Principles of International Investment Law

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VI

Expropriation

The rules of international law governing the expropriation of alien property have long been of central concern to foreigners in general and to foreign investors in particular. Expropriation is the most severe form of interference with property. All expectations of the investor are destroyed in case the investment is taken without adequate compensation.

On the level of customary international law, the minimum standard for the protection of aliens came to place limitations on the territorial sovereignty of the host state and to protect alien property. On the level of treaty law, all modern agreements on foreign investment contain specific provisions covering preconditions for and consequences of expropriation.

1. The Right to Expropriate

Consistent with the notion of territorial sovereignty, the classical rules of international law have accepted the host state's right to expropriate alien property in principle. Indeed, state practice has considered this right to be so fundamental that even modern investment treaties (often entitled agreements 'for the promotion and protection of foreign investment') respect this position. Treaty law typically addresses only the conditions and consequences of an expropriation, leaving the right to expropriate as such unaffected.[1]

Even clauses in agreements between the host state and the investor that freeze the applicable law for the period of the agreement ('stabilization clauses')[2] will not necessarily stand in the way of a lawful expropriation. The position is less clear if such an agreement explicitly excludes the right to expropriate. Except in extreme circumstances, an international tribunal will probably interpret such a

[1] Some states (eg Ecuador, Peru) provide in their constitutions that their contractual agreements with foreign investors may not be changed by a unilateral act. But they have not gone as far as excluding the right to expropriate. Article 249 of the Constitution of Ecuador (1998) provides for all contracts relating to public services: 'The agreed contractual conditions cannot be modified unilaterally by law or other measures.' Article 62 of the 1993 Peruvian Constitution states: 'Through contract-laws, the State can establish guarantees and grant assurances. They may not be amended legislatively....'

[2] See above, p. 75.

clause in a literal manner. In practice, however, such far-reaching provisions have played no significant role.

2. The Three Branches of the Law

Beyond the right of the host state to expropriate, the international law on expropriation has developed three branches, which regulate the scope and conditions of the exercise of this power. The first one defines the interests that will be protected. This facet has not traditionally been in the forefront of academic and practical discussions but has received some prominence more recently. Most contemporary treaties, in their provisions dealing with expropriation refer to 'investments'. Similarly, the jurisdiction of arbitral tribunals is typically restricted to disputes arising from 'investments'. Therefore, it is 'investments', as defined in these treaties that are protected.[3]

The second branch concerns the definition of an expropriation. While this matter raises no questions in case of a formal expropriation, the issue may acquire a high degree of complexity when the host state interferes with the rights of the foreign owner without a formal taking of title. Indeed, in the practice of the past three decades, most cases relating to expropriation have turned on the controversy of whether or not a 'taking' had actually occurred. Matters of public health, the environment, or general changes in the regulatory system may prompt a state to regulate foreign investments. This has led to claims against the state on the basis that a regulatory taking or indirect expropriation has occurred. The elements of indirect expropriation are discussed below.[4]

The third branch of the law on expropriation relates to the conditions under which a state may expropriate alien property. The classical requirements for a lawful expropriation are a public purpose, non-discrimination as well as prompt, adequate, and effective compensation. In practice, the requirement of compensation has turned out to be the most controversial aspect. This issue is discussed in the next section.

3. The Legality of the Expropriation

It is today generally accepted that the legality of a measure of expropriation is conditioned on three (or four) requirements. These requirements are contained in

[3] For the concept of an investment, see above, p. 60. See also below, at p. 115.
[4] See p. 32.

most treaties. They are also seen to be part of customary international law. These requirements must be fulfilled cumulatively:

- The measure must serve a public purpose. Given the broad meaning of 'public purpose', it is not surprising that this requirement has rarely been questioned by the foreign investor. However, tribunals did address the significance of the term and its limits in some cases.[5]
- The measure must not be arbitrary and discriminatory within the generally accepted meaning of the terms.
- Some treaties explicitly require that the procedure of expropriation must follow principles of due process.[6] Due process is an expression of the minimum standard under customary international law and of the requirement of fair and equitable treatment. Therefore, it is not clear whether such a clause, in the context of the rule on expropriation, adds an independent requirement for the legality of the expropriation.
- The expropriatory measure must be accompanied by prompt, adequate, and effective compensation. Adequate compensation is generally understood today to be equivalent to the market value of the expropriated investment.

Of these requirements for the legality of an expropriation, the measure of compensation has been by far the most controversial one. In the period between roughly 1960 and 1990, the rules of customary law on compensation were at the centre of the debate on expropriation. They were discussed in the broader context of economic decolonization, the notion of 'Permanent Sovereignty over Natural Resources', and of the call for a new international economic order. Today, these fierce debates are over and nearly all expropriation cases before tribunals follow the treaty-based standard of compensation in accordance with the fair market value. In the terminology of the earlier decades this means 'full' or 'adequate' compensation. However, this does not mean that the amount of compensation is easy to determine. Especially in cases of foreign enterprises operating on the basis of complex contractual agreements, the task of valuation requires close cooperation of valuation experts and the legal profession.

Various methods may be employed to determine market value. The discounted cash flow method will often be a relevant yardstick, rather than book value or replacement value, in the case of a going concern that has already produced income. Before the point of reaching profitability, the value of the original investment with appropriate adjustments will be the more appropriate measure.[7]

A traditional issue that has never been resolved entirely concerns the consequences of an illegal expropriation. In the case of an indirect expropriation, illegality will be the rule, since there will be no compensation.

[5] See eg *ADC v Hungary*, Award, 2 October 2006, paras 429–433.
[6] See eg Article 6(1)(d) of the 2004 US Model BIT.
[7] See below, p. 274.

According to one school of thought, the measure of damages for an illegal expropriation is no different from compensation for a lawful taking. The better view is that an illegal expropriation will fall under the general rules of state responsibility, while this is not so in the case of a lawful expropriation accompanied by compensation. In case of an illegal act the damages should, as far as possible, restore the situation that would have existed had the illegal act not been committed. By contrast, compensation for a lawful expropriation should represent the market value at the time of the taking. The result of these two methods can be markedly different.[8] The difference will mainly concern the amount of lost profits. The issue of compensation and damages is discussed in more detail below in the chapter on the settlement of investment disputes.[9]

The requirement of 'prompt' compensation means 'without undue delay'.[10] The requirement of 'effective' compensation means that payment is to be made in a convertible currency.[11]

4. Direct and Indirect Expropriation

The difference between a direct or formal expropriation and an indirect expropriation turns on whether the legal title of the owner is affected by the measure in question. Today direct expropriations have become rare. States are reluctant to jeopardize their investment climate by taking the drastic and conspicuous step of an open taking of foreign property. An official act that takes the title of the foreign investor's property will attract negative publicity and is likely to do lasting damage to the state's reputation as a venue for foreign investments.

As a consequence, indirect expropriations have gained in importance. An indirect expropriation leaves the investor's title untouched but deprives him of the possibility to utilize the investment in a meaningful way. A typical feature of an indirect expropriation is that the state will deny the existence of an expropriation and will not contemplate the payment of compensation.

(a) Broad Formulae: Their Substance and Evolution

The contours of the definition of an indirect expropriation are not precisely drawn. An increasing number of arbitral cases and a growing body of literature

[8] See eg DW Bowett, 'State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach' (1988) 59 BYIL 47; PCIJ, Case Concerning the Factory at Chorzów (1928), Serie A, No. 17, 47. For a full discussion, see I Marboe, 'Compensation and Damages in International Law, The Limits of "Fair Market Value"' (2006) 7 *Journal of World Investment & Trade* 723.

[9] Below, at pp. 271–275.

[10] R Dolzer and M Stevens, *Bilateral Investment Treaties* (1995) 112.

[11] Ibid.

Similarly, the tribunal in *SD Myers v Canada*[120] held:

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

In *Methanex v USA*,[121] the arbitral tribunal found that a Californian ban of the gasoline additive MTBE did not constitute an expropriation because the measure was adopted for a public purpose, was not discriminatory, and because no specific commitments had been given to the foreign investor:

> In the Tribunal's view, Methanex is correct that an intentionally discriminatory regulation against a foreign investor fulfils a key requirement for establishing expropriation. But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.[122]

Similarly, in *Saluka v Czech Republic*,[123] the tribunal said:

> In the opinion of the Tribunal, the principle that a State does not commit an expropriation and is thus not liable to pay compensation to a dispossessed alien investor when it adopts general regulations that are 'commonly accepted as within the police power of States' forms part of customary international law today. There is ample case law in support of this proposition.[124]

The references to general regulations and to non-discrimination suggest that the tribunals were influenced by the concept of national treatment. But the rules on foreign investment are not based on the principle of national treatment. General regulatory rules and the measures based on them are subject to the same standards of protection that have been developed for all other instances. In the words of the decision of *Pope & Talbot v Canada*, 'a gaping loophole' would otherwise exist in the operation of the rules protecting foreigners.[125]

In *Santa Elena v Costa Rica*,[126] the tribunal found that the fact that measures were taken for the purpose of environmental protection did not affect their nature

[120] *S D Myers v Canada*, First Partial Award, 13 November 2000, 40 ILM (2001) 1408, para 281.

[121] *Methanex v USA*, Award, 3 August 2005, 44 ILM (2005) 1345.

[122] Ibid Part IV, Chapter D, p. 4, para 4.

[123] *Saluka v Czech Republic*, Partial Award, 17 March 2006.

[124] Ibid at para 262, citing *Methanex v USA*.

[125] *Pope & Talbot v Canada*, Interim Award, 26 June 2000, 122 ILR (2002) 316, para 99; see also *ADC v Hungary*, Award, 2 October 2006, at paras 423, 424.

[126] *Santa Elena v Costa Rica*, Award, 17 February 2000, 5 ICSID Reports 153.

actions were taken *bona fide* and hence could not have violated the FET standard? Arbitral practice clearly indicates that the FET standard may be violated, even if no *mala fides* is involved.[172] For instance, the tribunal in *Mondev*[173] said:

> To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.[174]

The tribunal in *Tecmed*,[175] after pointing out that fair and equitable treatment is an expression of the *bona fide* principle recognized in international law, quoted the above passage from *Mondev* to underline that 'bad faith from the State is not required for its violation'.[176]

The tribunal in *Loewen*[177] also emphasized that bad faith or malicious intention is not an essential element of a breach of the fair and equitable treatment standard:

> Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice.[178]

The Award in *Occidental*[179] expresses the same idea. In the context of transparency and consistency as part of the fair and equitable treatment standard the tribunal said: '... this is an objective requirement that does not depend on whether the Respondent has proceeded in good faith or not.'[180]

In *CMS Gas Transmission Company v Argentina*,[181] the tribunal, after finding that FET was inseparable from stability and predictability, stated:

> The Tribunal believes this is an objective requirement unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.[182]

[172] The only contrary indication would be a dictum in *Genin v Estonia*, Award, 25 June 2001, 17 ICSID Review-FILJ (2002) 395, at para 371: '[A]ny procedural irregularity that may have been present would have to amount to bad faith, a willful disregard of due process of law or an extreme insufficiency of action.' However, this passage does not relate to fair and equitable treatment but to the standard of arbitrary and discriminatory measures in Article II (3)(b) of the Estonia–United States BIT.

[173] *Mondev v USA*, Award, 11 October 2002, 42 ILM (2003) 85.

[174] Ibid at para 116.

[175] *TECMED v Mexico*, Award, 29 May 2003, 43 ILM (2004) 133.

[176] Ibid at para 153.

[177] *Loewen v USA*, Award, 26 June 2003, 42 ILM (2003) 811.

[178] Ibid at para 132. See also *Azurix v Argentina*, Award, 14 July 2006, paras 369, 372.

[179] *Occidental v Ecuador*, Award, 1 July 2004, 12 ICSID Reports 59.

[180] Ibid at para 186.

[181] *CMS v Argentina*, Award, 12 May 2005, 44 ILM (2005) 1205.

[182] Ibid at para 280.