Protecting Foreign Investments by Using Bi-Lateral Investment Treaties

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I Introduction

Bilateral investment treaties (BITs) provide protection to foreign investors who are nationals of the States which are party to the BIT. The nature of protection provided pursuant to a BIT between Country A and Country B is such that if an investor from Country A makes an investment in Country B, Country B guarantees, pursuant to the BIT, certain levels of protection. The wording of these treaties is largely in a standard form, although there are subtle and important differences between treaties. The very general language adopted by these treaties can give rise to significant interpretation difficulties when trying to establish the limits of the protection provided.

In particular, BITs often provide protection against expropriation without compensation. Direct and indirect expropriation is usually prohibited, except in certain defined circumstances including where compensation is paid to the investor that owns the investment which is being expropriated. Other protections are also provided, which are generally directed to conduct by a State which is discriminatory against the investment (for example, a failure to provide fair and equitable treatment in respect of the investment).

The purpose of this article is to explore the prohibition against indirect expropriation found in most bilateral investment treaties. Indirect expropriation is often alleged to occur when a State's regulation of a particular industry reduces or eliminates the economic viability of the investment the subject of regulation.

In the Australian environment, three examples of recent potential claims of indirect expropriation come to mind.

First, in November 2009 it was reported that TRU Energy's parent company, CLP Group (formerly China Light and Power) considered that it would have a claim against the Australian government under the Australia-Hong Kong bilateral investment treaty if the government's proposed emissions trading scheme was enacted. It was alleged the scheme would severely reduce the value of its assets (such as the brown coal-fired Yallourn power station in Victoria),[1] and was tantamount to expropriation.

Secondly, in May 2010, it was suggested that the Australian Government's proposed resources rent tax had investment treaty implications and, if enacted, may give rise to claims for compensation as the effect of such legislation was tantamount to expropriation.[2]

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[1] Lenore Taylor, 'Generators threaten ETS legal action', *The Australian* (Sydney), 22 November 2009, (Local) 1.

[2] Chris Merritt, 'Impost may breach international treaties - Resources Turmoil', *The Australian* (Sydney), 26 May 2010, (Local) 6.

Thirdly, tobacco giant Philip Morris International Inc has suggested that Australia's proposed legislation to mandate plain packaging of cigarettes[3] imposes "restrictions tantamount to expropriation" on "extremely valuable intellectual property rights" which "threaten to violate existing bilateral and multilateral agreements with the U.S.".[4]

These claims have not been tested as none of the legislation in question has been enacted, yet. Time will tell whether such claims will be pursued. However, the fact that such claims can be seriously mooted is significant and is evidence of an increasing understanding in the international business community that BITs are a useful tool which can be utilised to protect foreign investments.

This article looks first at international investment treaties generally and discusses the concepts of "investment" and "investor" and the nature of the substantive protections provided to foreign investors by these treaties. The article then goes on to consider the limits of the protection against indirect expropriation and offers a third way of examining these limits.

II International Investment Agreements

A *What are investment treaties?*

A bilateral investment treaty is a binding agreement between two states in which each assumes obligations with respect to investments made in its country by the other's investors. These obligations are directly enforceable by the investors by way of international arbitration often before the International Centre for Settlement of Investment Disputes or a tribunal established under the Arbitration Rules of the United Nations Commission on International Trade Law. Investor-State arbitration, as opposed to state-state arbitration or indeed litigation, has the advantage of non-politicised dispute resolution, where the investor has greater control over pursuit of the claim.

A multi-lateral investment treaty is an agreement between three or more states to a similar effect. A Free Trade Agreement usually contains provisions which provide similar investment protections contained in bilateral and multi-lateral investment treaties.

The first bilateral investment treaty was agreed in 1959 between Pakistan and Germany. Now, there are approximately 3000 BITs currently in force worldwide. This number is likely to increase in 2011 and beyond. In particular, the number of BITs with China and India is expected to grow to provide an appropriate international legal framework for investments to and from these countries.

To date, Australia has entered into 22 bilateral investment treaties. These are set out in the table below. The first was entered into force with China in 1988 and the most recent with Turkey, in June 2009.

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[3] *Plain Tobacco Packaging (Removing Branding from Cigarette Packs) Bill 2009.*

[4] Submission of Philip Morris International in Response to the Request for Comments Concerning the Proposed Trans-pacific Partnership Trade Agreement. Similar comments were made in respect of Singapore's proposed amendments to its *Smoking (Control of Advertisements & Sale of Tobacco) Act*.

Argentina	Chile
China	Czech Republic
Egypt	Hong Kong
Hungary	India
Indonesia	Laos
Lithuania	Mexico
Pakistan	Papua New Guinea
Peru	Philippines
Poland	Romania
Sri Lanka	Turkey
Uruguay	Vietnam

Australia has entered into the ASEAN-Australia-New Zealand Free Trade Agreement[5] and has entered into bilateral Free Trade Agreements with the following countries:

Chile	New Zealand
Singapore	Thailand
United States[6]	

Australia has also signed but not yet ratified the Energy Charter Treaty. This treaty, signed by 52 countries with a further 24 'observer' countries, provides for arbitration of energy investment disputes between investors and Contracting States. Further, Australia is currently considering or negotiating individual free trade agreements with China, Korea, Malaysia, Japan, Indonesia and the Gulf Cooperation Council,[7] and a Trans-Pacific-Partnership Agreement[8].[9]

B *What qualifies as an Investment?*

The protections offered by international investment treaties are limited to "investors" and their "investments". Almost all investment treaties contain a definition of the nature of the investment and it is important to look at the terms of the treaty in question. Generally, "investment" includes movable and immovable property, shares and other interests in companies, claims to performance under a contract having an economic value, and intellectual property rights.

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[5] The 10 ASEAN members comprise Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam.

[6] The Australia-United States FTA provides, in the place of investor-state arbitration, for a dispute settlement panel.

[7] The Gulf Cooperation Council comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

[8] In addition to Australia, the Trans-Pacific-Partnership parties are Brunei, Chile, New Zealand, Singapore, Peru, the United States, Vietnam and Malaysia.

[9] Free Trade Agreements Homepage, Department of Foreign Affairs and Trade website <www.dfat.gov.au/trade/ftas.html>.

"Investment" has been held to encompass the control and management of bauxite mining facilities (*Kaiser Bauxite Co. v Jamaica* ICSID Case No. ARB/74/3), promissory notes issued by Venezuela (*Fedax N.V. v Venezuela* ICSID Case No. ARB/96/3), a joint-venture agreement to develop farmland (*Tradex Hellas S.A. v Albania* ICSID Case No. ARB/94/2) and a concession agreement to explore for oil and gas (*Deutsche Schachtbau- und Tiefbohrgesellschaft mbH (FR Germ.) v State of R'as Al Khaimah (UAE)* ICC Case No. 3572 of 1982).

The investment need not be fully owned by the investor to qualify as an "investment". For example, in *CMS v Argentine Republic* (ICSID Case No ARB/01/8), a minority shareholding in a company was found to constitute an "investment".

The investment must be "in accordance with law".[10]

C *Who qualifies as an investor?*

Only a "national" of one of the two contracting states may bring a claim under the investment treaty. Whether a claimant, either a natural or a legal person, is a national of a contracting state will be determined by the laws of the contracting state and any particular requirements of the relevant treaty. For example, the Australia-Argentina BIT defines an Australian investor as a natural person who is a citizen or permanent resident of Australia, or a company. In turn, a company is defined quite broadly as an incorporated entity under the law of Australia, or under the law of a third country but which is owned or controlled, directly or indirectly, by an Australian-incorporated company or a citizen or permanent resident of Australia.

An issue arises where, for example, an Australian "investor" chooses to invest in a country, say Bolivia, with whom Australia does not have a bilateral investment treaty. Accordingly, without more, the investment would not be afforded the protections provided by international investment treaties (discussed below). The investor has two options. It can draft certain safeguards into its contract with the relevant State prior to making the investment (and take out appropriate risk insurance) or it can structure its investment in order to take advantage of an investment treaty Bolivia has entered into with another country (for example, Argentina). To do so, the Australian investor could incorporate a vehicle in Argentina and then use that vehicle to invest in Bolivia.

Similar structuring used by Mobil (to take advantage of the Netherlands-Venezuela BIT) was held to be legitimate in *Mobil Corporation et al v Bolivarian Republic of Venezuela*.[11] In that case, Mobil (a US incorporated company) entered into an agreement for the production of extra-heavy crude oil in Venezuela. It also entered into another agreement for the exploration of oil (also in Venezuela). Venezuela subsequently began reforming the petroleum industry and introduced, inter alia, increased royalties and extraction taxes. At around the same time as the laws were being introduced, Mobil engaged in corporate restructuring and incorporated a Dutch holding company to own the companies that had invested in Venezuela. Venezuela later nationalised oil and gas projects (including those entered into

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[10] *Fraport AG Frankfurt Airport Services Worldwide v Republic of the Philippines* ICSID Case No. ARB/03/25.

[11] ICSID Case No ARB/07/27. See also *Aguas del Tunari S.A. v Republic of Bolivia* ICSID Case No. ARB/02/03, Award at [332].

by Mobil). The tribunal found that Mobil, through the Dutch holding company, was a Dutch investor and entitled to protection and to bring a claim under the Netherlands-Venezuela BIT.

Returning to the previous example, the advantage of using Argentina rather than, say, Paraguay (which has also entered into a BIT with Bolivia) is that Australia has a BIT with Argentina and not Paraguay. This means that the Australian investor's operations in Argentina are protected under the Argentina-Australia BIT. It must be noted, however, that the investment vehicle used in the third country (Argentina in the present example) must itself satisfy the "investment" and "investor" requirements under the Argentina-Bolivia treaty.

If an investor wishes to seek protection by clothing itself with a nationality, other than its own nationality, through a subsidiary, care needs to be taken to ensure that there is nothing in the particular BIT which will prevent it from so doing. In some BITs, protection is restricted, so that mere incorporation of the investor in a State which is a party to a BIT is not sufficient. Common further requirements, in addition to incorporation in the relevant State, include that:

(a) the main seat of business (the central place of administration) of the investor is located within a State whose nationality it seeks to claim; or

(b) the investor has a substantial economic bond with the State whose nationality it claims.

These additional requirements are obviously designed to prevent treaty shopping.

However, in most cases incorporation is sufficient to attract the required protection. For example, out of 22 BITs to which Australia is a signatory, only two[12] require more than incorporation.

Finally, the tax regime in the third country must be considered in determining the viability of using an investment vehicle. Tax considerations and other strategic issues involved in structuring investments are not dealt with in this paper.

D *How does an investment treaty protect investors?*

The substantive investment protections offered by bilateral investment treaties are largely the same. However, there can be subtle changes in the wording, so it is important to always return to the words of the particular investment treaty in question.[13]

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[12] Australia-Mexico BIT and Australia-Philippines BIT.

[13] The terms of a treaty shall be construed in accordance with their ordinary meaning: Vienna Convention on the Law of Treaties, Article 31(1).

(1) Fair and equitable treatment

Many investment treaties allow foreign investors to challenge the actions of the host State on the basis that the investor was not accorded fair and equitable treatment. Fair and equitable treatment has been interpreted to include the requirement of a stable and predictable legal framework, and to require the host State to act and make decisions consistently and transparently, and in accordance with the legitimate expectations of the investor.[14]

(2) National treatment standard

This protection requires the host State to treat foreign investments no less favourably than those investments made by nationals of the host State. This protection guards against discriminatory regulation such as special taxes or licensing requirements levied only on foreign investors. For example, in *Marvin Feldman v Mexico*,[15] Mr Feldman, a US citizen, filed a claim against Mexico on behalf of 'CEMSA', a foreign trading company exporting cigarettes from Mexico. CEMSA was denied tax refunds available to Mexican exporters (pursuant to a Mexican Supreme Court decision). The tribunal found that Mexico was in violation of the national treatment standard under NAFTA.

(3) Most favoured nation standard

This protection requires the host State to treat foreign investments no less favourably than investments from any other third state. For example, if the investors of a third state are allowed an exemption from a tax in, say, a particular Indonesian industry, Australian investors would be entitled to ask for the same treatment under the Australian-Indonesian BIT. In *Bayindir Insaat Turizm Ticaret Ve Sanayi AS v Islamic Republic of Pakistan*,[16] a Turkish investor was able to rely on an MFN clause in the Turkey-Pakistan BIT to benefit from the fair and equitable treatment provision in the Pakistan-Switzerland BIT. An equivalent provision was omitted in the Turkey-Pakistan BIT (and would therefore have been an inaccessible substantive protection but for the MFN clause).

Whether the MFN clause can be relied on to enable an investor to obtain a procedural benefit, such as the right of arbitration contained in another investment treaty, is not clear. This issue is relevant for Australian investors. The Australia-China BIT does not provide investors with a direct right to arbitration other than for the sole purpose of determining the amount of compensation payable for an expropriation (the existence of which has to be determined by the courts of the host State). China's more recent investment treaties however, provide a broader right to arbitration than the Australia-China BIT. The treaties with The Netherlands and Germany allow investors recourse to arbitration for all substantive rights. This raises the prospect of a possible MFN argument by an Australian investor.

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[14] See for example, *Tecnicas Medioambientales Tecmed S.A. v The Untied Mexican States*, Case No. ARB(AF)/00/2, Award 29 May 2003..

[15] Case No. ARB (AF)/99/1.

[16] ICSID Case No. ARB/ 03/29.

In *Maffezini v Spain*,[17] the tribunal found that if a third party treaty contained dispute settlement provisions more favourable to the protection of the investor's rights and interests than those found in the Argentina-Spain treaty, such provisions could be extended to the beneficiary of the MFN clause. The tribunals in *Gas Natural SDG SA v Argentina*[18] and *Siemens AG v Argentine Republic*[19] agreed with the reasoning and conclusion in *Maffezini v Spain*. In *Siemens AG v Argentine Republic*, Siemens AG relied on the MFN clause in the Germany-Argentina BIT and the dispute resolution provision in the BIT between Chile and Argentina to avoid submitting its dispute to local courts in the host country.

More recently, the tribunal in *Tza Yap Shum v Republic of Peru*,[20] interpreted the MFN clause in question narrowly, deciding that the protection does not extend to procedural rights.

Although it is submitted that dispute settlement arrangements are inextricably related to the protection of foreign investments and should be caught by the MFN standard, ultimately, it comes down to the language of the MFN clause in question. A means of clarifying the potential scope of MFN clauses is the use of clearer wording in international investment treaties. The Australia-Chile FTA, for example, expressly bars the MFN protection from applying to dispute settlement procedures.

(4) Free transfer of funds relating to investments

Many treaties oblige the host State to "permit all transfers related to an investment to be made freely and without delay into and out of its territory". This protects the investor's right to repatriate earnings, profits and capital back to its home State.

(5) Protection against expropriation

Investment treaties generally restrict a State's right to expropriate foreign investments except on a legal, non-discriminatory basis, for a public purpose and with adequate compensation. This protection is discussed in more detail in the following section.

III Protection against expropriation

A *What is an expropriation?*

An example of the common prohibition against expropriation is found in the BIT between Australia and Indonesia. That BIT provides as follows:

> "A Party shall not nationalise, expropriate or subject to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as "expropriation") the investments of investors of the other Party unless the following conditions are complied with:

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[17] ICSID Case No. ARB/97/7, Decision on Jurisdiction of January 25, 2000.

[18] ICSID Case No. ARB/03/10. The Decision of the Tribunal on Preliminary Questions on Jurisdiction of June 17, 2005 can be found at: http://www.asil.org/pdfs/GasNat.v.Argentina.pdf .

[19] ICSID Case No. ARB/02/8, Decision on Jurisdiction of August 3, 2004.

[20] ICSID Case No. ARB/07/6.

(a) the expropriation is for a public purpose related to the internal needs of the Party and under due process of law;

(b) the expropriation is non-discriminatory; and

(c) the expropriation is accompanied by the payment of prompt, adequate and effective compensation".

The definition of expropriation is wide. It encompasses both "direct" and "indirect" nationalisation or expropriation as a consequence of the provision extending to "measures having effect equivalent to nationalisation or expropriation". Cases involving a direct expropriation or nationalisation are not usually controversial. However, the extent of a "measure" which can give rise to an effect which is equivalent to expropriation or nationalisation is. This is so because there are a numerous State measures that can potentially substantially deprive an investor of the value of its investment. For example, a State may choose to ban all forms of gambling. Such a ban may not be discriminatory, as it affects foreign and domestic investors alike. While investors retain the assets used in the business, the business (gambling) has been lost. Many other examples of State regulation can be considered where a change in State law may destroy substantially or wholly the investment. Are all such measures equivalent to expropriation? If so, is an investor entitled to compensation? If no, where is the line to be drawn between a measure which must be the subject of compensation and a measure which need not?

In the case of an alleged indirect expropriation, the first issue which needs to be determined is whether the conduct in question constitutes a nationalisation or expropriation or has an effect equivalent to nationalisation or expropriation. To answer this question it is necessary to consider the meaning of the two principal expressions used in the standard BITs being, "nationalise" and "expropriate".

The Shorter English Oxford Dictionary defines "nationalise" in the following terms:

> "to bring under the control of, or to make the property of the nation".

"Expropriate" has a number of potentially relevant definitions. The Shorter English Oxford Dictionary includes the following:

> "**a.** to dispossess of ownership; to deprive of property. (now chiefly to deprive of property for the public use, generally with compensation); **b.** the action of depriving of property 1848, **c.** the action of taking (property) out of the owner's hands, esp. by public authority 1878".

In the context of a BIT, the meaning of the expression "nationalise" is straightforward. What is required is an act by the State which brings an investment under the control of, or makes the investment the property of, the State.

Given the definition of "expropriate", an act which nationalises an investment will fall within the ambit of that definition. This is so because nationalisation involves either an acquiring of the investment by the State or a transfer of control to the State of the investment. In either case, the act will dispossess or deprive the investor of the investment. However, the word "expropriate" has a wider meaning than the word "nationalise". As the definition set out in the Shorter Oxford English Dictionary demonstrates, the word "expropriate" extends to dispossession or deprivation of an investment **without** the State actually acquiring or controlling the investment.

Therefore, it is strongly arguable that the compound expression "nationalise, expropriate or subject to measures having effect equivalent to nationalisation or expropriation" extends to acts of the State which merely dispossess the investor of the investment even where such dispossession occurs without the State acquiring or controlling that investment.

Such an interpretation gives the prohibition against expropriation found in most BITs a very wide operation, unless somehow constrained by other principles.

It has been contended by Andrew Newcombe[21] that it is appropriate, when determining whether an expropriation has occurred, to consider whether there has been an acquisition by the State (or State agency). He contends that a State act which does not involve an acquisition should not be regarded as an expropriation.

If this argument is accepted, it would significantly narrow the operation of the provisions in relation to expropriation found commonly in BITs. As a matter of common sense, it might be thought that such a limitation on the concept of expropriation is necessary, because if a mere dispossession (without acquisition or a transfer of control) is all that is required, there is a risk that any regulation of business may be a measure which constitutes dispossession or deprivation of an investment entitling the investor to compensation.

For example, if a State sought to introduce a carbon trading scheme or a significant tax on the emission of carbon, such a tax may be sufficient to render older power stations burning (for example) brown coal no longer viable. That is, in a competitive electricity market the investors who own older power stations could not sell electricity at a price which would cover their costs (including the new tax). Accordingly, the value of the investment is lost overnight as a consequence of the change in law.

Is the investor entitled to compensation?

For the investor it will be argued that it is entitled to compensation, because the standard definition of expropriation has been satisfied. The measure (the carbon tax), while not a direct expropriation, is equivalent to expropriation because it deprives the investor of the value of the investment, it is non-discriminatory and it is for a public purpose (to reduce the amount of carbon in the atmosphere). Accordingly, compensation must be paid.

Foreign investors would no doubt argue that the purpose of a BIT is to provide an inducement for foreign investors to make investments in the host country, which would otherwise not be made. The State has accepted, as a price for that investment, that it will guarantee to the investors that any regulation which has the effect of depriving the investor of the value of the investment, will be the subject of compensation, even if the regulation is for a public purpose.

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[21] "The Boundaries of Regulatory Expropriation in International Law", *ICSID Review - Foreign Investment Law Journal,* 1.

The alternative contention for a State is that foreign investors, like domestic investors, take the risk of changes in law which may adversely affect their investments. Accordingly, BITs should be construed in a way which recognises that there is inherent in all investments risk including the risk of a change in the law.

While the likely contention identified by the State is at the opposite end of the spectrum to that which investors may advance discussed above, the answer is likely to lie somewhere in between these extremes. If that is so, what is the proper test for determining whether a measure, which has the potential to adversely affect the value of an investment, is expropriatory or not?

The balance of this paper considers that question and the defence of necessity.

As will be seen in the following discussion, the jurisprudence in relation to when a measure requires compensation and when it does not is yet to be settled. There are principally two schools of thought. The first has regard solely to the effect of the measure on the investment to determine whether there has been an indirect expropriation. This is known as the "sole effects" doctrine. If this is the correct approach it provides significant protection to investors because it provides for no significant limitation on the State's obligation to compensate for indirect expropriation.

However, for obvious reasons, a number of tribunals have attempted to restrict the nature of the protection so that States will not be subject to claims for compensation where the regulation, which might otherwise be tantamount to expropriation, is for a proper public purpose and is otherwise appropriate for achieving that purpose. This is known as the "police powers" doctrine.

B *A State's right to seize property*

Most States have a right to acquire property from citizens, but in most States such right is subject to proper compensation being paid. In Australia, the power reposes in the legislative branch of the government in section 51(xxxi) of the Commonwealth Constitution to make laws with respect to:

> *the acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws.*

In addition to providing for Commonwealth legislative power, section 51(xxxi) contains an express constitutional right: a guarantee of just terms where a law effects or provides for an acquisition of property. What is important to note is that the acquisition which is authorised by a law under section 51(xxxi) must be for a purpose within one of the Commonwealth's other legislative powers.

It is a principle of customary international law that certain takings or deprivations by a State are non-compensable.[22] However, whether such customary international law is relevant to the interpretation of

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[22] *Saluka Investments BV (The Netherlands) v The Czech Republic* (Partial Award, 17 March 2006) at [255]; *Methanex Corp v USA*, Final Award, 3 August 2005, 44 ILM 1343 at [410]. For examples of state practice see the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, the 1967 OECD Draft

BITs is debatable. Other international agreements dealing with the issue of expropriation expressly limit the types of expropriation which are caught by the protection. For example, the *European Convention on Human Rights* uses language which places a limitation on the absolute protection against expropriation. Article 1 of Protocol 1 provides:

> "Every natural or legal person is entitled to the peaceful enjoyment of it possessions. No one should be deprived of his possession except in the public interest and subject to conditions provided for by law and by the general principles of international law.
>
> The preceding provisions shall not, however, in any way impair the right of a State to enforce laws as it deems necessary to control the use of property in accordance with the general interest or to secure payment of taxes or other contributions or penalties".

The first paragraph of the Convention provides a general limitation on the State's obligation to pay compensation by use of the words "subject to the conditions provided for by the law <u>and general principles of international law</u>". These words make it clear that the obligation to pay compensation is subject to general principles of international law. Those principles, place a limitation on the circumstances where the State is regulating matters relating to a police power. The second paragraph also contains a Convention specific limitation on the protection.

Most BITs do not contain such a provision. The fact that other treaties (such as the BITs discussed below and the European Convention on Human Rights) provide a limitation, suggests that those BITs that do not should be read as not subject to customary international law. In interpreting a treaty, Article 31(3)(c) of the Vienna Convention on the Law of Treaties requires account to be taken of "any relevant rules of international law applicable in the relations between the parties". This includes rules of customary international law.[23] However, it is debatable whether the parties to BITs which are silent about the applicability of customary international law intended that such law would apply. If they had so intended it would have been easy to say so as was done expressly in the European Convention on Human Rights and a number of the more modern BITs discussed below.

It follows from this argument that the absence of such wording indicates that the contracting States were willing to provide enhanced protection to foreign investors. The logical motive for a State in making such an agreement is to increase the relative attraction for investors to invest in the State. Such an argument is consistent with the "sole effects doctrine".

The alternative argument is that there must be a natural limit to the protection offered by BITs, as it is unlikely that any State would have intended to absolutely fetter their capacity to regulate business, without paying compensation. Changes in the legal regime which affect business is one of the risks of being in business and must be generally accepted by investors, provided that the change falls within the police powers of the State.

Convention on the Protection of Foreign Property (71 ILM 117), and the United States Third Restatement of the Law of Foreign Relations (1987).

[23] *Case Concerning Oil Platforms (Islamic Republic of Iran v USA)* Judgment, 6 November 2003, ICJ Reports (2003), paras 23 and 41.

C *Economic effect as the exclusive criterion*

Pursuant to the "sole effects" doctrine regard is had exclusively to the (economic) effect that the measure in question has on the investment.

In *Tippetts v TAMS-AFFA Consulting Engineers of Iran*,[24] the Iran-United States Tribunal said:

> *the intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.*

Again, in the *Phelps Dodge* case,[25] the Iran-United States Tribunal expressly recognised "the financial, economic and social concerns that inspired the law" in question but said that "those reasons and concerns cannot relieve the Respondent of the obligation to compensate Phelps Dodge for its loss".

The sole effects doctrine was accepted by the ICSID tribunal in the case of *Compania del Desarrollo de Santa Elena v Costa Rica*.[26] In that case, the claimant was formed for the purpose of purchasing Santa Elena (a 30 kilometre terrain in Costa Rica) with the intention of developing it as a tourist resort. Costa Rica issued an expropriation decree for Santa Elena declaring it a preservation site. The tribunal said:

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

The tribunal also said:

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

The sole effects doctrine was also endorsed by the tribunal in *Metalclad Corporation v United Mexican States*.[27] Metalclad, an American company, purchased a Mexican company which owned a site in Mexico, with a view to constructing a hazardous waste landfill facility on the site. Metalclad alleged that its subsidiary's attempts to operate the hazardous waste landfill in the municipality of Guadalcazar were

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[24] 6 Cl. Trib. 219 (1984).

[25] 10 Iran-United States Cl. Trib. Rep. at 130.

[26] ICSID Case No. ARB/96/1 (17 February 2000).

[27] 30 August 2000.

frustrated by measures attributable to Mexico. The company obtained the requisite federal and state permits for construction of the facility but was denied a construction permit by the municipality. After exhausting avenues under Mexican law, the company submitted a claim to arbitration under NAFTA. Prior to the commencement of the arbitration, the state governor issued an ecological decree which designated the area of the municipality (including the site) to be an ecological preserve.

The arbitral tribunal found that Mexico had taken a measure tantamount to expropriation in violation of Article 1110 of NAFTA by permitting or tolerating the conduct of the municipality in relation to Metalclad and by thus participating or acquiescing in the denial to Metalclad of the right to operate the landfill. The tribunal said that the municipality denied the construction permit without any basis in the physical construction or any defect in the site. It stated that the improper denial of the construction permit effectively and improperly prevented Metalclad's operation of the landfill. The tribunal found that those measures amounted to an indirect expropriation.[28] The tribunal also found that the ecological decree was a further ground for a finding of expropriation because it had the effect of barring forever the operation of the landfill.

In making its determination, the tribunal stated[29] that it "need not decide or consider the motivation or intent of the adoption of the Ecological Decree".

The "sole effects" doctrine is not without its critics. Professor Salacuse says that giving an exclusive role only to the effects of the challenged measure without placing those effects in a broader context may lead to an incomplete analysis that is unintentionally biased in favour of a foreign investor.

D *Police Powers Doctrine*

In *Marvin Feldman v Mexico*,[30] the tribunal said:[31]

> *governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation...*

As discussed above, that case concerned the application of certain tax laws by Mexico to the export of tobacco products by a company owned and controlled by Mr Feldman. Mr Feldman alleged that

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[28] Note that Mexico challenged the award before the Supreme Court of British Columbia (the place of the arbitration was Vancouver BC). The Court found that the tribunal had decided a matter beyond the scope of the submission to arbitration in finding that the events preceding the announcement of the ecological decree amounted to an expropriation: *United Mexican States v Metalclad Corp* (2001) B.C.J. No. 950.

[29] At [111].

[30] Case No. ARB(AF)/99/1. Award dated 16 December 2002. Available at www.naftaclaims.com

[31] At [103].

Mexico's refusal to rebate excise taxes applied to cigarettes exported by his company violated Mexico's obligations under NAFTA, including Article 1110. The tribunal disagreed ultimately because severity of economic impact was not demonstrated: Mr Feldman's company was still able to engage in the exportation of Mexican products.

The tribunal relied on the "comments" to the American Law Institute's Restatement of the Law, Third, Foreign Relations Law of the United States, 1987, to assist in determining how to distinguish between an indirect expropriation and valid government regulation:

> *A state is responsible as for an expropriation of property under Subsection (1) when it subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property or its removal from the state's territory...A state is not responsible for loss of property or for other economic disadvantage resulting from* ***bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states****, if it is not discriminatory...* (emphasis added)

What is "bona fide" and "commonly accepted as within the police power of states" is not clear. The tribunal in *Saluka Investments BV (The Netherlands) v The Czech Republic* also spoke nebulously of "bona fide regulations that are aimed at general welfare". But, the tribunal gave some direction when it said:[32]

> *Faced with the question of when, how and at what point an otherwise valid regulation becomes, in fact and effect, an unlawful expropriation, international tribunals must consider the circumstances in which the question arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity.*

A test of "proportionality", alongside financial impact, was mooted by the tribunal in *Tecmed v Mexico*.[33] In that case, the tribunal took a "police powers" approach to the question whether a Mexican Resolution which refused to renew a permit to allow the claimant to operate a hazardous waste landfill expropriated the claimant's investment. Mexico argued[34] that the Resolution was "issued in compliance with the State's police power within the highly regulated and extremely sensitive framework of environmental protection and public health...[and] the Resolution is a legitimate action of the State that does not amount to an expropriation under international law".

The tribunal found that the Resolution was a measure equivalent to expropriation because the claimant was radically deprived of the economic use and enjoyment of its investment. However, the tribunal went on to consider the characteristics of the Resolution[35] and "whether such actions or measures are

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[32] At [264].

[33] *Tecnicas Medioambientales Tecmed S.A. v The Untied Mexican States*, Case No. ARB(AF)/00/2, Award 29 May 2003.

[34] At [97].

[35] At [118].

proportional to the public interest presumably protected thereby and to the protection legally granted to investments"[36] The tribunal said "there must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure".[37] There was no statement in the Resolution (or made at any time by a municipal or state officer prior to issuing the Resolution) that the landfill seriously or imminently posed a danger to public health, ecological balance or the environment. The tribunal found that the Resolution was driven by other socio-political factors (largely community pressure against the landfill). The tribunal concluded that these socio-political factors, weighed against the deprivation of the economic value of the claimant's investment and did not amount to a non-compensable expropriation under the Spain-Mexico investment treaty.

As discussed below, these concepts (character and context of a measure, and proportionality) are finding there way into recent investment treaties. However, their application to the standard wording of older treaties is less certain. The central thesis underlying the limitation in the police powers doctrine is that a State can escape liability to pay for a deprivation induced by a change in law if the change in law is in the public interest and the measure is otherwise proportional to that interest. Where these criteria are met, the State is not obliged to compensate the investor, notwithstanding the investor has been deprived of most of the value of its investment.

The problem with such an argument is that it requires a consideration of public interest at two points in the analysis:

(a) first, when considering whether the measure or regulation is within the police power of that State. If it is, no expropriation can occur even if there has been a full loss of the value of the investment. No further enquiry is necessary;

(b) secondly, in determining whether the expropriation is permissible. As will be recalled the standard BIT wording stipulates that expropriation is only permitted where:

  (i) it is in accordance with (domestic) law;

  (ii) non-discriminatory;

  (iii) adequately compensated; or

  (iv) for a public purpose.

The fact that "expropriation" is only permitted when it is for a public purpose, suggests that "public purpose" was not intended to be a filter on the concept of expropriation, as is required by the police powers doctrine. It seems unlikely that there would be two public purpose criterion intended by the parties, one express and the other not.

For these reasons, despite the awards which accept the concept in one form or another, the police powers doctrine is not intellectually satisfying, if it is understood to be a defence to the State's obligation to pay for a deprivation.

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[36] At [122].

[37] At [122].

E *A Third Approach*

It is unlikely that States intended that they would be obliged to pay compensation for any regulation which adversely affects a foreign investor. The challenge is to find an intellectually acceptable way of analysing the demarcation between a regulation which requires compensation and one that does not.

To date the discussion of the possible limitations on the obligation to pay compensation has been directed to whether there should be a limitation on the State's obligation to pay compensation. Another way to approach the issue is to consider the nature of the investment.

Any investment is subject to the domestic regulatory framework. International law has regard to domestic law to determine the scope of the rights which constitute the investment.[38]

In most cases of expropriation the approach has been to consider the legal framework which existed at the time of the investment. That is, it is assumed that any adjustment of the law as it applied at the time of the investment may potentially constitute an indirect expropriation. Such an analysis starts with a rigid legal system. However, all legal systems are constantly evolving. The rights associated with any investment are subject to the risk that such natural evolution will destroy value in the investment.

The nature and course of the evolution is likely to be different from country to country because of historical and cultural issues. An investor entering into a new country should be aware of such differences and factor them into its business case, prior to making its investment decision. For example, if the host State has an Islamic culture then the nature of the evolution is likely to be different from that of a secular or Christian State.

While it is true that the point of the prohibition on expropriation is to provide compensation when the rights inherent in an investment are interfered with, if the "rights" are not rigid (i.e. subject to the exact legal framework at the time of the investment) but are construed to be flexible within prescribed limits, then the concept of expropriation will only arise where the change in regulation falls outside such limits. Within those limits, the rights attached to the investment remain within the envelope of the evolution of the law which could reasonably have been anticipated at the time of the investment. That is, the rights associated with the investment have not changed. They were, at the time of investment, the rights stipulated by the domestic law, subject to the evolution in that law which could be reasonably anticipated.

No issue of expropriation can arise unless and until the new regulation falls outside the area of reasonable contemplation. This is so because until that occurs nothing has been lost. There is no deprivation or taking associated with the investment.

Pursuant to this approach most, if not all, of the exceptions ascribed to the police power doctrine would apply. However, the issue would not be to apply the doctrine to create an exception to the concept of expropriation, but to redefine the nature of the property rights associated with the investment, so that

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[38] Douglas, The Hybrid Foundation of Investment Treaty Arbitration 74BYIL 151 in particular the discussion from page 197.

there can be no taking or dispossession of a right, because the pre-existing right which has changed was always subject to change within the defined limits. Therefore, any change within those limits is merely an incident of the flexible nature of the rights.

The rights while adjusted, are the rights which were reasonably expected to be attached to the investment.

F *Recent investment treaties*

More recently, there has been explicit textual support (and accordingly State support) in investment treaties for greater government power to regulate without compensation being payable.

The chapter on investment in the recent ASEAN-Australia-New Zealand Free Trade Agreement, signed on 27 February 2009, includes an Annex which elaborates the nature and scope of “indirect” expropriation. Relevantly, it provides:

> *3. The determination of whether an action or series of related actions by a Party, in a specific fact situation, constitutes an expropriation of the type referred to in Paragraph 2(b) [i.e. indirect expropriation] requires a case-by-case, fact-based inquiry that considers, among other factors:*
>
> *a. the economic impact of the government action, although the fact that an action or series of related actions by a Party 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.*[39]
>
> *4. Non-discriminatory regulatory actions by a Party that are designed and applied to achieve legitimate public welfare objectives, such as the protection of public health, safety, and the environment do not constitute expropriation of the type referred to in Paragraph 2(b) [i.e. indirect expropriation].*

In so doing, the State parties require a tribunal to take the "police powers" approach and consider the character of the government action and the proportionality of the measure to the public purpose. The State parties have also specifically carved-out certain non-discriminatory regulatory actions by a State party: actions which are "designed and applied to achieve legitimate public welfare objectives".

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[39] “Public purpose” shall be read with reference to Article 9.1(a) and Article 9.6 (Expropriation and Compensation) of Chapter 11 (Investment).

The US-Chile Free Trade Agreement,[40] US-Central America Free Trade Agreement,[41] US-Australia Free Trade Agreement,[42] and the US-Morocco Free Trade Agreement[43] are all similarly worded to the ASEAN-Australia-New Zealand Free Trade Agreement.[44]

In entering into the 2003 Japan-Vietnam Agreement for the Liberalization, Promotion and Protection of Investment, Japan and Vietnam negotiated extensive treaty language which clarified that the imposition of a tax "does not generally constitute expropriation" and that "a taxation measure will not be considered to constitute expropriation where it is generally within the bounds of internationally recognized tax policies and practices".[45] The Agreed Minutes to this Agreement provide:

> *4. Both Contracting Parties confirm their understanding in respect of Article 19 of the Agreement that, when considering the issues of whether a taxation measure effects an expropriation, the following elements should be borne in mind:*
>
> *(a) The imposition of taxes does not generally constitute expropriation. The introduction of a new taxation measure, taxation by more than one jurisdiction in respect of specific investments, or a claim of excessive burden imposed by a taxation measure are not in themselves indicative of an expropriation.*
>
> *(b) A taxation measure will not be considered to constitute expropriation where it is generally within the bounds of internationally recognized tax policies and practices. Taxation measures aimed at preventing the avoidance or evasion of taxes should not generally be considered to be expropriatory.*
>
> *(c) While expropriation may be constituted even by measures applying generally (e.g., to all taxpayers), such a general application is in practice less likely to suggest an expropriation than more specific measures aimed at particular nationalities or individual taxpayers. A taxation measure would not be expropriatory if it was in force and was transparent when the investment was undertaken.*

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[40] Signed 6 June 2003.

[41] Signed 28 January 2004.

[42] Signed 1 March 2004.

[43] Signed 15 June 2004.

[44] See also the new US model BIT and Canada's updated Foreign Investment Promotion and Protection Agreement.

[45] Agreement Minutes, Article 4 of the 2003 Japan-Vietnam Agreement for the Liberalization, Promotion and Protection of Investment.

IV Defence of necessity

A *The defence of necessity*

When can a State, found to have expropriated a foreign investor's investment in breach of its international obligations, invoke the defence of necessity?

The defence of necessity has currency under customary international law in Article 25 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts. Article 25 provides that necessity can only be invoked as a defence where:

(i) the state's act is to safeguard an essential interest against a peril;
(ii) the peril shall be grave and imminent;
(iii) the course of action followed shall be the only option available; and
(iv) no other essential interest shall be seriously impaired as a result of the breach.

Article 25 continues by stating that necessity will not be available as a defence in circumstances where:

(i) the international obligation in question excludes the possibility of invoking necessity (i.e. the state renounces the defence); or
(ii) the state has contributed to the situation of necessity.

International investment treaties are less prescriptive in outlining circumstances in which the state of necessity defence applies. And many treaties are silent on the issue. The Australia-India BIT, in Article 15, states that:

> *Nothing in this Agreement precludes the host Contracting Party from taking, in accordance with its laws applied reasonably and on a non-discriminatory basis, measures necessary for the protection of its own essential security interests or for the prevention of diseases or pests.*

Article XI of the United States-Argentina BIT, which has been the subject of a number of international investment law disputes (discussed below), is expressed in similar terms:

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

Hungary invoked the state of necessity defence ("ecological necessity" to be precise) in the *Case Concerning the Gabčíkovo-Nagymaros Project* (under customary international law, not an investment treaty).[46] Hungary had certain obligations relating to the construction and operation of dams on a section of the River Danube. Hungary subsequently suspended and then abandoned the project. It did so as a consequence of political and economic change which, Hungary argued, called into question the economic

[46] (Hungary/Slovakia), Judgment, I.C.J. Reports 1997, 7.

and environmental viability of the project. The decision to suspend was ostensibly also driven by the Hungarian public's criticism of the project. The International Court of Justice accepted that the "state of necessity is a ground recognized by customary international law for precluding the wrongfulness of an act not in conformity with an international obligation"[47] but, on the facts, found that Hungary could not invoke the defence. The Court expressly acknowledged that Hungary's concerns for the natural environment was indeed an "essential interest", but found that the project did not pose an imminent peril to the environment; the purported risks alleged by Hungary were held to be too uncertain.[48] The Court also held that the suspension and abandonment of works was not the only means by which the perceived perils could be addressed.

B *Argentina's 1999-2002 economic crisis*

In the investment treaty space, the defence has been raised on a number of occasions by Argentina.[49] The "state of necessity" alleged is Argentina's 1999-2002 economic crisis.

Argentina's economic woes began in the mid 1980s with the introduction of a new currency (the Austral). This precipitated a sustained period of hyperinflation which had serious consequences for real wages. To combat the threat of inflation, the Argentine currency was fixed against the United States dollar (with guaranteed 'convertibility' to US dollars). This contributed to Argentina's growing debt and, by the late 1990s, caused a substantial drop in GDP. The freezing of bank accounts in 2001, combined with uncontrolled public debt totalling some US$130bn, led to social unrest and widespread rioting.

It was against this backdrop that Argentina introduced certain emergency laws beginning in 2002. Broadly, the laws removed indexation, restricted currency transfers out of Argentina and, most importantly, fixed the US dollar and peso at a ratio of one-to-one ("pesofication"). For foreign investors, this had the immediate effect of considerably devaluing their Argentine investments. Many of these investors initiated claims against Argentina for expropriation of their investments (in addition to other grounds including discrimination and violation of fair and equitable treatment). As well as defending the specific grounds raised by investors, Argentina has sought to rely on the state of necessity defence to excuse its alleged breaches in the different cases. The defence has been successfully invoked in only two decisions.

In *LG&E Energy Corporation v Argentine Republic*,[50] LG&E had an equitable interest in Argentine gas distribution companies. Argentina, under the emergency laws, renegotiated contracts with these gas distribution companies with the effect of removing certain guarantees. This caused LG&E to suffer considerable losses on its investment. It sought relief under the United States-Argentina BIT, and Argentina raised the state of necessity defence (pursuant to both Article 25 of the ILC's Articles and Article XI of the United States-Argentina BIT).

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[47] Ibid at 40.

[48] (Hungary/Slovakia), Judgment, I.C.J. Reports 1997, 7 at 42.

[49] As at 17 January 2011, 27 cases against Argentina are pending <http://icsid.worldbank.org/ICSID/FrontServlet>.

[50] ICSID Case No. ARB/02/1.

The ICSID tribunal found that "[a]ll of these devastating conditions - economic, political, social - in the aggregate triggered the protections afforded under Article XI of the Treaty to maintain order and control the civil unrest" and that Argentina had no real choice but to act and that there was no evidence that it had contributed to the crisis.[51] The tribunal concluded that Argentina was exempted from liability under the United States-Argentina BIT.[52] Importantly, the exemption was only operative from 1 December 2001 to 26 April 2003 - when Argentina was subject to a state of necessity - and Argentina was not liable to pay damages during this time period (but was after 26 April 2003).

In *Continental Casualty Co. v Argentine Republic*,[53] Continental Casualty suffered losses to certain banking investments due to the Argentine emergency legislation (and the prohibition on outgoing transfers). It made claims under the United States-Argentina BIT and again Argentina relied on Article 25 of the ILC's Articles and Article XI of the investment treaty.

The tribunal found that a state of necessity existed, and the defence could be invoked. It said:[54]

> *the fact that Argentina's Congress declared a "public emergency" in economic, financial, exchange, social and administrative matters in conformity with Art. 76 of its Constitution, and enacted a specific "Public Emergency Law" to cope with the crisis, powerful evidence of its gravity such as that could not be addressed by ordinary measures.*

Like the tribunal in *LG&E*, the tribunal in *Continental Casualty* found that Argentina had no alternative but to introduce the emergency measures; no other action offered even a reasonable chance of success (of overcoming the economic crisis).[55] The tribunal also found that Argentina had not contributed to the state of necessity. It said predictive intervening action years before would have been required to avoid the state of necessity.[56]

V Conclusion

BITs provide significant protection for foreign investors. However, investors need to understand prior to making their investment:

(a) whether their investment satisfies the requirements of the relevant BIT;

(b) whether they have the necessary nationality to take advantage of a relevant BIT. If they do not, there may be steps that can be taken to clothe the investor with the necessary nationality;

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[51] Ibid at [237] and [257].

[52] Ibid at [259].

[53] ICSID Case No. ARB/03/9.

[54] ICSID Case No. ARB/03/9 at [181].

[55] Ibid at [230].

[56] Ibid at [236].

(c) the nature of the protection provided.

In this paper, we have concentrated on the expropriation protection provided in most treaties. Expropriation or nationalisation of an asset in a conventional sense is relatively straight forward. More difficult are cases dealing with indirect expropriation (or conduct tantamount to expropriation). The exact defining line between acceptable and unacceptable behaviour is not yet adequately defined by the available cases. However, in time it is expected that an international consensus will develop in relation to this issue.

It is unlikely that that consensus will result in all regulation which is adverse to a business, being potentially expropriatory. In the writers' view, it is a distinct possibility that the exact limit of the protection provided in relation to indirect expropriation, will depend upon historical and cultural matters relevant to the particular State and any specific representations or agreements made with a particular investor. To put it another way, the dividing line between expropriation and non-expropriation will depend upon what should have been within the reasonable contemplation of the investor at the time of the investment.

In the meantime, those investing outside their home country should embrace every opportunity to protect the investment, including ensuring that any available BIT is properly engaged.