



# STATE MEASURES AFFECTING THE PROPERTY OF FOREIGN INVESTORS: EXPROPRIATION OR REGULATION?

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## LIST OF CASES

- A. Olguin v. Republic of Paraguay, ICSID Case No. ARB/98/5, 2001
- Biloune and Marine Drive Complex Ltd. v. Ghana Inv. Centre and Government of Ghana, 1989
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- Tradex Hellas S.A. v. Republic of Albania, ICSID Case No. ARB/94/2, 1999

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## 1. INTRODUCTION

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The erosion of the borders and market barriers, the reduction in the costs of transportation and communications which are driving forces of globalization are making the world smaller. Advances in economy, technology and politics create interdependence between countries. Corporations, as well as individuals, have important responsibilities to achieve the general raising welfare and sustainable development. Today there is no question on the significance of foreign investments on economic development. Especially for the developing countries whose economic development depends to a large extent on private foreign capital, it is so important to create a satisfactory and stable climate for the flow of foreign investment.

There has been a general tendency in international protection of foreign property to transfer domestic norms of property protection on to the international sphere. The fundamental purpose of this movement is to promote the economic development by ensuring the high standard protection to foreign investment.

However, the international legal framework for foreign investment is far from being uniform. As a result of the absence of a multilateral consensus, the intergovernmental negotiations on protection of investment are carried out at the bilateral, regional and interregional level.<sup>[1]</sup>

The present study examines how state measures affecting the property of foreign investors are treated in arbitral practice. The purpose of the thesis is as follows:

- To reproduce the evolution of international legal norms on property related measures
- To analyze the international law governing expropriation and
- To attempt to clarify what are the relevant legal standards for foreign investment in practice.

The thesis is divided into four substantive chapters: Chapter 2 “*Historical Development of Norms on Property Related Measures*” summarizes the evolution of the modern understanding of the minimum standard as applied to foreign direct investment. Chapter 3, “*International Legal Norms on Property Related Measures*”, summarizes the state of customary international law, international human rights law, international investment law, and international law de lege ferenda on protection of foreign investment. It examines the evolution of

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[1] Radu, A., Foreign Investors in the EU-Which “Best Treatment?” Interactions Between Bilateral Investment Treaties and EU Law, 2008, *European Law Journal*, v.14, no.2, p.237

the modern understanding of the minimum standard as applied to foreign investment.

Chapter 4 “*International Arbitration Practice on State Measures Affecting Acts on Foreign Investors’ Property Rights*”, aims to distinguish expropriation, measures having equivalent effect to expropriation and mere regulation by using the standards based on arbitration practice. It focuses on particular ICSID decisions and discusses the cases that inform us on expropriation and level of compensation, leading cases determining whether the state measure amounts to indirect expropriation or regulation.

Finally Chapter 5 “*Conclusion*” states the answers of following questions:

- How much protection does international law afford to foreign investment?
- What is the common standard under investment law?
- Does it also influence the customary law standard? and
- What is the influence of the arbitration practice beyond resolving individual cases?

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## 2. HISTORICAL DEVELOPMENT OF NORMS ON PROPERTY RELATED MEASURES

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### 2.1. The Colonial Period

Until the Communist Revolution in Russia in 1917 neither state practice nor the commentators of international law had reason to pay special attention to rules protecting foreign investment. Treaty practice in the nineteenth century protected alien property not on the basis of an autonomous standard, but by reference to the domestic laws of the host state.<sup>[2]</sup>

In 1868 an Argentinean foreign minister and jurist Carlos Calvo in his *Le Droit International* had said: “*Aliens who established themselves in a country are certainly entitled to the same rights of protection as nationals, but they can not claim any greater measure of protection.*”<sup>[3]</sup> The so-called “*Calvo doctrine*” was based on the view that foreigners must assert their rights before domestic courts and that they have no right of diplomatic protection by their home state or access to international tribunals.<sup>[4]</sup>

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[2] Dolzer R. & Schreuer C. , *Principles of International Investment Law*, Oxford University Press, 2008, p. 11

[3] Sornarajah, M., *The International Law on Foreign Investment*, Cambridge University Pres, 1999, Footnote 32 p.11

[4] Dolzer R. & Schreuer C. supra note 2 p. 11

After the Russian Revolution in 1917, the Calvo doctrine was reviewed in view of the expropriation by the Soviet Union of foreign enterprises without compensation. The Soviet Union relied on national treatment and did not protect foreign property. In 1930 a dispute led to the Lena Goldfields Arbitration and a tribunal required the Soviet Union to pay compensation to the foreign claimant, based upon the concept of unjust enrichment.<sup>[5]</sup>

In 1938, another dispute over Mexico's nationalization of foreign owned oil fields led US secretary of state Cordell Hull to write a famous letter to his Mexican counterpart spelling out that; international law allowed expropriation of foreign property, but required Mexico to pay "*adequate, effective and prompt*" compensation. This shorthand summary of the standard claimed by US is generally called the "*Hull Formula*".<sup>[6]</sup>

In the nineteenth and twentieth century the sum of these rules, Calvo doctrine, the Russian Revolution, and the Mexican position, eventually became known as the international minimum standard.<sup>[7]</sup>

## 2.2. The Post Colonial Period

With the end of Second World War, developments and origins of the customary law of responsibility for injury to foreigners, the law of human rights, and the economic relations between different states and private individuals had significant changes. Those issues have a growing interrelationship among themselves.

After the Second World War, human rights became a matter of international concern and a specific subject matter of international law. The law of human rights has developed and responsibility for injury to foreign nationals has extended its boundaries. Furthermore there have been a lot of discussions as to whether or not there is an international minimum standard of treatment for foreign investment. Such a standard has been proposed by the capital exporting states since the beginning of the twentieth century. "*For a considerable number of years, the International Law Commission tried unsuccessfully to reach an agreement on a codification of the law of the state responsibility for injury to aliens. Fundamentally differing views on the basic principles of state responsibility*

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[5] Lena Goldfields Ltd. v. Soviet Government Arbitration 1930 see at Dolzer R. & Schreuer C. supra note 2 p. 13

[6] Norton, P.M., Back to the Future: Expropriation and the Energy Charter , The Energy Charter Treaty : an East-West Gateway for Investment and Trade / Edited by Thomas W. Wälde, 1996, Footnote 1, p.365

[7] Roth, H., The Minimum Standard of International Law Applied to Aliens, 1949 International Affairs, Royal Institute of International Affairs 1944-, Vol. 27, No. 2, April, 1951 p. 220

were the principle stumbling block”.<sup>[8]</sup> Those different views can be summarized as following:

**(i) Latin America**

According to Latin American states, a sovereign state was entitled to complete freedom from interference in any form. Furthermore, aliens were entitled no greater rights and privileges than those available to nationals. Therefore the response of Latin America to an international standard was “*national treatment*”.<sup>[9]</sup>

**(ii) Socialist Countries**

The emergence of the socialist countries of Eastern Europe involved extensive nationalizations of private property. Although they undertook to pay compensation for nationalization, they rejected the idea of an international minimum standard. They held the view that regulation of alien property falls under exclusive competence of national law and argued that “*traditional concept of state responsibility was not supportable it addressed the concerns of one side, the investors’ home state to the exclusion of those of the host*”.<sup>[10]</sup>

**(iii) Newly Independent States**

Newly independent states after colonialism especially in Africa and Asia challenged the principle of international minimum standard as it had been developed without their consent.<sup>[11]</sup> In the word of one critic these standards stem from “*international treaties made without significant participation by the developing countries*”.<sup>[12]</sup>

### 2.3. Situation since 1990

In recent years, those diametrically opposite views have yield under the pressure of important changes in world economic order. These have included the collapse of U.S.S.R. and Eastern European states’ effort to move toward

[8] Damrosch & Henkin, & Pugh & Schacter & Smit, International Law Cases and Materials 4th Edition, 2001, p.747

[9] Guzman A.T., Why LDCs Sign Treaties That Hurst Them: Explaining the Popularity of Bilateral Investment Treaties, Virginia Journal of International Law, 1998, Vol. 38 p.748

[10] Brazell, L., The Energy Charter Treaty: Some Observations on its International Context and Internal Structure, The Energy Charter Treaty : an East-West Gateway for Investment and Trade / edited by Thomas W. Wälde, 1996, p.229

[11] Guzman See supra note 9, p.748

[12] Laing, E.A., International Economic Law and Public Order in the Age of Equality , Law and Policy in International Business, 1980, Vol.12 p.740

privatization and market economies. After this collapse free market economy has become widespread. “*The post-war Bretton Woods system has gradually given way to a new more complex structuring of the world economy*”.<sup>[13]</sup> Over the past fifty years international trade in goods and services has become increasingly important. To govern international money, investment and trade multilateral institutions have been established such as International Monetary Fund (IMF), World Bank (WB) and General Agreements on Tariffs and Trade (GATT). The world has been enjoying economic integration across national borders, international trade and economic liberalization. A new political and economic system so called “*liberal democracy*” is rapidly becoming commonplace. New rules of international law have been developed to reflect these new conditions.

Also many other developing countries have acknowledged that foreign private investment has a significant role in economic development and to encourage the inflow of private investment with its new technology and job opportunities, it is necessary to maintain legal security of the foreign investment. As a consequence, developing countries have felt the pressure to limit their regulations in order to attract foreign direct investment. Need for capital, transfer of technology and know-how and job opportunities evoked developing countries to move beyond the debates over doctrinal differences with respect to the minimum standard of state responsibility. Therefore both capital importing and capital exporting states have come to share a common interest at this point.

However, it is still observed from the arbitral decisions, governments in the developing countries commonly play a far more pervasive interference, most of the time indirectly, in business operations than in the industrialized countries. As it was discussed above, “*the doctrinal positions of Latin American states, socialist states and the developing states in Africa and Asia are deeply rooted, it has been impossible to fashion in a code of binding rules, compromises on the basic rules of state responsibility that will commend widespread support*”.<sup>[14]</sup> Instead there has been a movement towards bilateral arrangements such as bilateral investment treaties between states or stabilization clauses between investor and host state to protect foreign investment.

It is therefore necessary to analyze in detail the legal sources of the international protection of foreign property:

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[13] Sornarajah See supra note 3, p.1

[14] Guzman See supra note 9, p.777



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### 3. INTERNATIONAL LEGAL NORMS ON PROPERTY RELATED MEASURES

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#### 3.1. Customary international law

Article 38(1)(b) of the Statute of the International Court of Justice calls upon the Court to apply “international custom, as evidence of a general practice accepted as law. According to the Court of Justice, if a practice is followed by those concerned because they feel legally obliged to behave in such a way through the possession of *opinio juris* this practice would be recognized as customary international law. Court of Justice in the North Sea Continental Shelf cases stated:

*“Although the passage of only a short period of time is not necessarily, or of itself, a bar to the formation of a new customary international law... an indispensable requirement would be that within the period in question, short though it might be, State practice, including that of States whose interests are specially affected, should have been both extensive and virtually uniform in the sense of the provision invoked- and should moreover have occurred in such a way as to show a general recognition that a rule of law or legal obligation is involved.”*<sup>[15]</sup>

Custom must be distinguished from mere usage. A rule of customary international law derives its law hallmark through the possession of behavior and practice of states and subjective conviction held by states that the behavior in question is compulsory and not discretionary.<sup>[16]</sup>

Many rules in the field of foreign investment derive from the “*state sovereignty*” principle. States’ rights to expropriate property within their borders, to permit or restrict commerce, right to exclude and to regulate foreign investment are all an expression of state sovereignty. Once a host state permits a foreign investment, it will be subject to a minimum standard when only customary law governs.

There are few customs in this sense in the field of foreign investment. It will, however, be argued that there is now a customary principle that compensation must be paid following the nationalization of foreign property, although there is no agreement on the basis of the calculation of that compensation.<sup>[17]</sup>

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[15] North Sea Continental Shelf Cases, Judgement of February 20, 1969, p.43, para.74 available at <http://www.icj-cij.org/docket/index.php?p1=3&p2=3&k=cc&case=52&ccde=cs2&p3=4>

[16] Wallace, R.M.M., International Law, Fifth Edition, London, Sweet & Maxwell, 2005, p.9

[17] Sornarajah, M., *supra* note 3, p.74

Below discussed United Nations General Assembly resolutions which seek to support principles of state sovereignty, are not custom and do not per se establish rules of customary international law, but nevertheless they can be used to reflect opinio juris of the states, if adopted by unanimously, and also create a strong presumption that their rules reflect customary law.

### 3.1.1. UNGA Resolution 1803 (1962)

Between 1945 and 1990 there were major confrontations between the newly independent developing countries and capital exporting states about the status of customary law governing foreign investment. The new battleground chosen by developing states was the United Nations General Assembly, where they held and still hold the majority of the votes.<sup>[18]</sup>

In 1962 United Nations General Assembly, by a vote of 87 to 2 with 12 abstentions, adopted Resolution 1803 (XVII 1962) on Permanent Sovereignty over Natural Resources which declared that states had “*permanent sovereignty over natural resources*”. Paragraph 4 of the resolution provided that;

*“Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law.”*<sup>[19]</sup>

It neither mentioned the Hull Formula’s stronger “*prompt, adequate and effective*” formulation nor explicitly confirmed the Calvo doctrine for the compensation standard.

Also Paragraph 8 of the resolution states that foreign investment agreements freely entered into by or between sovereign States shall be observed in good faith.<sup>[20]</sup>

*“It is particularly important to note that the majority voted for this text, including many States of the Third World, but also several Western developed countries with market economies, including the most important one, the United States. The principles stated in this Resolution were therefore assented to by a great many States representing not only all geographical areas but also all economic systems.”*<sup>[21]</sup>

[18] Dolzer R. & Schreuer C. supra note 2 p. 14

[19] UNGA Resolution 1803, 17th Session, December 14, 1962, para.4 available at <http://daccessdds.un.org/doc/RESOLUTION/GEN/NR0/193/11/PDF/NR019311.pdf?OpenElement>

[20] UNGA Resolution 1803, para 8 supra note 19

[21] Bodansky, UN General Assembly Resolutions: Expropriation of Foreign Property, University of Georgia School of Law, Class 16, available at <http://www.law.uga.edu/~bodansky/>

Some authors, certain international arbitral decisions and many authorities on international law suggest that paragraph 4 of Resolution 1803 represents customary international law and argue that later UN instruments do not reflect customary international law.<sup>[22]</sup>

### 3.1.2. UNGA Resolution 3281 (1974)

In 1970's developing countries attempted to establish what they termed "New Economic Order" through a series of UNGA Resolutions such as the "Declaration on the Establishment of a New International Economic Order"<sup>[23]</sup> and the "Charter of Economic Rights and Duties of States"<sup>[24]</sup>.

UNGA Resolution 3281, the Charter of Economic Rights and Duties of States, was adopted in 1974. There was no general consensus with respect to the most important provisions and in particular those concerning nationalization. Having been the subject of a roll-call vote, the Charter was adopted by 118 votes to 6, with 10 abstentions. It reinforces the rights of states to expropriate foreign property, but states that;

*"To nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principles of free choice of means."*<sup>[25]</sup>

This standard "appropriate compensation", had appeared earlier in General Assembly Resolution 1803.

It has been a controversial issue whether these resolutions create international law. Some authors<sup>[26]</sup> have supported the view that principles of General Assembly resolutions constitute "instant customary law". Some authors<sup>[27]</sup>

courses/International\_Law/class16.html

[22] Newcombe, A., Regulatory Expropriation, Investment Protection and International Law: When Is Government Regulation Expropriatory and When Should Compensation Be Paid?, 1999, p.48

[23] UNGA Resolution 3201, 29th Session, 1974

[24] UNGA Resolution 3281, 29th Session, December 12, 1974 available at <http://daccessdds.un.org/doc/RESOLUTION/GEN/NR0/738/83/IMG/NR073883.pdf?OpenElement>

[25] UNGA Resolution 3281 Article 2, para 2(c) see at supra note 24

[26] Cheng, B., United Nations Resolutions on Outer Space: Instant International Customary Law in Tiryakioğlu B., Doğrudan Yatırımların Uluslararası Hukukta Korunması, Dayınlarlı Press, Ankara, 2003 p. 57

[27] Walde, T.W., North/South Economic Cooperation and International Economic Development Law, Legal Process and Institutional Considerations in Zamora, S., Is

designated them as “*alternative international law*” on the basis of being more oriented towards the specific issues of interaction between host state and foreign investor. However both views were established in the context of areas that are not occupied by existing legal norms.

As mentioned above there is also a generally accepted view that these resolutions reflect *opinio juris* of the states and also have significance as to what the law ought to be in the future.

It is now possible to recognize that resolutions of the United Nations have a certain value. However, this legal value differs considerably, depending on the type of resolution and the conditions attached to its adoption and its provisions. In this respect only Resolution 1803 was supported by a majority of UN member states representing all of the various groups. On the other hand, the other Resolutions mentioned above were supported by a majority of States “*but not by any of the developed countries with market economies which carry on the largest part of international trade.*”<sup>[28]</sup>

### **3.1.3. World Bank Guidelines 1992**

Until around 1990 the confrontation led to insecurity about the customary rules governing foreign investment. In 1990s international financial institutions revised their position on the role of private investment. The views they have supported and codes of conducts and guidelines they have formulated had an effect in the shaping of the law on foreign investment.

In 1992 World Bank adopted a set of guidelines on the Treatment of Foreign Direct Investment. In Section IV (1) it is stated that;

*“State may not expropriate or otherwise take in whole or in part a foreign private investment in its territory or take measures which have similar effects, except where this is done in accordance with applicable legal procedures, in pursuance in good faith of a public purpose, without discrimination on the basis of nationality and against the payment of appropriate compensation.”*<sup>[29]</sup>

In Section IV(2) and (3) it is stated that;

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There Customary International Economic Law?, p.13, reproduced in Prof. Hoffmeister's PILC 2007-2008 Session Lecture Materials

[28] Bodansky, UN General Assembly Resolutions: Expropriation of Foreign Property, University of Georgia School of Law, Class 16, available at [http://www.law.uga.edu/~bodansky/courses/International\\_Law/class16.html](http://www.law.uga.edu/~bodansky/courses/International_Law/class16.html)

[29] World Bank Guidelines 1992 World Bank Guidelines Vol.II, Legal Framework for the Treatment of Foreign Investment, 1992, Section VI, p. 41 available at [http://www.wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/1999/11/10/000094946\\_99090805303082/Rendered/PDF/multi\\_page.pdf](http://www.wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/1999/11/10/000094946_99090805303082/Rendered/PDF/multi_page.pdf)

*“Compensation for a specific investment taken by the State will, according to the details provided below, be deemed “appropriate” if it is adequate, effective and prompt.*

Compensation will be deemed “adequate” if it is based on the fair market value of the taken asset as such value is determined immediately before the time at which the taking occurred or the decision to take the asset became publicly known.”

The guidelines set out parallel principles with UNGA resolutions such as public utility, good faith and appropriate compensation. However, here it is determined in Section IV (2) and following; compensation is “appropriate” if it is adequate, effective and prompt; and it is “adequate” if it is based on the fair market value of the taken asset whereas in UNGA Resolutions the compensation was determined in accordance with the rules in force in the expropriating host state.

The guidelines contribute the evolution of emerging principles of international law and reflect the need for a compromise between controversial views. The Guidelines direct states to act in conformity with the principles contained in them, which is important to reflect the States’ opinio juris.

## **3.2. International Human Rights Law**

### **3.2.1. UN Covenants**

The United Nations Human Rights Covenants<sup>[30]</sup>, recognize the “*inherent dignity*” and “*equal and inalienable rights of all members of the human family... the foundation of freedom, justice and peace in the world.*”<sup>[31]</sup>

Article 2 of the Covenant on Economic, Social, and Cultural Rights ensures to “*all individuals within its territory and subject to its jurisdiction*” certain freedoms and rights without any discrimination on race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status.

On the other hand heavily criticized provision article 2(3) of the Covenant on Economic, Social and Cultural Rights justifies denial of economic rights to aliens and states that “developing countries, with due regard to human rights and their national economy, may determine to what extent they would guarantee the economic rights recognized in the present Covenant to non-nationals.

[30] International Covenant on Civil and Political Rights, December 16, 1966, and International Covenant on Economic, Social and Cultural Rights, December 16, 1966

[31] See the Preambles of the 1966 UN Human Rights Covenants available at <http://www.hrweb.org/legal/undocs.html>

The UN Covenants do not include any property related article. Therefore there is no global UN Human Rights standard for protection of foreign property.

### ***3.2.2. The European Convention on Human Rights***

The European Convention on Human Rights of 1950 explicitly protects private property rights. Article 1 of its First Additional Protocol of 1952 stipulates the peaceful enjoyment of one's possession, requirements for deprivation of possessions, and the legal regulation of State control in accordance with the general interest.

Although the cases decided by the European Court of Human Rights have not explicitly dealt with the deprivation of non-nationals' property,<sup>[32]</sup> the court's findings and Article 1 are applicable to foreign investment.

Article 1 of Protocol 1 to the Convention is written in the following terms:

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

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

The Court has given a combined interpretation of the three distinct rules comprised in Article 1, as from the *Sporrong and Lönnroth* case and further perfected in the *James* case:<sup>[33]</sup> The first rule, which is of a general nature, enounces the principle of peaceful enjoyment of property; it is set out in the first sentence of the first paragraph. The second rule covers deprivation of possessions and subjects it to certain conditions; it appears in the second sentence of the same paragraph. The third rule recognizes that the States are entitled, amongst other things, to control the use of property in accordance with the general interest, by enforcing such laws as they deem necessary for the purpose; it is contained in the second paragraph. The Court must determine, before considering whether the first rule was complied with, whether the last two are applicable.<sup>[34]</sup>

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[32] Ruffert, M., *The Protection of Foreign Direct Investment by the European Convention on Human Rights*, German Yearbook of International Law, 2000, v.43, p.116-148

[33] Frigo, M., *Peaceful Enjoyment of Possessions, Expropriation and Control of the Use of Property in the System of the European Convention on Human Rights*, Italian Yearbook of International Law 2000, v.10, p45-69

[34] Eur. Court H.R., *Case of Sporrong and Lönnroth*, Judgment of 23 September 1982, A52, para. 61 available at

A few years later in its decision in *James* the court stated that: The three rules are not, however, “*distinct*” in the sense of being unconnected. The second and third rules are concerned with particular instances of interference with the right to peaceful enjoyment of property and should therefore be construed in the light of the general principle enunciated in the first rule.<sup>[35]</sup>

The principles of Article 1 of Protocol No.1 elucidates that all limitations of property rights should be considered in the light of the overall guarantee stipulated. With respect to foreign property, there is a close connection between Article 1 and the protection of foreign investment as the notion of property in the Convention is inferred from Public International Law. In fact there is no definition of property in Article 1. Therefore it covers what have been acceded as property rights in international law.

The Court does not exclude any recognized vested right from the guarantee which would consequently be of great efficiency to the investor if applied to foreign direct investment (FDI) in so far as the first sentence of this article contains a general principle in the light of which any state interference regarding private property will have to be considered.<sup>[36]</sup>

Considering the legality of expropriation; in Article 1, public purpose is explicitly mentioned as “*public interest*” and determination of this interest is subject to sovereign appreciation of the national interest and general principles of international law. Considering discrimination, if an expropriation is deemed to discriminate in breach of Article 14 of ECHR<sup>[37]</sup> could be applied if there is a connection with the guaranteed freedoms.

Finally considering compensation requirement, there is no explicit reference to this requirement is made by the above rule, which only contains a general reference to the conditions set forth by the general principles of international law. Therefore the standard of conformity with the Convention is adequate compensation.

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<http://cmiskp.echr.coe.int/tkp197/view.asp?item=2&portal=hbkm&action=html&highlight=Sporong%20%7C%20L%F6nnroth&sessionid=6918773&skin=hudoc-en>

[35] Eur. Court H.R., *Case of James and Others*, Judgment of 21 February 1986, A98, para.37 available at <http://cmiskp.echr.coe.int/tkp197/view.asp?item=1&portal=hbkm&action=html&highlight=james%20%7C%20others&sessionid=6919132&skin=hudoc-en>

[36] Ruffert, M *supra* note 32, p.116-148

[37] Eur. Conv. H.R. Article 14 “*The enjoyment of the rights and freedoms set forth in this Convention shall be secured without discrimination on any ground such as sex, race, colour, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status.*”

### 3.3. International Investment Law

#### 3.3.1. Bilateral Investment Treaties

##### 3.3.1.1. Historical Development

The number of bilateral investment treaties (BITs), an international legal instrument through which two countries set down rules that will govern investments by their respective nationals in the other's territory<sup>[38]</sup>, has increased rapidly in recent years.

Generally in most of the definitions of BITs it is said that BITs propose benefits for both two states who conclude it. The typical idea is that BIT offers a protection for the investment against the possible arbitrary treatment which may take place in host state's legal regime and for the host state benefits of capital, technology, employment, new industries and markets which follow the flow of the investment.

Writers are divided as to the actuality of this win-win situation. According to Sornarajah, even these treaties propose a two-way flow of investments between the two states, in reality there is only one-way flow of investments between unequal parties, from developed exporting state to the developing state.<sup>[39]</sup> According to this view, inequality emanates from the inexistence of "*any firm obligation on the part of the capital exporting state to ensure such flows take place*" and inexistence of "*legal departments sophisticated enough in developing country to understand the nuances in the variations in the language that is used in BITs.*"<sup>[40]</sup>

A more bitter view is taken by Guzman; his basic argument is that BITs represent a "*prisoner's dilemma*"<sup>[41]</sup> for developing countries. He argues that developing countries who are the major dissidents against Hull formula started to sign thousands of BITs including obligations even more protective than "*prompt, adequate, effective*" compensation for expropriation.<sup>[42]</sup> According to Guzman developing countries find that signing a BIT is better than refusing to sign in a regime where the BITs cover the world because "*the benefits to a less developed country of signing a BIT with a wealthier country may exceed the value of staying out and losing investment funds to rival countries.*"<sup>[43]</sup>

[38] Sullivan & Salacuse, Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain, Harvard International Law Journal, Winter 2005, Vol. 46, No.1, p.68

[39] Sornarajah, M., supra note 3 p.228

[40] Sornarajah supra note 3, p.228

[41] Guzman, supra note 9 , p.666,667

[42] See Guzman supra note 9, p.643

[43] See Guzman in Bubb & Ackerman, BITs and Bargains: Strategic Aspects of Bilateral and Multilateral Regulation of Foreign Investment, International Review of Law and Economics, 2007, Vol..27, p.292



Despite these arguments, it is obvious that these treaties represent an important part of the international investment scene.

### ***3.3.1.2. Reasons and General Purposes of Bilateral Investment Treaties***

Many of these investment treaties have their roots in the 1967 OECD Draft Convention on the Protection of Foreign Property. The first treaty was signed by Federal Republic of Germany and Pakistan in 1959.<sup>[44]</sup>

After the Second World War, attempts for multilateral arrangements to protect foreign investment ended up with failure because of the ongoing controversial views between developing and developed countries. It was unacceptable for developing countries to be party to a multilateral agreement which interrupts the principle of national control.

Developing countries while advocating a series of decisions in their United Nations resolutions and opposing the idea for a multilateral treaty, they have started to sign bilateral investment treaties as they need foreign private investment.

Bilateral arrangements became necessary because of the failures on multilateral arrangements by the effects of political, historical and legal controversies and of the efforts of developing countries to attract foreign direct investment for its contribution to their domestic economy.

Bilateral treaties were supported by developing countries because “*such treaties could be negotiated in such a manner as to suit the mutual interests of parties, whereas a multilateral treaty can't be.*”<sup>[45]</sup> Bilateral investment treaties provided the parties with the opportunity to set out the definite norms, among all the confused state of conflicting norms.

The basic aim of the bilateral investment treaties is encouragement and protection of investment flow between the two states. But this is not the sole aim; they may also have the objective to create a broader framework for economic cooperation between the two states or the objective to eliminate the former images of the developing countries where fear of expropriation deterred investment.

### ***3.3.2.3. General Features of Bilateral Investment Treaties***

BITs provide security for investors in several ways. Most obviously, they regulate the conditions under which a lawful expropriation can occur and set

[44] See Salacuse, BIT by BIT : The Growth of Bilateral Investment Treaties and their Impact on Foreign Investment in Developing Countries, 1990, in Damrosh & Henkin, & Pugh & Schacter & Smit, International Law Cases and Materials 4th Edition, 2001, p. 808

[45] See Sornarajah at supra note 3, p. 232

a standard of compensation in the event of expropriation. BITs may also provide detailed terms for capital repatriation, national treatment requirements, most favored nation type requirements and dispute settlement procedures that provide for international arbitration<sup>[46]</sup>

The United States 2004 Model BIT<sup>[47]</sup> goes further and requires substantial liberalization i.e. prohibiting parties from imposing performance requirements on investment such as demands for technology transfer and export requirements.<sup>[48]</sup> The U.S. treaties differ from many entered into by European countries in that their purpose is not merely protection of investment but also ensuring free access, with limited exceptions, of investors of each contracting state to the markets of the other contracting states.<sup>[49]</sup>

Most of the BITs have similar objects and purposes. Arbitral decisions often refer to the object and purpose of BITs. The object and purpose of these treaties are mostly tied to benefits of investors and host states, conditions for inducement of foreign investment and removal of obstacles that may stand in the way of foreign investment flow.

They also have similar provisions on the scope of application, entry and establishment of investment. They provide national or most favored nation treatment to foreign investors in host country; they have provisions on expropriation, compensation and dispute settlement.

Despite these similarities BITs have variety of approaches concerning issues of investment protection. There are two main models. The traditional “*admission model*” apply to investment only once it has been admitted into the host country in accordance with the latter’s domestic laws and regulations. A minority of BITs afford relatively little protection to foreign investment. Another category of BIT imposes a higher degree of discipline on the contracting parties compared to the previous categories. These BITs include commitments on certain issues often not covered by treaties based on the “*admission*” model, such as performance requirements, top managerial personnel, and, more recently, transparency.<sup>[50]</sup>

The basic structure of any BIT encompasses eight topics:

“A. Scope of Application

[46] Guzman supra note 9, p.640-654

[47] Available at [http://www.ustr.gov/assets/Trade\\_Sectors/Investment/Model\\_BIT/asset\\_upload\\_file847\\_6897.pdf](http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf).

[48] Ginsburg, T., International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance, *International Review of Law and Economics*, 2005, No.25, p.109

[49] Damrosch & Henkin & Pugh & Schachter & Smit, *International Law Cases and Materials*, 4th Edition, 2001, p. 809

[50] UNCTAD, *International Investment Rule Setting: Trends, Emerging Issues and Implications*, January 5, 2007 available at [http://www.unctad.org/en/docs/c2d73\\_en.pdf](http://www.unctad.org/en/docs/c2d73_en.pdf)

- B. Conditions for the Entry of Foreign Investment
- C. General Standards of Treatment of Foreign Investments
- D. Monetary Transfers
- E. Operational Conditions of the Investment
- F. Protection against Expropriation and Dispossession
- G. Compensation for Losses
- H. Investment Dispute Settlement”<sup>[51]</sup>

One of the most common standards of treatment found in BITs is an obligation that the host state country accord foreign investment “*fair and equitable treatment*”.<sup>[52]</sup> One may divide the “*general standard of treatment*” of most BITs into six component parts: 1. Fair and equitable treatment; 2. the provision of full protection and security; 3. protection from unreasonable or discriminatory measures; 4. national treatment; 5. most-favored-nation treatment; and 6. requirement to respect obligations made to investors and investments. An individual BIT may provide some or all of these treatment standards.<sup>[53]</sup>

US Model BIT of 2004 has a comprehensive provision on minimum standard of treatment different than some other recent Model BITs. Article 5(1) and 5(2) states:

“1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security.

2. For greater certainty, paragraph 1 prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments. The concepts of “*fair and equitable treatment*” and “*full protection and security*” do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights. The obligation in paragraph 1 to provide:

(a) “*fair and equitable treatment*” includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world; and

[51] Sullivan & Salacuse see at supra note 38 p.68

[52] see UK Model BIT, 2005, Article 2(2), Article 3  
US Model BIT, 2004 Article 5, Article 4, Article 3  
German Model BIT, 2005, Article 2(2), Article 3  
France Model BIT, 2006, Article 4, Article 5  
Chinese Model BIT, 2003, Article 3

See at Dolzer R. & Schreuer C. , Principles of International Investment Law, Oxford University Press, 2008, Annexes, p.352-419

[53] Sullivan & Salacuse see supra note 38 p.83

(b) “full protection and security” requires each Party to provide the level of police protection required under customary international law<sup>[54]</sup>

Expropriation provisions of BITs typically provides that a state may expropriate if only the expropriations is non-discriminatory, is for a public purpose, is performed with due process of law and compensation is paid. However, it is not clear what state measures amount to expropriation, except US Model BIT 2004, they simply refer to “measures having the effect of expropriation” and “measures tantamount to expropriation”. A representative sample of expropriation provisions in recent BITs is reproduced below:

The UK Model BIT (2005)	Article 5: “Investments . . . shall not be nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation . . .” <sup>1</sup>
German Model BIT (2005)	Article 4: “Investments . . . shall not directly or indirectly be expropriated, nationalized or subjected to any other measure the effects of which would be tantamount to expropriation or nationalization . . .” <sup>2</sup>
The United States Model BIT (2004)	Article 6: “Neither party may expropriate or nationalize . . . either directly or indirectly through measures equivalent to expropriation or nationalization . . .” <sup>3</sup>

Annex B of US Model BIT<sup>[55]</sup> on expropriation aims to define and give useful criteria to determine whether a measure of state amounts to expropriation or indirect expropriation:

Definition of Expropriation :	“An action or a series of actions by a Party cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in an investment.”
Definition of Direct Expropriation:	“Where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure.”

[54] See Dolzer R. & Schreuer C., supra note 2, Annexes p.390

[55] See Dolzer R. & Schreuer C supra note 2, Annexes p.418 also available at [http://www.ustr.gov/assets/Trade\\_Sectors/Investment/Model\\_BIT/asset\\_upload\\_file847\\_6897.pdf](http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf)

Definition of Indirect Expropriation:	"Where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure."
Criteria to Determine Indirect Expropriation:	<p>"The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:</p> <p>(i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;</p> <p>(ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and</p> <p>(iii) the character of the government action."</p>

Whether or not BITs provisions will find their way into customary international law or general principles of law is not clear yet. What is clear is that BITs have become a permanent part of the international system. They are attaining their goals and the process of creating an international law of investment has been evolving from a situation where the absence of appropriate custom prompted the criterion of over 2200 BITs, which in turn has led to the custom.<sup>[56]</sup>

### 3.3.2. NAFTA

Although some agreements include more superficial integration models, they have a considerable effect on foreign direct investment regulations. The North American Free Trade Agreement (NAFTA) between Canada, the United States of Mexico, and the United States of America is not only limited to developed countries, it is also applicable to other countries. Officially it is only a free trade area; it is not a common market on economic integration. The treaty aims at the free movement and liberalization of trade and investment. NAFTA is accepted as a special example of free trade agreements including foreign direct investment in its scope. Its provisions on foreign direct investment have influenced other agreements and regulations on the issue.

Chapter 11 of NAFTA specifically addresses the treatment of investments following its objectives stated at Article 102; to eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services; promote

[56] Sullivan & Salacuse see supra note 38 p.115

conditions of fair competition in the free trade area; increase substantially investment opportunities; create effective procedures for the resolution of disputes between an investor and the host government.<sup>[57]</sup>

In its substance Chapter 11 builds upon the treaty practice of the United States, including the treaty with Canada concluded in 1989.<sup>[58]</sup> Chapter 11 has three sections; in Section A (Articles 1101 to 1114) standards for treatment of investors, in Section B (Articles 1115 to 1138) rules on dispute settlement and in Section C definitions.

According to Article 1101, Chapter 11 applies to measures of a NAFTA state relating to “investors” of a NAFTA state and to “investments” by investors of a NAFTA state. In addition, Article 1106 (Performance Requirements) and 1114 (Environmental Measures) apply to all investments including domestic investments and investments from third countries.

According to Articles 1102 and 1103 NAFTA; parties must not treat NAFTA investors less favorable than they treat non-NAFTA investors and than domestic investors in like circumstances (Most-favored-nation treatment and National treatment). Moreover, NAFTA parties should accord to investments and investors of other parties in accordance with international law, fair and equitable treatment and full protection and security.<sup>[59]</sup>

NAFTA prohibits certain performance requirements for the establishment, acquisition, expansion, management, conduct or operation of an investment.<sup>[60]</sup> Article 1106 is also the only part of Chapter 11 to deal with the use of investment incentives. Article 1106 does not prevent a NAFTA party from using incentives. It simply restricts their ability to link the use of incentives to certain performance requirements.<sup>[61]</sup>

Article 1110(1) strongly guarantees investment protection:

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

- (a) for a public purpose;
- (b) on a non-discriminatory basis;
- (c) in accordance with due process of law and Article 1105(1); and

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[57] NAFTA Article 102(1) available at <http://www.nafta-sec-alena.org/DefaultSite/index.html>

[58] Dolzer R. & Schreuer C., supra note 2 p.29

[59] NAFTA Article 1105(1)

[60] NAFTA Article 1106 (1)

[61] Kurtz, J., Jean Monnet Working Paper, A General Investment Agreement in the WTO? Lessons from Chapter 11 of NAFTA and the OECD Multilateral Agreement on Investment, NYU School of Law, 2002, p.23

(d) on payment of compensation in accordance with paragraphs 2 through 6.”

The critical problem that has arisen with Article 1110 is that there is no clear definition of what will constitute an indirect expropriation (“*measure tantamount to expropriation*”). There is no guidance within NAFTA as to when legitimate governmental regulation which in some way adversely impacts on a foreign investor constitutes indirect expropriation.<sup>[62]</sup>

Even the jurisprudence on Article 1110 evolved on the basis of arbitral decisions<sup>[63]</sup> it is not the only provision in NAFTA which ensures investment protection. As mentioned above Article 1105 provides investors with a minimum standard of treatment “*in accordance with international law, including fair and equitable treatment and full protection and security*”. The problem was it was not clear what was the standard meant by “*fair and equitable treatment*” and “*full protection and security*”.

Then in 2001, formed the subject of a (below mentioned) Notes of Interpretation, which seemed to clarify the provision by way of stating that it was meant to refer to customary law rather than a higher standard.<sup>[64]</sup>

Notes of Interpretation stated that;

“Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

The concepts of “*fair and equitable treatment*” and “*full protection and security*” do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.

A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).”<sup>[65]</sup>

Following articles of Chapter 11 establishes a procedure by which a private investor of a party may bring a claim against another NAFTA party when any of the above mentioned commitments are not met.

The NAFTA investment dispute settlement procedure thus most closely resembles those that exist in the many bilateral investment treaties which have proliferated over the last twenty years.<sup>[66]</sup>

[62] Kurtz, J see at supra note, p. 60

[63] Dolzer R. & Schreuer C. , supra note 2 p.29

[64] Dolzer R. & Schreuer C. supra note 2 , p.29

[65] Notes of Interpretation of Certain Chapter 11 Provisions, NAFTA Free Trade Commission, July 31, 2001 available at <http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/NAFTA-Interpr.aspx?lang=en>

[66] Heindl, J., Toward a History of NAFTA's Chapter 11, Berkeley Journal of International Law, Vol.24:2, 2006, p. 675

### 3.3.3. Energy Charter Treaty

The Energy Charter Treaty was the first multilateral treaty containing substantive rules on foreign investment.<sup>[67]</sup> It was signed in Lisbon in 1994 following up on the non-binding “*European Energy Charter*” of 1991. It is a binding agreement between member states of the OECD and the former socialist countries.

The purpose of the agreement was to consolidate the political reform and stability of the former East Bloc, by bringing in Western capital and know-how to speed up modernization of the energy industries of those economies.<sup>[68]</sup>

The scope of the treaty is not limited to investment, it deals with many issues. It is a remarkable and unique document with its extremely detailed provisions containing on more peripheral issues such as competition law and policy.<sup>[69]</sup>

The investment related provisions of the treaty govern the conditions under which investments can be made with minimum risk.

Article 13(1) of the Treaty provides that investments of nationals of one party in the territory of another shall not be expropriated except where the expropriation is:

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

It provides that compensation under clause d “*shall amount to the fair market value of the investment expropriated at the time immediately before the expropriation or impending expropriation became known in such a way as to affect the value of the investment...*” Article defines “*expropriation*” to include nationalization and makes clear that full compensation is required for both.

The treaty thus also encompasses measures of “*creeping expropriation*” i.e. measures that collectively or cumulatively rather than individually take property.

The adoption of the “*Hull formula*” to the ECT is especially significant because it is the first multilateral agreement to adopt that formula and because

[67] Dolzer R. & Schreuer C. , supra note 2 p.27

[68] Brazell, L., The Energy Charter Treaty: Some Observations on its International Context and Internal Structure, *The Energy Charter Treaty : an East-West Gateway for Investment and Trade* / edited by Thomas W. Wälde, 1996, p.226

[69] Waelde, T., International Investment under the 1994 Energy Charter Treaty. Legal, Negotiating and Policy Implications for International Investors within Western and Commonwealth of Independent States/Eastern European Countries , *Journal of world trade* Vol. 29. No. 5. October 1995. p. 5-72.



the treaty governs the energy sector that has so often been the battleground for past expropriation disputes.<sup>[70]</sup>

Article 13(2) of the Treaty states that:

“The Investor affected shall have a right to prompt review, under the law of the Contracting

Party making the Expropriation, by a judicial or other competent and independent authority of that Contracting Party, of its case, of the valuation of its Investment, and of the payment of compensation, in accordance with the principles set out in paragraph (1).”

Under international law generally a state may not espouse a claim based on injury inflicted on its national by another state unless its national has first exhausted all administrative and judicial remedies available in the defendant state.<sup>[71]</sup> However Article 13(2) gives the investor the right but obligation to exhaust local remedies. According to article; investor is entitled to seek prompt review of the legality of the expropriation and the valuation of the expropriated investment by local authorities.

On the other hand, we see the obligation of “*the exhaustion of local remedies*” in article 21(5)(b) when the investor believes that a tax constitutes an expropriation. When taxes are at issue the investor alleging the expropriation, shall refer the issue to the relevant Competent Tax Authority. If an investor or a contracting state fails to refer to local tax authorities, arbitrators refer the issue back to the host state’s component tax authorities.

In addition to Article 13 there are other provisions on treatment and protection of investment. Article 10 of the Treaty provides that contracting parties shall not in any way impair by unreasonable or discriminatory measures, management, maintenance, use, enjoyment or disposal of investments. It also prohibits the parties to accord treatment less favorable than that required by international law, including treaty obligations.

Article 10(1) thus intended to establish a minimum standard of treatment for foreign investments.<sup>[72]</sup>

Finally, Articles 26 and 27 provide the general remedies for the disputes including expropriation. According to article 26(1) the disputes between a contracting state and an investor of another contracting state concerning the

[70] Norton, P.M., Back to the Future: Expropriation and the Energy Charter , The Energy Charter Treaty : an East-West Gateway for Investment and Trade / Edited by Thomas W. Wälde, 1996, p.366

[71] Damrosch & Henkin & Pugh & Schachter & Smit, International Law Cases and Materials, 4th Edition p.755

[72] Bamberger, C. See footnote 12 at Norton, P.M., Back to the Future: Expropriation and the Energy Charter , The Energy Charter Treaty : an East-West Gateway for Investment and Trade / Edited by Thomas W. Wälde, 1996, p.368

breach of an obligation under this treaty should be settled amicably. If amicably solution is not possible, the investor may choose to submit it for resolution to

- a) the courts or administrative tribunals of the host state, or
- b) in accordance with the applicable, previously agreed dispute settlement, or
- c) one of the possibilities provided in the article 26(4) which includes ICSID, ad hoc arbitration under UNICITRAL rules and Arbitration Institute of the Stockholm Chamber of Commerce.

Article 27 provides compulsory arbitration for the disputes between contracting states by an ad hoc tribunal under UNICITRAL rules. However most of the time investors choose to exercise dispute resolutions on behalf of themselves directly against the host state in the case of expropriation.

### **3.4. International law de lege ferenda**

#### ***3.4.1. OECD Draft Convention***

In the early 1960's, a number of Organization for Economic Co-operation and Development (OECD) countries prepared a draft Convention on the Protection of Foreign Investment which was revised and approved by the OECD in 1967 (the "*OECD Draft*").

The convention proposed an international minimum standard of protection for foreign investment but was opposed by developing countries, mainly in Latin America, that insisted on subjecting foreign investment to domestic control with disputes being settled in domestic courts.<sup>[73]</sup>

Article 3 of the OECD Draft provides that;

"No Party shall take any measures depriving, directly or indirectly, of his property a national of another Party unless the following conditions are complied with:

(i) The measures are taken in the public interest and under due process of law;

(ii) The measures are not discriminatory or contrary to any undertaking which the former Party may have given; and

(iii) The measures are accompanied by provisions for the payment of just compensation. Such compensation shall represent the genuine value of the property affected, shall be paid without undue delay..."

Article 1 of the Draft states that;

*"Each Party shall at all times ensure fair and equitable treatment to the property of the nationals of the other Parties. It shall accord within its territory the most*

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[73] Tobin & Ackerman, Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties, Yale Law School, Center for Law, Economics and Public Policy Research Paper No: 293, May 2, 2005, p.7

*constant protection and security to such property and shall not in a way impair the management, maintenance, use, enjoyment or disposal thereof by unreasonable or discriminatory measures...*"

The Draft indicates that “*the phrase ‘fair and equitable treatment’*”, customary in relevant bilateral agreements, indicates the standard set by international law for the treatment due by each State with regard to the property of foreign nationals . . . The standard required conforms in effect to the “*minimum standard*” which forms part of customary international law.”<sup>[74]</sup>

The OECD Draft failed to gain sufficient support among OECD countries for adoption but it served as an important model for later BITs established by European countries and the United States.

### **3.4.2. MAI Draft Negotiating Text**

The Multilateral Agreement on Investment (MAI) negotiations were launched by governments at the Annual Meeting of the OECD Council at Ministerial level in May 1995. Participants were the governments of all OECD countries at that time — Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States—as well as the European Communities.<sup>[75]</sup> Argentina, Brazil, Chile, and Hong-Kong, China participated as observers from an early stage. Estonia, Latvia, Lithuania, and the Slovak Republic were later also invited as observers.<sup>[76]</sup>

While 29 OECD countries were busy negotiating, more than 600 organizations in 70 countries expressed vehement opposition to the treaty. MAI was denounced as a major and immediate threat to democracy, sovereignty, the environment, human rights, and economic development. It was claimed that the MAI would give corporations the “*sovereign power to govern countries*” make elected governments “*their compliant puppets*”.<sup>[77]</sup>

[74] Mayeda, G., Playing Fair: The Meaning of Fair and Equitable Treatment in Bilateral Investment Treaties, *Journal of World Trade*, Vol.42 No:2, 2007, p.280

[75] OECD countries share “*principles of the market economy, pluralist democracy and respect for human rights.*” OECD, Membership, available at <http://www.oecd.org/about/general/member-countries.htm>

[76] OECD, Multilateral Agreement on Investment, Documentation from the Negotiations, Introduction available at <http://www1.oecd.org/daf/mai/intro.htm>

[77] Kobrin, S.J., The MAI and the Clash of Globalizations, *Journal of Foreign Policy*, Washington, DC, No.112, 1998, p.98

In April 1998 as a result of those significant concerns and opposition, he OECD indefinitely suspended further negotiations on the agreement<sup>[78]</sup> and released what it called the “MAI Negotiating Text” which was a consolidation of the text of the agreement considered in the course of the MAI negotiations.<sup>[79]</sup> On December 3, 1998 the OECD announced that negotiations on the MAI were no longer taking place.<sup>[80]</sup>

The primary objective of the MAI was “to establish a broad multilateral framework for international investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement procedures” and it was to be a “free standing international treaty, open to all OECD Members and the European Communities, and to accession by non-OECD Member Countries”<sup>[81]</sup> The MAI was willing to establish a framework for international investment which the GATT established for international trade.

The MAI Negotiating Text as of 22 April 1998 has the following provisions on investment protection:

“1. Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favorable than the treatment it accords [in like circumstances] to its own investors and their investments with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments.

2. Each Contracting Party shall accord to investors of another Contracting Party and to their investments, treatment no less favorable than the treatment it accords [in like circumstances] to investors of any other Contracting Party or of a non-Contracting Party, and to the investments of investors of any other Contracting Party or of a non-Contracting Party, with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment, and sale or other disposition of investments.”<sup>[82]</sup>

The expropriation and compensation provisions of Article IV.2.1 of the MAI Negotiating Text and Commentary as of April 22, 1998 provide:

“A Contracting Party shall not expropriate or nationalize directly or indirectly an investment in its territory of an investor of another Contracting Party or

[78] OECD News Release, October 23, 1998 available at [http://www.oecd.org/news\\_and\\_events/release/nw98-101a.html](http://www.oecd.org/news_and_events/release/nw98-101a.html)

[79] Wagner, J.M., International Investment, Expropriation and Environmental Protection, Golden Gate University Law Review, 1999, Vol.29, p.480

[80] OECD News Release December 3, 1998 available at <http://www.oecd.org/daf/cmisi/mai/mainindex.htm>

[81] MAI Consolidated Text and Commentary, April 1998 Preamble available at <http://www1.oecd.org/daf/mai/pdf/ng/ng971r2e.pdf>

[82] MAI Consolidated Text and Commentary, April 1998 available at <http://www1.oecd.org/daf/mai/pdf/ng/ng971r2e.pdf>

take any measure or measures having equivalent effect (hereinafter referred to as “expropriation”) except:

- a) for a purpose which is in the public interest,
- b) on a non-discriminatory basis,
- c) in accordance with due process of law, and
- d) accompanied by payment of prompt, adequate and effective compensation in accordance with Articles 2.2 to 2.5 below.”

Including mentioned above expropriation provision, the fundamental provisions of MAI are similar to those of NAFTA. MAI provisions on dispute settlement provides both state-to-state and investor-to-state dispute settlement procedures<sup>[83]</sup> which is again parallel to NAFTA dispute settlement procedure.

Although some newspapers proclaimed that the internet and the anti-MAI forces had sunk the MAI, the negotiators’ inability to agree also played an important role. The short preamble to the treaty, for example, contains 17 footnotes expressing the concerns of one or more delegations.<sup>[84]</sup>

### 3.5. Result

Today, there is a lack of a clear and comprehensive international document covering all aspects of foreign investment. Efforts at multilateral treaties containing the substantive rules of investment protection have failed. It is not possible to clearly determine the certain rules in the area. Although there is a general international framework, it can be described as a patchwork of international investment norms and instruments proceeding at different levels.

As a summary, substantive standard for investment protection is that a taking must be for a public purpose, in a non-discriminatory way and against the payment of compensation but there is no universal agreement relating to the manner of assessment of the compensation due. With regard to procedural protection; in the past there was no international protection. UN Resolution 3281, Charter of Economic Rights and Duties of States, provided an obligation to settle disputes under the domestic law of the host state and by its tribunals. However, today foreign investors are able to benefit from international procedural protection.

The claims relating to norms of an international law of foreign investment can be accepted as principles of international law only if they are based on the

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[83] MAI Consolidated Text and Commentary, April 1998 see at supra note

[84] Kobrin, S.J. see at supra note..80 p.100

accepted sources of public international law. These sources of international law are stated in Article 38(2) of the Statute of the International Court of Justice.<sup>[85]</sup>

Consequently, although the standards in investment law are high and precise; the lack of a multilateral consensus results in a patchwork of the current norms remaining with its gaps.

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## 4. INTERNATIONAL ARBITRATION PRACTICE ON STATE MEASURES AFFECTING ACTS ON FOREIGN INVESTORS' PROPERTY RIGHTS

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### 4.1. EXPROPRIATION

Under international law every state has a right to regulate property within its territorial sovereignty. As a general rule all contractual and property rights are subject to domestic law of that state. States are free to expropriate property within their borders, to permit or restrict commerce with other states, to discriminate in their trade relations and to regulate their own currency. These rules are passive in character; they support the principle of freedom of state action from limitations imposed by international law.<sup>[86]</sup>

Expropriation is the most severe form of interference with property. All expectations of the foreign investor are destroyed in case the investment is taken without adequate compensation. As a classical rule of international law, expropriation may be practiced by all states as regards the property of foreigners established in their territory. Indeed state practice has considered this right to be so fundamental that even modern investment treaties respect this position. Treaty law typically addresses only the conditions and consequences of expropriation, leaving the right to expropriate as such unaffected.<sup>[87]</sup>

Over the past many decades expropriation occurred sometimes as spontaneous events or sometimes as a result of revolution or extreme political events. Conception of property was originally regarded as an absolute right. This aspect has been considerably modified. The absolute right is replaced by a right that is conditioned more and more by needs of the community.<sup>[88]</sup> It

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[85] Sornarajah, M., supra note 3 p.72

[86] Zamora, S., *Is There Customary International Economic Law?*, p.34, reproduced in Prof. Hoffmeister's PILC 2007-2008 Session Lecture Materials

[87] Dolzer R. & Schreuer C. , supra note 2, p. 89

[88] Freidman, S. , *Expropriation in International Law*, The London Institute of World Affairs, 1953 p.5

is now well accepted that, under customary international law, states have the right to expropriate foreign-owned property located within their territories<sup>[89]</sup>.

However the exercise of this power is subject to some conditions. International law attempts to ensure a balance between the rights of the investor, to be compensated for property taken, and of the state, to regulate the property within its territory. Classical requirements for a lawful expropriation, are public purpose, non discrimination, prompt, adequate and effective compensation which will be discussed in the section 3.1.2. .

#### **4.1.1. Lawful Expropriations**

International law is a continuous process of authoritative decision making, through which the members of a community of independent sovereign states chart and implement their common interests. According to this view, the absence and effectiveness of states' international obligations is determined at least as much by expectations and interests as by the legal requirement to do so.<sup>[90]</sup>

The distinction between lawful and unlawful expropriations goes back at least to Chorzow Factory case. The distinction lies in the remedies to which the investor is entitled. Chorzow Factory indicates that "*restitutio in integrum*" i.e., restoration of tangible assets or specific performance of a contract, is available when the expropriation unlawful but not otherwise.<sup>[91]</sup> By contrast compensation for a lawful expropriation should represent the market value at the time of taking. The difference will mainly concern the amount of lost profits.<sup>[92]</sup>

Also it is possible to say that a state has unlawfully expropriated a foreign investment by for example; violating a stabilization clause or discriminating for political reasons in its expropriation. "*Many of the most controversial expropriations of the Twentieth Century have involved the abrogation of contractual rights, rather than the taking of tangible assets.*"<sup>[93]</sup> The use of stabilization clauses has given rise to the question whether the breach of the clause amounts to not only a compensable expropriation but also an unlawful expropriation. If however, the investor have been paid the "*fair market value*" of its investment, it is hard to imagine the investor bringing a claim against the expropriating state for

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[89] Akinsaya, A.A., The Expropriation of Multinational Property in the Third World, 1980, p.17

[90] Brazell, see supra note 10, p.227

[91] Sohn & Baxter, Recent Codifications of the Law of State responsibility for Injuries to Aliens, 1974, p.133

[92] Dolzer R. & Schreuer C. see at supra note 2, p. 92

[93] Norton, P.M., Back to the Future: Expropriation and the Energy Charter , The Energy Charter Treaty : an East-West Gateway for Investment and Trade / Edited by Thomas W. Wälde, 1996, p. 371

“*restitutio in integrum*” or a tribunal ordering the state to allow a foreign investor to continue to use the assets in its territory.<sup>[94]</sup>

Today it is generally accepted that lawful expropriation is subject to three conditions<sup>[95]</sup>. These requirements are contained in most treaties. They are also seen to be part of customary international law.

- The rule of non discrimination
- Principle of public utility
- Prompt, adequate, and effective compensation. Adequate compensation is generally understood today to be equivalent to the market value of the expropriated investment.

In addition to these conditions, some treaties explicitly require that the procedure of expropriation must follow principles of due process. Due process is an expression of the minimum standard under customary international law ad of the requirement of fair and equitable treatment.<sup>[96]</sup>

The procedure is applied to a certain property. This principle is frequently embodied in provisions of a constitutional character, sometimes in ordinary legal rules and nowadays in most of the BITs. Before examining the conditions for lawful expropriation, it is necessary to define “*property*” and the “*foreign character of the property*”:

### ***Property***

Property or the ownership of a specific subject is a legal status which is created by the municipal law of each state. “*Initially the definition of the property was said to include all movable and immovable property, whether tangible or intangible, including industrial, literary and artistic property as well as rights and interests in any property*”<sup>[97]</sup> but not rights derived from contracts. However the definition has been extended to include contractual rights.

In the modern investment context, many investment decisions are accompanied and protected by specific investment agreements, with the host state, often covering matters such as taxation, customs regulations, the right and duty to sell at a certain price to host state or pricing issues. Practically all investment

[94] Lillich, R.B. , International Law of State responsibility for Injuries to Aliens, 1983, p.61 in Norton, see supra note. 92, p. 374

[95] Kronfol, Z.A. , Protection of Foreign Investment, A Study in International Law, 1972, p.24-27

[96] Dolzer R. & Schreuer C. see at supra note 2, p. 91

[97] 1961 Harvard Draft Convention, Art. 10(7) in Wallace, see supra note 16, p. 202



treaties state that contracts are covered by the term “*investment*”. It follows that contracts are protected against expropriation.<sup>[98]</sup>

For example, the tribunal in *Siemens v. Argentina* case, on the basis of BIT between Argentina and Germany, stated that:

“*The contracts fall under the definition of “investments” under the Treaty and Article 4(2) refers to expropriation or nationalization of investments. Therefore, the State parties recognized that an investment in terms of the Treaty may be expropriated. There is nothing unusual in this regard. There is a long judicial practice that recognizes that expropriation is not limited to tangible property.*”<sup>[99]</sup>

There are of course different explanations of the right to property in municipal systems. There is no definition of a theory of property in international law itself. It relies on municipal law for the recognition of property. The right to property is guaranteed by constitutions of many states.

But the notion of property does not remain static. Both the function of property as well as the function of the state has undergone a radical transformation in the European legal systems to require a concept of property that extends beyond the protection of the physical assets.<sup>[100]</sup> As the state interference by regulatory measures increased the acts of the states did not solely affect the physical assets but also the rights incidental upon property. This has given rise a change in the notion of property. Property has come to be regarded as “*as a bundle of intangible rights*”<sup>[101]</sup>.

Sornarajah argued that, there was a need for the transfer of those changing rations of property on to the international scene due to the increase in administrative controls instituted in the developing countries over the process of foreign investment.<sup>[102]</sup> But actually the real ground for that kind of transfer could be nothing else than the dominant ideology of the industrialized states, which are the owner of the lion’s share in the world economy, to transfer their own domestic law on to the international scene.

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[98] Dolzer R. & Schreuer C. see at supra note 2, p. 116

[99] *Siemens A.G. v. Argentina*, ICSID Case No. ARB/02/08, Award, February 6, 2007, available at <http://ita.law.uvic.ca/documents/Siemens-Argentina-Award.pdf>, para. 267

[100] Sornarajah, M., supra note 3 p.293-294

[101] Horowitz, M. *The Transformation of American Law 1870-1960*, 1992, p.146 in Sornarajah, see supra note 3

[102] See Sornarajah, supra note 3, p.297

### ***Foreign Character of the Property***

The property must have a foreign character since the international law is not concerned with the interference by a state to its own national's property which stays in the jurisdiction of that state.

For purposes of expropriation, foreign property is property belonging to a foreign national possessing a certain connection with the territory in which expropriation takes place and with the property expropriated. Therefore the mere fact that a person possesses the character of a foreign national is not a sufficient criterion for determining whether he may be the object of expropriation in international law.<sup>[103]</sup>

#### ***4.1.2. Conditions for a Lawful Expropriation***

There is a general view in international law that the expropriation of a foreign investment will be lawful only if such expropriation is for a public purpose, not discriminatory and accompanied by compensation. "*The first two requirements are generally accepted. As regards the third, it too is widely accepted in principle, but there is no universal agreement relating to the manner of assessment of the compensation due*"<sup>[104]</sup>. As mentioned in Chapter 2, international investment law instruments such as bilateral investment treaties, NAFTA and Energy Charter Treaty roughly introduce similar conditions. Requirement of a "*public purpose*", "*non-discrimination*" and "*compensation*" are dealt with in this section:

##### ***4.1.2.1. Public Purpose***

It is generally accepted that to decide what is in public interest is left to host state's determination. This view was taken by the tribunal in Goetz and Others v. Republic of Burundi case. Tribunal held that "*In the absence of an error of fact or law, of an abuse of power or of a clear misunderstanding of the issue, it is not the Tribunal's role to substitute its own judgment for the discretion of the government of Burundi of what are 'imperatives of public need ... or of national interest'*"<sup>[105]</sup>

Challenges to expropriations on the ground that they are not for a public purpose have been rare and in no case has property been ordered restored to its former owner because the expropriation was considered to be for other

[103] See Freidman, *supra* note 91, p. 163-166

[104] UN Conference on Trade and Development, Taking of Property, UNCTAD Series on issues in international investment agreements, 2000, p.10 available at <http://www.unctad.org/en/docs/psiteitd15.en.pdf>

[105] Goetz and Others v. Republic of Burundi, ICSID Case No. ARB/95/3, Decision on Liability, September 2 1998, para 126 available French version at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC537\\_Fr&caseId=C151](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC537_Fr&caseId=C151)

than a public purpose.<sup>[106]</sup> Because the state regulation of private property is so commonplace that it would be difficult for tribunals to determine what is in host state's public interest. But the requirement continues to stay in most of the bilateral investment treaties.

Similarly, European Court of Human Rights deciding whether the taking had a public purpose, held that in general state reasons would be accepted, however not in cases of abuse. The court said:

*"The Court finding it natural that the margin of appreciation available to the legislature in implementing social and economic policies should be a wide one, will respect the legislature's judgment as to what is "in the public interest" unless the judgment be manifestly without reasonable foundation."*<sup>[107]</sup>

But still there are some arbitral decisions although considering that content of public interest are left to host state, they examine the policy taken by the states based on the requirement of a public purpose. Marvin Feldman v. Mexico case concerns a dispute regarding the application of certain tax laws by Mexico to the export of tobacco products by a company owned by the claimant. The Claimant alleges that Mexican government policy is designed to prevent cigarette resellers including claimant's company from exporting cigarettes from Mexico to other countries, and such measures do not have a valid public purpose.

The tribunal was reluctant to give excessive weight to the public purpose<sup>[108]</sup> and referred to the Third Restatement of the Law of Foreign Relations of the United States. According to the Restatement, the public purpose requirement *"has not figured prominently in international claims practice, perhaps because the concept of public purpose is broad and not subject to effective reexamination by other states."*<sup>[109]</sup>

However in the following paragraphs the tribunal nevertheless examined the relation of Mexico's policy with the public interest and held that:

*"...there are rational public purposes for this policy. These include, inter alia, discouraging "grey" market exports and seeking to control illegal re-exportation of Mexican cigarettes into Mexico. There is ample evidence on the record to suggest that cigarette smuggling is a significant problem for Mexico...It is undeniable,*

[106] See Damrosch & Henkin, & Pugh & Schacter & Smit at supra note 8, p. 779

[107] James Case, 1988 in Sornorajah see supra note 3, p.318

[108] Marvin Roy Feldman Karpa v. United Mexican States, ICSID Case No. ARB(AF)/99/1, Award December 16, 2002, para.135 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587\\_En&caseId=C175](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587_En&caseId=C175)

[109] American Law Institute, Restatement of the Law Third, the Foreign Relations of the United States, USA, American Law Institute Publishers, Vol. 1, 1987 in Marvin Feldman see supra note 111, para 99

as both parties in this proceeding have recognized, that smuggling of cigarettes is a serious problem not only for Mexico but for many other nations.”<sup>[110]</sup>

#### **4.1.2.2. Non-Discrimination**

The measure must not be arbitrary or discriminatory within the generally accepted meaning of the terms. Discriminatory expropriation of a foreign investment by a state violates majority of investment agreements including Article 1105 of NAFTA, Article 13(1)/b of Energy Charter Treaty, Article 14 of ECHR and provisions of all BITs. A racially discriminatory taking is unlawful in international law the principle against racial discrimination is a *ius cogens* principle of international law.

“*Discrimination implies unreasonable distinction. Takings that invidiously single out property of persons of a particular nationality that are rationally related to the state’s security or economic policies might not be reasonable.*”<sup>[111]</sup> In fact as the issue of regulatory expropriation increases any expropriation that amounts to discriminatory or arbitrary action, or any action without legitimate justification is considered to be contrary to non-discrimination requirement even it is not on the basis of nationality i.e. discrimination due to process or payment of compensation.

#### **4.1.2.3. Compensation**

##### ***General Problems Relating to Compensation***

It is well recognized under international law that for a lawful expropriation, state must pay compensation for expropriated foreign property. The standard of compensation is the most controversial issue relating to expropriation whether it is to be determined under international law.

During the nineteenth century the right to property was protected at the very high level. A State was able to take the private property with the obligation to pay full compensation and only by reason of public purpose. Furthermore the content of the public purpose was being interpreted in such a limited way. However, with the changing circumstances of twentieth century state interference especially nationalizations had extremely increased i.e. nationalizations in Russia after the revolution and nationalizations in Mexico and Spain after the Second World War. States which are taking expropriation measures were having difficulties to fulfill the “*full compensation*” obligation.

[110] See Marvin Feldman case at supra note 111, paras. 115, 136

[111] See American Law Institute, Restatement of the Law Third, the Foreign Relations of the United States, § 712, Comment f in Damrosch & Henkin, & Pugh & Schacter & Smit at supra note 8, p. 779

Under these circumstances “*prompt, adequate and effective*” compensation formulation which is also known as “*Hull formula*” has become valid from an international point of view. This standard has been recognized by all developing countries and by most of the BITs.

However; developing countries relied on Resolution 3171 (XXVIII 1974) on Permanent Sovereignty over Natural Resources and Charter of Economic Rights and Duties of States affirming that determination of compensation and any dispute which might arise should be solved according to host state’s relevant laws and regulations. Many developing countries, socialist states and the Latin American countries supported the view that compensation should be determined under national law.

On the other hand U.N. General Assembly Resolution 1803 (XVII 1962) on Permanent Sovereignty over Natural Resources proposed a mixed solution to the problem affirming that both international law and domestic law of the state should be taken into consideration while determining the compensation. It refers to “*appropriate compensation*” in accordance with the rules in force in the state taking such measures in the exercise of its sovereignty and in accordance with international law. This decision was recognized as a reflection of customary international law. The “*appropriate compensation*” criterion was referred as a rule of customary international law in Texaco case<sup>[112]</sup> World Bank Guidelines 1992 on Foreign Investment also refers to “*appropriate compensation*” and affirms that the term appropriate should be interpreted as prompt, adequate and effective compensation.<sup>[113]</sup>

Today these debates are over and most BITs and other treaties for the protection of investments refer often to the expropriated investment’s fair market value<sup>[114]</sup>. For example US Model BIT 2004 provides: “*The compensation... shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place...*”<sup>[115]</sup>

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[112] Texaco Overseas Petroleum Co. And California Asiatic Oil Co. v. Government of the Libyan Arab Republic in Tiryakioglu, B. , The Protection of Foreign Direct Investment under International Law, Ankara, 2003, p.218

[113] World Bank Guidelines Vol.II, Legal Framework for the Treatment of Foreign Investment, 1992, p.41 available at [http://www.wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/1999/11/10/000094946\\_99090805303082/Rendered/PDF/multi\\_page.pdf](http://www.wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/1999/11/10/000094946_99090805303082/Rendered/PDF/multi_page.pdf)

[114] NAFTA Article 1110(2), Energy Charter Treaty Article 13(1)

[115] US Model BIT 2004 Article 6(2)b

Also nearly all expropriation cases<sup>[116]</sup> before the tribunals follow the treaty based standard of compensation in accordance with the “*fair market value*”.<sup>[117]</sup> Fair market value is the amount that a willing buyer would pay to willing seller in a free market. It is different than the intrinsic value that may be based on different individuals’ different preferences and several circumstances. This valuation is based on the active actors of a free market.

However, for some assets such a circumstance does not exist and there can be no market price.<sup>[118]</sup> In that situation market value may be fiction, especially where a market for large and complex investment does not exist. Therefore, market value is determined often on the basis of future prospects or earning capacity of the investment.<sup>[119]</sup>

Discount cash flow (DCF) method can be used to determine the market value. This method requires the projection of the future receipts expected by the enterprise after deducting the costs associated with the making of the receipts.<sup>[120]</sup> Meaning that, an estimate of the price that might be expected if a market were to exist can then be made by discounting an estimated future net cash flow to produce a present value.<sup>[121]</sup>

While calculating the value of any asset, there might be many circumstances to be taken into account. There is not just one absolute value of the asset. Another variation used in investment agreements that do not adopt Hull formula is an explicit reference to the “*book value*” method of valuation.<sup>[122]</sup> Book value of assets represents the difference between the corporation’s assets and liabilities, as stated in its books.<sup>[123]</sup>

Another debated issue is the different effects of compensation requirement on lawful expropriations and unlawful expropriations. The obligation of compensation also exists for a state which unlawfully expropriates. As mentioned above in Chorzow Factory case, it is accepted that for unlawful expropriations preferential obligation is *restitutio in integrum* but “*in practice it is generally*

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[116] See *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre and Government of Ghana*, Award on Jurisdiction and Liability, October 27, 1989

See *SPP v. Egypt*, Award, May 20, 1992 at para. 97

See *Compania del Desarrollo de Santa Elena S.A. v. Costa Rica*, Award, February 17, 2000, at para 70

[117] Dolzer R. & Schreuer C. *supra* note 2 p. 274

[118] Penrose & Joffe & Stevens, Nationalisation of Foreign-Owned Property for a Public Purpose : An Economic Perspective on Appropriate Compensation, *The Modern Law Review* Vol. 55, May 1992, p.363

[119] Dolzer R. & Schreuer C. *supra* note 2 p.274

[120] Sornarajah *supra* note 3 p.413

[121] Penrose & Joffe & Stevens *supra* note 121 p. 363

[122] UNCTAD *supra* note 107 p.14

[123] Sornarajah *supra* note 3 p.413

admitted that *restitutio in integrum* is possible only in exceptional cases and that in the overwhelming majority of cases the responsibility of the state is discharged by the payment of pecuniary compensation.”<sup>[124]</sup> However, in lawful expropriations different principals are applied. The ground on which the compensation is founded in this case is unjust enrichment and state is not under the obligation of *restitutio in integrum* but only lies under the obligation to pay compensation<sup>[125]</sup>.

Nevertheless there is a difference in the measure of compensation between unlawful and lawful expropriations. The state unlawfully interfering with the property of foreign investor must pay a full compensation i.e. if the unlawful taking emanates from racial discrimination compensation would include the investors loss (*damnum emergens*) and prospective profits (*lucrum cessans*).<sup>[126]</sup>

When an illegal act has been committed “*the first step in the determination of the amount of compensation in any particular case is assessment of the damages for which the compensation is to be paid. One difficulty in assessing damages is that international claims are usually presented in greatly exaggerated amounts.*”<sup>[127]</sup> Unless otherwise provided by agreement or statute, “*the compensation of damages for loss is based upon the difference in value of the property before and after the damages occurred.*”<sup>[128]</sup> This subjective method includes any consequential damage but also incidental benefi<sup>[129]</sup>ts arising as a consequence of the illegal act.

“*One method to calculate damages would be to look at the replacement value of property that has been taken or destroyed. This presupposes that the equipment in question is actually replaceable. If the illegal act results in deprivation of income, damages may have to include lost profits. Lost profits will be awarded only if they are not speculative, that is, in cases where the investment has a record of profitability or there are other clear indicators of future profits.*”<sup>[130]</sup>

In practice it is rare to see the cases where the total damage of the investor is paid as compensation.

Finally, according to Hull formula compensation must be paid “*immediately before the expropriation or impending expropriation became known in such a way as to affect the value of the investment.*”<sup>[131]</sup> International tribunals have ruled that compensation be paid “*le plus rapidement possible*”, or “*within a reasonable*” time

[124] Kronfol at supra note 98, p. 99, 100

[125] Kronfol at supra note 98, p.96

[126] Tiryakioglu, B., *The Protection of Foreign Direct Investment under International Law*, Ankara, 2003, p.220

[127] Kronfol at supra note 98, p.100

[128] Kronfol at supra note 98, p.101

[129] Dolzer R. & Schreuer C. supra note 2 p. 272

[130] Dolzer R. & Schreuer C. supra note 2 p. 273

[131] Energy Charter Treaty , Article 13(1)

or in “*due time*”.<sup>[132]</sup> But in practice this formula is applied in a more flexible manner. It is expected from expropriating state that the compensation should be paid “*without undue delay*”<sup>[133]</sup>.

#### 4.2. Measures having similar effect to expropriation or Indirect Expropriation

Direct expropriations have become considerably rare when comparing with the increasing number of indirect expropriation acts. The need to attract foreign capital and technology have led the states expropriate foreign investments indirectly as “*they do not wish to be perceived internationally as posing a frequent or arbitrary threat of expropriation*”.<sup>[134]</sup> Therefore it is anticipated that foreign investments may be expropriated “*indirectly through measures tantamount to expropriation or nationalization*”.<sup>[135]</sup>

Measures having similar effect to expropriation comprise obvious indirect expropriations with the intention of expropriation, creeping expropriations and regulatory acts affecting the property rights of the foreign investors-regulatory expropriations. Furthermore it includes “*an egregious failure to create or maintain the normative “favorable conditions” in the host state.*”<sup>[136]</sup> It is very difficult to state precisely indirect expropriation as there is a lack of formal definition. There are many different criteria used to determine whether a regulatory measure of the state is considered as an indirect expropriation. Notwithstanding there is an obvious extension of the concept of indirect expropriation since 1980s, resulting from the tribunal decisions and bilateral investment treaties.

In NAFTA, the issue is addressed in Article 1110 Expropriation and Compensation:

“1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment (“expropriation”), except...”

Other international documents dealing with protection of foreign investment (Mentioned under Chapter 2) include provisions on indirect expropriation as well. Most of the BITs also contain provisions on indirect expropriation and accords it at the same legal treatment as direct expropriation or nationalization. Some of them do not contain a definition or criteria but just a general reference of indirect expropriation which causes different interpretations of the concept.

[132] See Kronfol at supra note 98, p.28

[133] OECD Draft Convention on The Protection of Foreign Property 1967 , Article 3

[134] Reisman, W. M.,& Sloane, R.D., Indirect Expropriation and Its Valuation in the BIT Generation, 2004, British Yearbook of International Law, vol.74, p.118

[135] U.S. – Russia BIT. Art.3(1) at supra note 7, p.118

[136] See Reisman & Sloane, supra note 137, p.119



To limit the possible interpretations of the indirect expropriation concept, the latest models of North American BITs contain, in an appendix, useful criteria for assessing whether a regulatory measure amounts or not to an indirect expropriation, based on lessons learned from the NAFTA cases.<sup>[137]</sup>

Some tribunals have referred to the investor's expectations as a core factor in deciding that an investment has been indirectly expropriated by the state respondent; others, particularly in some of the most recent awards, have referred to the investor's expectations as being a core indicator as to whether there has been a failure to accord "*fair and equitable treatment*" to the investor, often in circumstances where there was no accompanying finding of expropriation. In other cases where the supposed expectations of the investor were disappointed as a result of state conduct, tribunals have nevertheless found that there has been no breach of the expropriation or "*fair and equitable*" provisions of the applicable treaty.<sup>[138]</sup>

Sometimes only the effect of a regulatory measure is taken into account but not its purpose. For example in the ICSID Case *Metalclad v United Mexican States*, the refusal by the host state's authorities to issue a license for dangerous waste disposal was considered by the tribunal as measures having similar effect to expropriation under NAFTA Article 1110, since those actions "*effectively and unlawfully prevented the Claimant's operation of the landfill.*"<sup>[139]</sup>

#### 4.2.1. *Sole Effect Doctrine*<sup>[140]</sup>

To understand a general meaning of measures having similar effect to expropriation, findings of the doctrine and the case law are needed to be taken into account. According to most of the authors, the basic element in an indirect expropriation is the substantial loss of control or economic value of a foreign investment, although there is no dispossession actually taking place. For example Dolzer defined indirect expropriation as "*a deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected.*"<sup>[141]</sup>

[137] Radu, A., Foreign Investors in the EU-Which "*Best Treatment?*" Interactions Between Bilateral Investment Treaties and EU Law, 2008, *European Law Journal*, v.14, no.2, p.256

[138] Pieta, S., Expropriation and the "*Fair and Equitable*" Standard, *Journal of International Arbitration*, 2006, p.375

[139] *Metalclad Corp. v. United Mexican States*, ICSID (Additional Facility) Case No. ARB (AF)/97/1, Award Aug. 30, 2000, available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542\\_En&caseId=C155](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542_En&caseId=C155)

[140] Dolzer, R., Indirect Expropriations: New Developments?, 2002, *N.Y.U. Environmental Law Journal* v.11, p.87

[141] Dolzer, *supra* note 143, p.88

According to sole effect doctrine the intent of the host state's authority is not important. What is to be considered is the measure taken by the state and its effects on the investors' property rights. In other words, whether the host state interferes with the investor's property rights with the aim of mere limiting the use of the property or acts with the purpose of protecting a public good is not considered.

The Iran- U.S. Claims Tribunal, for example, has repeatedly held that "the intent of the government (concerning expropriation) 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."<sup>[142]</sup>

The ICSID Case *Metalclad v United Mexican States* is a primary example of indirect expropriation based on the "*sole effect doctrine*". The dispute arose from the construction, by an enterprise owned and controlled by Metalclad, of a landfill in Guadalucazar in the central Mexican state of San Luis Potosí, designed for the confinement of hazardous waste from the area. Metalclad concluded an agreement with federal environmental agencies setting forth the conditions under which the landfill would operate. However, the local municipality issued a denial of a construction permit for the landfill which had been requested thirteen months earlier. The municipality then challenged the agreement Metalclad had concluded with federal agencies and obtained a judicial injunction which prevented the operation of the landfill through May 1999. The Tribunal award that, by permitting the actions of the municipality, Mexico had taken measures having similar effect to expropriation of Metalclad's investment under NAFTA Article 1110, since those actions effectively and unlawfully prevented the Claimant's operation of the landfill.

In this specific case, the tribunal found that the arbitrary denial of a construction permit and the adoption of an "*ecological decree*" establishing a protected area in the project site amounted to indirect expropriation, as they prevented the operation of the investor's waste management facility.<sup>[143]</sup>

The tribunal also noted that:

*"expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favor of the host state, but also covert and incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant*

[142] Reisman & Slaone, see supra note 137, p. 120

[143] Cotula, L., *Regulatory Takings, Stabilization Clauses and Sustainable Development*, 2008, OECD Global Forum on International Investment, OECD Investment Division, p.4 available at <http://www.oecd.org/dataoecd/45/8/40311122.pdf>

part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.”<sup>[144]</sup>

A Canadian court reviewing this decision found that the Metalclad Tribunal “gave an extremely broad definition of expropriation for the purposes of Article 1110.”<sup>[145]</sup> U.S commentator William S. Dodge criticized the judgment as being not so clear and persuasive and that the tribunal could hardly have written an award more favorable to foreign investors.<sup>[146]</sup>

In the United Nations Conference on Trade and Development it is stated that “indirect expropriation occurs when a country takes an action that substantially impairs the value of an investment without necessarily assuming ownership of the investment. Accordingly, indirect expropriation may occur even though the host country disavows any intent to expropriate the investment.”<sup>[147]</sup> Besides the sole effect doctrine, there are other approaches to determine whether measures taken by host state amounts to indirect expropriation. These approaches are dealt within the doctrine and the ICSID case law:

#### **4.2.2. Appropriation Approach<sup>[148]</sup>**

The appropriation approach requires an actual acquisition by the host state in order to accept the existence of indirect expropriation. Even the sole effect doctrine is still dominant, this approach is accepted by some of jurists and of tribunal awards. Such analysis suggests that state responsibility for expropriation is based on the principle of “unjust enrichment”.<sup>[149]</sup>

The appropriation approach holds for a narrower meaning of expropriation as it also considers whether there is an acquisition, use or control of the property by the public authority besides the effects of the measures taken.

Some recent awards take acquisition as a basis of expropriation. In Eudora A. Olguin v. Republic of Paraguay case where the dispute arose from the bankruptcy of a Paraguayan financial institution in which Mr. Olguin had made deposits of over one million dollars, for the purpose of setting up a food

[144] Metalclad Corp. v. United Mexican States, ICSID (Additional Facility) Case No. ARB (AF)/97/1, Award Aug. 30, 2000, para.103 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542\\_En&caseId=C155](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542_En&caseId=C155)

[145] Dolzer supra note 137, p.88

[146] Dolzer supra note 137, p.88

[147] U.N. Conference on Trade and Development, Bilateral Investment Treaties in the Mid-1990s, 1998, p.66

[148] Newcombe, A., The Boundaries of Regulatory Expropriation in International Law, 2005, 20:1 ICSID Review – FILJ, p.15 available at <http://www.law.uvic.ca/newcombe/publications.html>

[149] Newcombe, supra note 151, p.15

production and distribution enterprise in Paraguay. Olgiun claimed expropriation for non-payment of investment certification from the bankrupt financial institution. The tribunal award that Paraguay's actions were not expropriation of the investment and noted:

*“For an expropriation to occur there must be actions that can be considered reasonably appropriate for producing the effect of depriving the affected party of the property it owns, in such a way that whoever performs those actions will acquire, directly or indirectly, control, or at least the fruits of the expropriated property. Expropriation therefore requires a teleologically driven action for it to occur; omissions, however egregious they may be, are not sufficient for it to take place.”*<sup>[150]</sup>

The same view is partially taken by the tribunal in *S.D. Myers Inc. v. Canada*. *S.D. Myers* is a U.S. corporation which operates at Canada, in the remediation industry of a chemical called PCB. In 1995, government of Canada banned the export of PCBs on the basis of danger to human health and to the environment. *S.D. Meyers* claimed that Canadian government's action amounted to expropriation. However, the tribunal held:

*“the term “expropriation” carries with it the connotation of a “taking” by a governmental-type authority of a person’s “property” with a view to transferring ownership of that property to another person, usually the authority that exercised its de jure or de facto power to do the “taking”.*<sup>[151]</sup> The tribunal decided that the host states action did not amount to an expropriation because the evidence did not support a transfer of property or benefit to others.

#### ***4.2.3. Substantial Deprivation Approach***

In fact, the substantial deprivation approach is not a separate method to determine indirect expropriation. It is a limit for determining the framework of the *“measures tantamount to expropriation”* phrase. Some recent awards emphasize more the severity of the host state's interference with the investment.

The term *“substantial deprivation”* and the magnitude of the interference are rigorously explained in the *Pope & Talbot v. Canada* case. In many following cases, tribunals referred to the test defined in *Talbot* decision. Such

[150] *Eudora A. Olguin v. Republic of Paraguay*, ICSID Case No. ARB/98/5, July 26, 2001, para 84, available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CaseSRH&actionVal=showDoc&docId=DC575\\_En&caseId=C171](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CaseSRH&actionVal=showDoc&docId=DC575_En&caseId=C171)

[151] *S.D. Myers Inc. v. Canada*, NAFTA Award, November 13, 2000, para. 282-283 available at [http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/myersvcanadapartialaward\\_final\\_13-11-00.pdf](http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/myersvcanadapartialaward_final_13-11-00.pdf)

cases including *Siemens v. Argentina*,<sup>[152]</sup> *Enron v. Argentina* <sup>[153]</sup>, *Vivendi v. Argentina*<sup>[154]</sup>, *Sempra v. Argentina*<sup>[155]</sup>.

Pope & Talbot Inc. a Portland based wood products company that operates in Canada and sells standardized and specialty wood lumber. The dispute arose from implementation of 1996 Softwood Lumber Agreement between the U.S. and Canada. Pursuant to agreement Canadian government established an Export Control Regime requiring export permits, export permit fee and creating discretionary quota allocation regime. Pope & Talbot claimed that Canada violated at least four provisions of the NAFTA by implementing the Softwood Lumber Agreement through Export Control Regime.<sup>[156]</sup>

The tribunal stated that the phrase tantamount to nationalization or expropriation in NAFTA Article 1110 shouldn't be interpreted in a way that broadens the concept of expropriation under international law without regarding the severity of the measures affecting the property. Tribunal continues by stating that "*regulations can indeed be exercised in a way would constitute creeping expropriation*" and quotes from Third Restatement of the Foreign Relations Law of the U.S.:

*"relating to responsibility for injury from improper takings applies not only to avowed expropriations in which the government formally takes title to property, but also to other actions of the government that effect of "taking" the property in whole or in large part, outright or in stages ("creeping expropriations"). A state is responsible as for an expropriation of property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective of enjoyment of an alien's property or its removal from the state's territory".*<sup>[157]</sup>

[152] *Siemens A.G. v. Argentina*, ICSID Case No. ARB/02/08, Award, February 6, 2007, available at <http://ita.law.uvic.ca/documents/Siemens-Argentina-Award.pdf>, para. 271.

[153] *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, May 22, 2007, available at <http://ita.law.uvic.ca/documents/Enron-Award.pdf>, para. 245.

[154] *Compania de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Award, August 20, 2007, available at <http://ita.law.uvic.ca/documents/VivendiAwardEnglish.pdf>, paras. 11 and 34.

[155] *Sempra Energy International v. The Argentina Republic*, ICSID Case No. ARB/02/16, Award, September 28, 2007, para.284 available at <http://ita.law.uvic.ca/documents/SempraAward.pdf>,

[156] *Pope & Talbot Inc. v. Government of Canada*, NAFTA Notice of Arbitration, March 25,1999, p.2 available at <http://www.naftaclaims.com/Disputes/Canada/Pope/PopeNoticeOfArbitration.pdf>

[157] *Pope & Talbot Inc. v. Government of Canada*, Interim Award, June 26, 2000, para.99 available at <http://www.appletonlaw.com/cases/P&T-INTERIM%20AWARD.PDF>

After expressing that state regulations might amount to indirect expropriation, tribunal analyzed whether the Export Control Regime had the effect of expropriation, by using specific criteria. These criteria are:

- a. whether the investor is in control of the investment,
- b. whether the government manages day-to-day operations of the company,
- c. whether officers or employers of the company is under arrest,
- d. whether the payment of dividends has been interfered with,
- e. whether the directors and managers of the company are appointed by the company, and the investor has full ownership and control of the investment.<sup>[158]</sup>

After applying the substantial deprivation test, the tribunal found that the Canadian government's act was not a measure tantamount to expropriation.

The overall meaning of these criteria is whether there has been a “*substantial deprivation*”, whether the state interference is sufficiently restrictive that the property has been “*taken*” from the investor. One can say that the substantial deprivation approach is a limitation to the “*sole effect doctrine*” which has a broader context and have been criticized for giving an extremely broad definition of expropriation.

The 2004 US Model BIT Annex B, is a good example to understand the difference between sole effect doctrine and the substantial deprivation approach. The rule in Annex B is based on the criteria used by the tribunal in Pope & Talbot and states that “*although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred.*” Meaning that to determine indirect expropriation not only the existence of adverse effects of the measure but also the sufficiency of the restriction should taken into account.

Also in C.M.S. v Argentina the tribunal referred to Talbot case and after applying the test mention in Talbot, stated that “*...neither there has been substantial deprivation of the fundamental rights of ownership nor have these rights been rendered useless...the investor is in control of the investment, the government does not manage the day-to-day operations of the company; and the investor has full ownership and control of the investment*” and held that “*...the Government of Argentina has not breached the standard protection laid down in Article 4(1) of the Treaty*”.<sup>[159]</sup> Therefore tribunal refused C.M.S's claim because of the temporal character of the measures.

As a result; it is obvious that in recent arbitral awards there is a tendency to focus mainly on the effects of the measure on investors, so called “*sole effect*”

[158] Pope & Talbot Case, *supra* note 160, para.100

[159] CMS Gas v. Republic of Argentina, ICSID Case No. ARB/01/08, May 12, 2005, para.259-264 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC504\\_En&caseId=C4](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC504_En&caseId=C4)

*doctrine*". However, considering these three different approaches; it is proposed that the most appropriate one to determine whether a state measure ends up with indirect expropriation is the "*substantial deprivation approach*" which goes one step further than sole effect doctrine and pays attention to both the effects and to importance and restriction capacity of those effects. With regard to appropriation approach, it limits the meaning of expropriation by requiring an actual acquisition by host state in order to accept existence of expropriation. This narrower understanding is not suitable to assess many different state measures in order to distinguish expropriation or mere regulation.

### 4.3. Type of Measures Amount to Indirect Expropriation

#### 4.3.1. Exorbitant Taxation

Different nations have different philosophies of taxation. There is nothing in international law which prevents the national powers to tax. Taxation considered as an attribute of the sovereignty of the state. "*States are sovereign and free to legislate as they please within the confines of their own territory.*"<sup>[160]</sup>

But "*excessive and repetitive tax*" measures have a confiscatory effect and could amount to indirect expropriation.<sup>[161]</sup> A uniform increase in taxation by itself cannot have such an effect. But where only a foreign investment is subjected to the exorbitant taxation, this situation can clearly amount to indirect expropriation.<sup>[162]</sup>

Restatement Third recognized the non-discrimination rule to distinguish general tax regulation with the one amounts to indirect expropriation: "*One test suggested for determining whether regulation and taxation programs are intended to achieve expropriation is whether they are applied only to alien enterprises.*"<sup>[163]</sup>

Many tribunals have reached to same conclusion i.e. "*taxes legally levied and without discrimination cannot be recovered*"<sup>[164]</sup>

"*A State is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation or any other action that is commonly accepted as within the police power of States, provided it is not discriminatory and*

[160] Freidman supra note 91, p.115

[161] World Bank Guidelines 1992 World Bank Guidelines Vol.II, Legal Framework for the Treatment of Foreign Investment, 1992, p.24

[162] Sornarajah, M. supra note 3, p. 315

[163] American Law Institute, Restatement of the Law Third, the Foreign Relations of the United States, USA, American Law Institute Publishers, Vol. 1, 1987, Section 712

[164] Brewer, Moller & Co. Case (Ger. v. Ven.), 10 R. Int'l Arb. Awards 423 (1903) in Wagner, J.M., International Investment, Expropriation and Environmental Protection, Golden Gate Unvesity law Review ,1999, Vol..29, p.511

*is not designed to cause the alien to abandon the property to the State or to sell it at a distress price...*<sup>[165]</sup>

In some bilateral investment treaties the issue is regulated by a different approach, for example according to U.S. Model BIT an investor who wants to make an indirect expropriation claim against a host state based on a taxation measure must first refer to “*competent tax authorities of both Parties in writing the issue of whether that taxation measure involves an expropriation*” and investor may proceed to arbitration only if after 180 days of consideration the authorities “*fail to agree that the taxation measure is not an expropriation*”.<sup>[166]</sup>

As a result it is accepted in international law a general tax regulation on a non-discriminatory basis does not amount to indirect expropriation. Nevertheless a tax measure applied solely on foreign investment might have reasonable grounds and would not amount to expropriation i.e. unexpected increase in the prices and as a result of this unexpected increase in profits might give rise to a high level of taxation on foreign investment without being subject to compensation.

#### ***4.3.2. Import & Export Bans***

Imported or exported goods may be the raw material for an investor to run his business operations and import and export restrictions may have considerable adverse effects on the investment.

A good example of the issue is *Middle East Cement Shipping v. Egypt* case. The case concerned the revocation of a free zone license through the prohibition of import cement. The import ban resulted in the annulment of a concession granted by Egypt to investor previously. *Middle East Cement Co.* a Greek company was licensed to exercise for the import and storage of bulk cement in Egypt for ten years. But three years before the end of the duration of the guarantee and privileges granted to the investment, the Egyptian government prohibited the import of all kinds of cement through public or private sectors with the exception of cement imports covered by existing contracts of the Egyptian Cement Office. According to prohibition claimant was not allowed to continue its business. Claimant alleged that the arbitrary and unjustified prohibition was amount to expropriation of its investment. The tribunal found

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[165] Iran-United States Claims Tribunal, *Too v. Greater Modesto Insurance Associates Award* December 29, 1989, 23 Iran-United States Cl. Trib. Rep.378. in OECD Working Papers on International Investment, Number 2004/4, *Indirect Expropriation and The Right to Regulate in International Investment Law*, September 2004, p.19 available at <http://www.oecd.org/dataoecd/22/54/33776546.pdf>

[166] U.S. 2004 Model BIT, Article 21 available at [http://www.ustr.gov/assets/Trade\\_Sectors/Investment/Model\\_BIT/asset\\_upload\\_file847\\_6897.pdf](http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf)



that investor had been deprived of use and benefit of its investment although there was no direct taking of its property by the state and held that:

*“When measures are taken by a state the effect of which is to deprive the investor of the use and benefit of his investment even though he may retain nominal ownership of the respective rights being the investment, the measures are often referred to as a “creeping” or “indirect” expropriation or, as in the BIT, as measures “the effect of which is tantamount to expropriation.”* As a matter of fact, the investor is deprived by such measures of parts of the value of his investment. This is the case here, and, therefore, it is the Tribunal’s view that such a taking amounted to an expropriation within the meaning of Art.4 of the BIT and that, accordingly, Respondent is liable to pay compensation therefore.”<sup>[167]</sup>

Another outstanding example of the issue is Ethyl Corp. v. Government of Canada case concerning an import and trade ban of methylcyclopentadienyl manganese tricarbonyl (MMT), a fuel additive, by Canadian government. The act of state prohibits Ethyl Corp. and Ethyl Canada from importing MMT into Canada for use in unleaded gasoline. But the act does not prohibit the manufacturing or use of MMT in Canada, it only requires that all MMT sold in Canada be 100% Canadian.<sup>[168]</sup> Ethyl Canada, the Canadian subsidiary of Ethyl Corp., is the sole importer and sole distributor across Canada of MMT, alleged that as a result of the prohibition it had been deprived of the substantial benefit of his investment and suffered economic losses therefore the measure taken by Canadian government amounts to expropriation of his investment. And argued that the act of Canadian government was discriminatory and aimed to protect domestic industry. According to Ethyl,

*“An expropriation therefore exists, whenever there is a substantial and unreasonable interference with the enjoyment of a property right. . . . Article 1110 of NAFTA does not prevent regulatory actions. It requires governments to compensate investors for interference with their property rights as set out in the NAFTA.”*<sup>[169]</sup>

*“The government of Canada’s actions unreasonably interfered with the effective enjoyment of Ethyl Canada’s property. The MMT Act interfered with Ethyl*

[167] Middle East Cement Shipping v. Egypt, ICSID Case No. ARB/99/6, April 12, 2002, para.107 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=Case sRH&actionVal=showDoc&docId=DC595\\_En&caseId=C182](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=Case sRH&actionVal=showDoc&docId=DC595_En&caseId=C182)

[168] Ethyl Corporation v. Government of Canada, Statement of Claim, October 2, 1997, p. 4, available at <http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/ethyl3.pdf>

[169] Ethyl Corporation v. Government of Canada, Notice of Arbitration, April 14, 1997, paras.32-33, available at <http://www.international.gc.ca/assets/trade-agreements-accords-commerciaux/pdfs/ethyl2.pdf>

*Canada's enjoyment of its goodwill as it will remove Ethyl Canada from the octane enhancement market and deprive it of the substantial benefits of the investment.*"<sup>[170]</sup>

The court found that Ethyl Canada has suffered economical loss both in Canada and U.S. as a result of the prohibition. "In July 1998, after a Canadian domestic trade panel ruled in favor of several provincial governments that had brought a claim that the ban violated Canada's Agreement on Internal Trade, the government of Canada announced that it had settled Ethyl's NAFTA challenge. The settlement provided for a payment of approximately US \$13 million dollars."<sup>[171]</sup>

#### ***4.3.3. Revocation of Licenses and Permits Necessary for the Foreign Business to Function within the State***

In Goetz and Others v. Republic of Burundi the dispute concerned AFFI-MET, a company incorporated in Burundi owned by Belgian investors. The company was granted a certificate of free zone by Burundi in 1993, conferring tax and customs exemptions. However, two years later Burundi withdrew the certificate of free zone. The investors claimed economical loss as a result of the withdrawal and alleged that government's act as expropriation of their investment.<sup>[172]</sup>

The tribunal held that the government's act fell under the concept of indirect expropriation and stated that:

*"Since... the revocation of the Minister for Industry and Commerce of the free zone certificate forced them to halt all activities... , which deprived their investment of all utility and deprived the claimant investor of the benefit which they could have expected from their investments, the disputed decision can be regarded as a "measure having similar effect to" a measure depriving of or restricting the property within the meaning of Article 4 of the investment treaty."*<sup>[173]</sup>

The above discussed Metalclad case also concerns a denial of a construction permit contrary to prior assurances which causes an indirect expropriation as it has the effect of depriving in significant part, of the use and expected economic benefit of the investment.

[170] See Ethyl Corporation v. Government of Canada at supra note, para. 27

[171] Wagner, J.M., International Investment, Expropriation and Environmental Protection, Golden Gate University Law Review, 1999, Vol. 29, p. 490

[172] Goetz and Others v. Republic of Burundi, ICSID Case No. ARB/95/3, Introductory Note, available at <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC536&caseId=C151>

[173] Goetz and Others v. Republic of Burundi, ICSID Case No. ARB/95/3, Decision on Liability, September 2 1998, in Schreuer, C., The Concept of Expropriation under the ETC and other Investment Protection Treaties, 2005, p.8

#### 4.3.4. Breach of Stabilization Clauses

Stabilization clauses aim to stabilize the terms and conditions of an investment project, thereby contributing to manage non-commercial risk. They involve a commitment by the host government not to alter the regulatory framework governing the project, by legislation or any other means, outside specified circumstances.<sup>[174]</sup>

It is very important for foreign investors whether the investment regulation of the host state has legal stability. Those regulations also have significant importance for especially developing countries to attract foreign investment. There is a correlative interest balance between these two actors: the host state wants to attract the foreign investment and a contribution to reach sustainable development goals; to investors wish to protect their assets and benefits from a stable regulatory framework. By stabilization clauses, host state engages itself in securing a stable regulatory framework for the equilibrium of the investment and to compensate the damages if it fails to.

There are also stabilization clauses which are project-specific commitments between host state and the investors in foreign investment contracts.

*“Although stabilization clauses might seem irrelevant considering that recent ICSID tribunals tend to find their jurisdictional basis in BITs (which tend to be broadly protective with regard to indirect expropriations), some cases demonstrate the continued relevance of stabilization clauses”*.<sup>[175]</sup> In *Tradex Hellas v. Republic of Albania*, the dispute arose from an alleged expropriation of an agricultural joint venture in Albania. The joint venture agreement was signed by Tradex and a state-owned company Torovitsa and provided for commercial and agricultural use of a land in Albania for a period of ten years. Tradex claimed that particular measures taken by government of Albania made the development of the joint venture impossible and left the participation and investment in the joint venture valueless, so that these acts must be considered as act of expropriation.<sup>[176]</sup> The land was subsequently privatized, prompting the investor to initiate ICSID proceedings against host state alleging indirect expropriation. Here, the Greek investor did not enjoy protective rights by virtue of a stabilization clause but by an updating clause. Unlike stabilization clause, in updating clauses host

[174] Cotula, L., *Regulatory Takings, Stabilization Clauses and Sustainable Development*, 2008, OECD Global Forum on International Investment, OECD Investment Division, p.5 available at <http://www.oecd.org/dataoecd/45/8/40311122.pdf>

[175] Kunoy, B., *The Notion of Time in ICSID's Case Law on Indirect Expropriation*, 2006, *Journal of International Arbitration*, p.339

[176] *Tradex Hellas S.A. v. Republic of Albania*, ICSID Case No. ARB/94/2, Award April 29, 1999, para. 54, 57 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC535\\_En&caseId=C148](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC535_En&caseId=C148)

state reserves the right to modify its legislation or administrative acts, even it could amount to indirect expropriation.<sup>[177]</sup> The tribunal stated that it has to examine whether such rights were acquired by Tradex or were covered by the reference to the Land Law and so from the beginning of the investment subject to possible privatization measures and held:

*“The legal significance could only be that the parties to the Agreement, including Tradex, accepted future applications of the Land Law and that the investment was subject to future applications of the Land Law, in other words: subject to future privatizations. If this was a legal limitation on Tradex’ investment from the very beginning, then it could be argued that the actual application of the Land Law at a later stage did not infringe the investment and thus did not constitute an expropriation.”*<sup>[178]</sup>

For these reasons tribunal refused Tradex’s claim on indirect expropriation.

Above mentioned C.M.S v. Argentina case also includes an alleged indirect expropriation by reason of the breach of two stabilization clauses in the license granted to C.M.S Gas. License ensured “...a regime under which tariffs were to be calculated in dollars... and would be adjusted every six months...”. The stabilization clause in the license provided that rules governing the license would not be amended, totally or partially without the consent of licensee’s.<sup>[179]</sup> However the investor’s acquired right of price adjustment in U.S. dollars was abandoned. Investor claimed that the breach of those stabilization clauses amounted to indirect expropriation but as mentioned above tribunal refused the claim as the measures were ephemeral.

#### 4.4. Property Regulation

Although state measure interferes with or impedes the foreign investors’ property rights, it may not constitute a taking of his property as the measure represents a reasonable exercise of the state power to regulate matters which fall under its absolute sovereignty, such as safety or health, currency, public order, balance of payments etc. For example “conduct that is reasonably necessary for the maintenance of public order, safety, or health or the enforcement of laws of the state that do not depart from the international minimum standard of justice would normally not be violation of international law”<sup>[180]</sup> and would be considered as a governmental regulatory measure for which does no compensation is due.

[177] Kunoy, B. see supra note 178, p. 340

[178] Tradex v. Albania, see supra note 179, para. 130

[179] C.M.S Gas, see supra note 162, para. 57, 146

[180] See Damrosh & Henkin, & Pugh & Schacter & Smit at supra note 8, p.767

The question is to what extent a governmental regulatory measure stays in the boundaries of regulation. The issue is not clear and depends on the specific facts and circumstances in each case. However, criteria used for determining indirect expropriations might also be useful for delimitation of regulatory measures.

Of course not all state measures interfering with property rights of investor are expropriation. *“State measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.”*<sup>[181]</sup>

It is an accepted principle of customary international law that where economic injury results from a bona fide non-discriminatory regulation within the police powers of the State, compensation is not required.<sup>[182]</sup>

This view is reflected in international instruments. European Convention of Human Rights implies that duty to compensation is not applicable where there is a general regulatory measure. Article 1 of First Additional Protocol:

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

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

The MAI Negotiating Text in its Annex 3 Article 3 it is stated:

*“A Contracting Party may adopt, maintain, or enforce any measure that it considers appropriate to ensure that investment activity is undertaken in a manner sensitive to healthy, safety or environmental concerns provided that such measures are consistent with this agreement.”*

Interpretative note to Article 5:

*“This Article... does not establish a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments.”*

[181] Brownlie, I., Public International Law, 2003, 6th Edition , p.509

[182] See Dolzer & Stevens in OECD Working Papers on International Investment, Number 2004/4, Indirect Expropriation and The Right to Regulate in International Investment Law, September 2004, p.5 available at <http://www.oecd.org/dataoecd/22/54/33776546.pdf>

#### 4.4.1. Criteria to Distinguish Expropriation and Mere Regulation

Although in this thesis it is proposed that “*substantial deprivation approach*” is the most appropriate method to distinguish expropriation and mere regulation, some arbitral tribunals also consider other criteria such as duration of the regulation, degree of interference with the property rights and purpose and context of the regulation. In *S.D. Meyers Inc. v. Canada* case, *S.D. Myers, Inc.*, an Ohio corporation that processes and disposes of PCB waste, claimed that Canada’s ban on the export of PCB wastes from Canada to the United States breached Canada’s obligations under Chapter Eleven of the NAFTA.

1. The tribunal used the degree of interference criterion to distinguish regulation from expropriation: “*expropriations tend to involve the deprivation of ownership rights; regulations are lesser interference.*”<sup>[183]</sup>
2. Tribunal also looked at the purpose and effect of Canadian government’s conduct: “*A tribunal should not be deterred by technical or facial considerations from reaching a conclusion that an expropriation or conduct tantamount to an expropriation has occurred. It must look at the real interests involved and the purpose and effect of the government measure.*”<sup>[184]</sup>
3. Tribunal also referred to an actual taking by the state, above mentioned “*appropriation approach*”, to distinguish expropriation and regulation: “*The term “expropriation” in Article 1110 must be interpreted in light of the whole body of state practice, treaties and judicial interpretations of that term in international law cases. In general, the term “expropriation” carries with it the connotation of a “taking” by a governmental-type authority of a person’s “property” with a view to transferring ownership of that property to another person, usually the authority that exercised its de jure or de facto power to do the “taking.”*”<sup>[185]</sup> Tribunal held that Canada neither had realized any benefit from the measure nor transferred the property or benefit directly to others.
4. Finally tribunal analyzed the export ban on the basis of the duration of the measure affirming that in some cases even temporal or partial deprivations might amount to expropriation. However, in this case tribunal did not find *S.D. Myers*’ eighteen month prohibition to venture into the Canadian market supportable to constitute an indirect

[183] *S.D. Myers Inc. v. Canada*, NAFTA Award, November 13, 2000, para. 282 available at <http://www.international.gc.ca/assets/trade-agreements-accords->

[184] See *S.D. Myers Case* supra note 186, para. 285

[185] See *S.D. Myers Case* supra note 186, para. 280

expropriation. Therefore considering all the facts examined tribunal concluded export ban of Canadian government did not amount to expropriation<sup>[186]</sup>

5. Another criterion used by the arbitral tribunals is whether the governmental measure affects the investor's reasonable expectations. "*In these cases the investor has to prove that his/her investment was based on a state of affairs that did not include the challenged regulatory regime. The claim must be objectively reasonable and not based entirely upon the investor's subjective expectations.*"<sup>[187]</sup>

In Marvin Feldman v. Mexico case where the claimant's key contention was the application of certain tax laws by Mexico to the export of tobacco products was resulted in indirect expropriation of his investment under NAFTA. The tribunal firstly affirm that not every business problem experienced by a foreign investor is an indirect or creeping expropriation under Article 1110 of NAFTA and referred to Azinian tribunal : "*It is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities... It may be safely assumed that many Mexican parties can be found who had business dealings with governmental entities which were not to their satisfaction...*" and continued that governments may frequently change their regulations in accordance with the changing circumstances and needs exist in society. Not every regulation that makes it difficult for an investor to carry out its business is expropriation under Article 1110 of NAFTA.<sup>[188]</sup>

Here, the tribunal implies that each regulation which does not meet with the expectations of an investor does not constitute an indirect expropriation. The investor as a businessman should foresee that typical risks of business life may result from changing circumstances in a state.

The tribunal finally found that there was no expropriation since "*the regulatory action has not deprived the Claimant of control of his company, interfered directly in the internal operations of the company or displaced the Claimant as the controlling shareholder. The Claimant is free to pursue other continuing lines of business activity....Of course, he was effectively precluded from exporting*

[186] See S.D. Myers Case supra note 186, paras. 283-284-288

[187] OECD Working Papers on International Investment, Number 2004/4, Indirect Expropriation and The Right to Regulate in International Investment Law, September 2004, p.19 available at <http://www.oecd.org/dataoecd/22/54/33776546.pdf>

[188] Marvin Roy Feldman Karpas v. United Mexican States, ICSID Case No. ARB(AF)/99/1, Award December 16, 2002, para.112 available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587\\_En&caseId=C175](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587_En&caseId=C175)

cigarettes...However, this does not amount to Claimant's deprivation of control of his company".<sup>[189]</sup>

#### 4.4.2. Police Powers of the State

Another very significant factor in characterizing a governmental measure whether it refers to the state's right to promote public purpose or general welfare by regulation. "*The existence of generally recognized considerations of the public health, safety, morals or welfare will normally lead to a conclusion that there has been no taking.*"<sup>[190]</sup>

The police powers of the state "*term can be used in a general sense to refer to all forms of domestic regulation under a state's sovereign powers...which refers to measures that justify state action which would otherwise amount to a compensable deprivation or appropriation of property.*"<sup>[191]</sup>

"*However a state's justification that a measure is based on its police powers does not preclude an international tribunal from making an independent determination of the issue.*"<sup>[192]</sup>

There are other state measures which may amount to indirect expropriation of the investment such as, forced sales of property, forced sales of shares, failure to provide protection when there is interference with the property of the foreign investor, exercising management control over the investment, inducing others to take over the property, expulsion of the foreign investor contrary to international law, act of harassment such as the freezing of bank accounts, promoting of strikes, lockouts and labour shortages.<sup>[193]</sup>

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## 5. CONCLUSION

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In this thesis, protection of foreign investment was discussed within the framework of international investment norms and instruments proceeding at different levels. The study aimed to determine the controversial norms and standards of international investment law.

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[189] See Marvin Roy Feldman case at supra note 191, para.142

[190] See Christie at OECD Working Papers on International Investment, Number 2004/4, Indirect Expropriation and The Right to Regulate in International Investment Law, September 2004, p.16 available at <http://www.oecd.org/dataoecd/22/54/33776546.pdf>

[191] See Newcombe, A., at supra note 151 p. 20

[192] Newcombe, A., Regulatory Expropriation, Investment Protection and International Law: When Is Government Regulation Expropriatory and When Should Compensation Be Paid?, 1999, p. 74

[193] See Sornarajah, supra note 3, p.284



This area of international law was considerably affected by historical, political and economical developments. In Chapter 2, historical evolution of international legal norms on property related measures, economical and political developments and effects of these developments on investment law were displayed. As mentioned above, before 1990s there was an extreme diversion between the views of developing countries and developed countries. As a result of this diversion, efforts for a multilateral treaty containing the substantive rules of investment protection have failed. However in recent years those diametrically opposite views have yield under the pressure of major changes in world economic order. The new political and economic system has been developed to reflect the rules of international law. Therefore it is concluded that; although the ongoing controversial views of the past, there is a general tendency towards bilateral arrangements between those conflicting parties.

In Chapter 3, the international legal norms and instruments on property related measures and the attempts of a multilateral arrangement were discussed within a general framework. In this framework it was displayed that developing countries while advocating a series of decisions in their UN Resolutions, they have started to sign many bilateral investment treaties as they need foreign direct investment. It was mentioned that these BITs have a considerable impact on the evolution of international investment law. Therefore it is concluded that; the increasing number of BITs have become a permanent part of the international system.

Finally in Chapter 4, state measures interfering with the property rights of foreign investors were discussed in the light of international arbitration practice. According to this assessment; under international law, taking of property has a broad definition. It is not limited to only formal transfer of ownership. Taking may occur even where no formal transfer of ownership takes place for instance; through taxation or regulation that interfere with property rights to such extent that these rights are rendered so useless. So it is generally accepted that for a taking occur there is no need for formal transfer of ownership; intent of the government and measure itself is less important then its effects. However, although the definition is given in most BITs, in practice it is not always easy to determine indirect expropriation. The critical problem has arisen here is that although standards mentioned in Chapter 3 are well accepted and spelled out in international legal instruments; there is no guidance as to when a governmental regulation which in some way adversely impacts on a foreign investor constitutes indirect expropriation, even within investment law instruments which have the most precise and high standards. Here the issue should be handled in the light of arbitral awards. In Chapter 4 it was proposed that above mentioned NAFTA award *Pope&Talbot*, (substantial deprivation approach)

lies down necessary criteria to distinguish expropriation and mere regulation. Furthermore, it is proposed that arbitral practice may have an influence on bilateral investment treaties of states desiring to have an effective legal system to attract foreign investment. They would follow certain basic criterion as the goal of having an effective foreign investment legal regime encourages them to do. “Recently, new generation of investment agreements, have introduced specific language and established criteria to assist in determining whether an indirect expropriation requiring compensation has occurred. These criteria are consistent with those emerging from arbitral decisions.”<sup>[194]</sup> For instance, recent U.S. Model BIT contains, in Annex B, useful criteria for assessing whether a regulatory measure amounts or not to an indirect expropriation based on lessons learned from the NAFTA cases. Therefore, it is concluded that, arbitral decisions create an effective influence on state practice, beyond resolving individual disputes between a host state and an investor.

Consequently, with respect to question that how much protection international law affords to foreign investment, I have argued throughout this thesis that, under international law, host states have sovereign right to expropriate assets and to regulate activities within their jurisdiction, based on the principle of permanent sovereignty of states over natural resources. It is generally recognized as being a principle of customary law.

However, as mentioned above according to common standard under investment law, host states must comply with certain conditions while expropriating foreign investors’ assets: Taking must be for a public purpose, in a non-discriminatory way, on the basis of due process and against the payment of compensation. These requirements are stated in a large number of international instruments, BITs and arbitral awards. These requirements are widely regarded as being part of customary international law, although the standard of compensation is still a controversial issue.

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[194] OECD Working Papers on International Investment, Number 2004/4, Indirect Expropriation and The Right to Regulate in International Investment Law, September 2004, p.22 available at <http://www.oecd.org/dataoecd/22/54/33776546.pdf>

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## (Footnotes)

- 1 See Dolzer R. & Schreuer C., supra note 2, Annexes p. 379
- 2 See Dolzer R. & Schreuer C supra note 2, Annexes p.370
- 3 See Dolzer R. & Schreuer C supra note 2, Annexes p.391