the majority of commentators believe that the two formulas are equivalent and that the terms "fair" and "adequate" refer to full compensation.

In general, the tribunals conclude that full compensation is always due in the event of expropriation, despite the diversity of terms used in BITs. For the tribunals, in the absence of express indications to the contrary, the terms "fair, prompt and adequate," "fair market value," "appropriate" and "fair" are interchangeable and refer to the same standard.

b. Towards the Integration of Other Factors?

It is possible to envisage compensation that would not cover the entire market value of the investment, especially in the case of indirect expropriation. Indeed, the assessment of compensation could take into account other financial and non-financial factors in order to achieve a result that strikes a balance between the interests of investors and those of the host State. In certain situations, compensation equal to the fair market value of the investment may be inappropriate or unjust. A balancing of factors therefore becomes necessary.

Thus the SADC Model BIT introduces a major innovation by requiring "fair and adequate" compensation. In doing so, the SADC Model BIT clarifies that this means taking into account all relevant circumstances when calculating compensation. This rule therefore obliges arbitrators to go beyond fair market value and purely financial factors in general.

For example, one of the options proposed in Section 6.2[32] of the SADC Model BIT reads as follows:

> The assessment of fair and adequate compensation must be based on a fair balance between the public interest and the interests of the injured parties, taking into account all relevant circumstances, and taking into account the current and past use of the property, the history of its acquisition, the fair market value of the property, the purpose of the expropriation, the extent of past profits made by foreign investors through the investment, and duration of the investment.[33]

In this option, fair market value is only one factor to be considered among others. Thus, the tribunal may consider, for example, the fact that the expropriated investment has generated extraordinary profits in the past in order to set "fair and adequate" compensation below the current market value of the property. The SADC model provides only an

[32] The model proposes other options to states negotiating BITs. One of them consists of positing a presumption in favour of fair market value as a means of assessment, provided that the court considers it appropriate in the case in hand to use other complementary factors.
[33] Translation of the author.

indicative list and the tribunals retain the discretion to consider weighting other factors such as earlier misconduct on the part of investors, costs associated with damage to the environment (funds needed for site remediation or cleaning up hazardous waste dumped on site), and the depletion of natural resources.

But we will have to wait for treaties based on this model to be signed and for the subsequent practice of the arbitral tribunals to find out the practical implications of such a clause on the amount of compensation due as a result of expropriation.

2. The Reference Date for Assessing the Value of the Investment

Observation

In accordance with the due date for compensation provided in the BITs, the value of compensation should be calculated in the period prior to or no later than the date of expropriation. Thus, section 6.1 of the Canada–Lebanon BIT states that the value of the investment must be based: "on the fair market value of the investment or expropriated revenues immediately before the expropriation or as soon as it became public knowledge, whichever is the earlier." In addition, the majority of BITs state that the calculation of compensation "shall not reflect any change in value occurring because the intended expropriation had become known".[34] The reference date is critical for two reasons. On the one hand, the value of the investment can vary over time, especially when the tribunal takes market value and market fluctuations into account. On the other hand, the amount of interest can vary substantially depending on the selected reference date.

Problem

It can be tricky to determine this date in two situations. The first is where the arbitration award was made several years after the adoption of the expropriation measure. Similarly, if the value of the investment fluctuated over time, the date chosen as the expropriation date becomes crucial because it will determine the maximum or minimum value of the investment to compensate. Thus recently, a tribunal ruled that it was appropriate in the case of wrongful expropriation to choose any date between the date of formal expropriation and the date of the award that allowed the investor to obtain compensation corresponding to "the optimal use" of the Property. Thus, in *Marion and Reinhhard Unglaube v. Costa Rica*, about the wrongful direct expropriation of a plot of land some years after placing this plot in an environmentally protected area, the tribunal held that the market value of the land could be assessed at a date subsequent to the date of the direct expropriation.[35] The second situation is where an investment is injured by an accumulation of state actions over time. This is called gradual expropriation, also called "creeping" expropriation to highlight the bad faith of the host state.[36] Gradual indirect expropriation poses a major issue of determining the moment of expropriation. In substance, it is necessary to distinguish which, among a series of successive measures, was the decisive one. In other words, "the last step in creeping expropriation that tilts the balance is like the straw that broke the camel's back."[37] The identification of the critical act can be tricky and tribunal analyse each situation on a case by case basis.

[34] See, for example, section 1110 (2) of the NAFTA.
[35] Marion Unglaube et Reinhard Unglaube v. Costa Rica (ARB/08/1 et ARB/09/20), judgement of May 16, 2012, §§309 and 315–316.
[36] Progressive 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 culminate in the expropriatory taking of such property". Generation Ukraine Inc. v. Ukraine (ARB/00/9), Award of September 16, 2003, ILM, Vol. 44, 2005, pp. 404 et seq., § 20.22.
[37] Siemens AG v. Republic of Argentina (ARB/02/8), Award of February 6, 2007, § 263.

3. The Absence of a Method for Assessing the Value of the Investment

Observation

Almost no BITs provide any guidance on methods of assessment of the injury.

Problem

This deficiency is regrettable, because the amounts involved may vary from one extreme to another, depending on the calculation method used. States party to a BIT are thus leaving a margin for manoeuvre to arbitrators and especially to accountancy firms, who use varied and unpredictable formulas from case to case.

III. The Assessment by the Tribunals of the Value of the Investment Expropriated

If the principles guiding the determination of the scope and the due date of compensation for expropriation generally lack clarity in BITs, guidance on practical methods for calculating this compensation can be said to be nonexistent. Indeed, how does one calculate full compensation or the market value of an investment? It has fallen to the tribunals to determine the calculation methods applicable to each case in hand.

Although some methods of calculation can be isolated and analyzed, it should be noted that the common practice of the tribunals is to apply a combination of methods to varying degrees. In many cases, the tribunals' decisions fail to state why one calculation method was preferred over another. In any case, calculation of compensation and particularly of lost profits is generally left to accounting firms. However, at this level, as ironically noted by one author, experts appointed by the parties "while arriving at wildly disparate results, still ensure that the factors they use accurately anticipate future events. These calculations contain so many elements of conjecture that they appear to the uninitiated to accounting science barely less speculative and just as obscure as the prophecies of Nostradamus"[38].

There are three categories of method of evaluation. The first encompasses methods that focus exclusively on the market (market value). The second encompasses methods based on assets (adjusted book value, net book value, liquidation value), and the third brings together methods based on revenue (discounted cash flow, capitalized cash flow, adjusted present value). Three methods of the most commonly used methods are discussed below.

A. The Market Value Method

The market value method literally consists of finding the value of the investment under the laws of the market. Thus, as stated by the tribunal in the CMS v. Argentina award, this is the price "at which the property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[39] This method presupposes that there is a real market where such transactions can be carried out. A reference transaction is therefore needed to determine the amounts that market participants are willing to spend to acquire an investment operating in the same industry and subject to the same economic variables. Finally, it has to be possible to determine a reference date, given that markets are inherently changeable, or even volatile, in the case of stock markets. Thus, the choice of a comparable market transaction and comparison period is crucial. This method is very often adopted by the tribunals when the investment has shown proven profitability.

This method has advantages that make it attractive in principle, but that do not compensate for its many disadvantages. Regarding its advantages, part of the literature and some tribunals believe it to be the only method of providing genuinely full compensation. They believe that an investment such as a business is not only the sum of assets owned. It is not a static asset, but an activity that generates income, and this potential is an integral part of its value. Thus, when economic activity is compromised, the investor not only loses what it has invested up to the date of expropriation, but also and above all, the profits it will no longer receive.

[38] Siedl-Hohenveldern (1987). "L'Évaluation des dommages dans les Arbitrages Transnationaux" ["The Assessment of Damages in Transnational Arbitration"]," in Annuaire français de droit international, Vol. 32.
[39] See CMS Gas Transmission Company v.. Argentina (ARB/01/8), Award of May 12, 2005, § 402. Author's Translation.

Its disadvantages, however, are not insignificant. First, this method entails a significant risk of speculation and manipulation, since it is based primarily, if not exclusively, on prospective profits. Second, it fails to address what happens when there is no national competitive "market" available—because the investor had a monopoly, for example, or if there is no similar international market, due to the fact that the economic context in other countries is very different. In this scenario, how can one make the adjustments needed to reflect the economic and socio-political context that can greatly influence the market value of an investment? Finally, how can realistic forecasts be made in markets that are not always rational? Because of all these unknowns in the equation, the market value method entails a significant risk of over-compensating investors.

B. The Net Book Value Method

The net book value of an asset is defined as its gross value less amount for depreciation and/or provisions. In practice, the net book value method consists in this case of evaluating the static value (in principle the minimum) of the total assets of an investment at a given date. It takes account only of the past and not of expectations of future earnings.

This method is generally adopted by the tribunals for investments that have not proven their profitability in the past, either because operations were never able to start due to the actions of the host State or because it was in deficit. Indeed, tribunals appear to be reluctant to compensate lost profits in these cases.[40] In customary international law, this method and its variants are used by those tribunals that follow the interpretation that under customary international law, only the *damnum emergens* (losses) should be compensated in cases of lawful expropriation.

This method has several advantages. It is more objective because it is based on historical earnings. As a corollary, it also decreases the risk of manipulation because it involves few or no future elements. This method is criticized, however, for ignoring the dynamic aspect of the investment, that is to say, its ability to generate profits. Thus, it can lead to compensation below the total value of the investment on the market. However, this method remains relevant in some cases.

C. The Net Present Value of Discounted Future Cash Flow Method

This is the net present value calculated by weighing the cash flow. This method consists of estimating future cash flows and then applying a "discount rate" that reflects the cost of capital and risks (e.g., a rate that incorporates a risk adjusted to take account of the industry, the performance of the enterprise, the country) for estimated future revenue flows to identify the current value. This, then, is a particularly complex method that tries to anticipate likely increases and decreases in the market value of an investment over a longer or shorter future period to determine its "average" value. This method has been widely used by the tribunals for more than three decades for performing assets, despite many criticisms.[41]

The success of net present value of discounted future cash flow method is due to its perceived benefits. It is said to be more objective, realistic and cautious than the market value method, because it combines several factors and weights the amount of compensation to account for future risks.

[40] See PSEG Global Inc. v. Republic of Turkey, Award, ICSID, ARB/02/5, Award of January 19, 2007, § 310.
[41] Thus, a tribunal declared in 1987 that "one of the most established rules in the law of the international responsibility of states is that no reparation for speculative or uncertain damage can be awarded." Amoco International Finance Corp. v. Iran, Partial Award of July 14, 1987, Iran–US CTR, (1987), § 238.

In practice, however, this method is not without serious drawbacks. The choice of factors for discounting the value and the weight given to one factor compared to another is crucial. This method can easily lead to very different results depending on the experts involved. For example, it suffices to maintain a high initial future growth rate to multiply the present value of the investment. On the other hand, by taking into account a frequent reduction in the future growth rate or a possible and often probable decrease from factors such as competition from new investors, increased taxes, or a change in regulations, this value can be reduced. As two authors have noted, "there is no reliable way of predicting such events several years down the line as we are unable to even predict the stock market of tomorrow."[42] Ultimately, although almost every tribunal has said that "speculative elements" are weighed with this method,[43] it remains an inherently speculative method "dressed up in the appearance of a mathematical equation."[44]

[42] T.W. Wälde & B. Sabahi (2007, November). "Compensation, Damages and Valuation in International Investment Law." *Transnational Dispute Management*, Vol. 4(6). Available at www.transnational-dispute-management.com/article.asp?key=1165.
[43] See, for example; Metalclad Corp. v. United Mexican States (ARB(AF)/97/1), Award of August 30, 2000, § 122; Wena Hotels Limited v. Arab Republic of Egypt (ARB/98/4), Award of December 8, 2000. §123-124.
[44] T.W. Wälde, B. Sabahi, op. cit., p. 19.

IV. Conclusion and Recommendations

It should be noted that regarding expropriation, the most important recommendation for signatory States to BITs is to define more clearly what can be qualified as indirect expropriation when certain types of legitimate laws and regulations are at issue. After all, whatever standard and method of calculation are adopted, compensation is always due for indirect expropriation. It is, therefore, simpler and far more effective to challenge the existence of an act of indirect expropriation under a BIT rather than to seek to balance the amount of compensation due.

At the same time, and in addition, States are strongly recommended to be more precise when drafting clauses related to compensation for expropriation in order to address certain current problems. While it is impossible to find a magic formula good enough to apply to all situations, it is possible to guide the tribunals that will have to assess the compensation payable for expropriation. This clarification of standards for calculating compensation is particularly necessary in the case of indirect expropriation, because its evaluation can be very complex.

Thus, indemnification provisions could particularly, but not exclusively:

- Specify by distinguishing between the standards for the assessment of compensation for lawful and wrongful expropriation. The use of customary international law may be helpful in this regard, but only on condition of settling within the BIT any differences that remain.
- Clearly indicate the date upon which interest begins to accrue, depending on the type of expropriation, the applicable interest rate or a specific reference, the capitalization or not of interest and, if relevant, the frequency of this capitalization.
- Introduce reasonable, embedded flexibility in the timing of payments in certain circumstances.
- Require, regardless of the valuation method adopted in the BIT, the taking into account of all relevant factors, not purely financial ones, that may lead to a balanced assessment of the amount of compensation. An indicative list of these factors is also recommended.

On these last two points, Section 6 of the SADC Model BIT can serve as a reference text.[45]

[45] See previous comments in paragraphs II.A.3 and II.B.1.b respectively.

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