

JUSTIFICATION FOR INDIRECT EXPROPRIATION WITHIN A GOVERNMENT MEASURE*

Pulkeria Proprieta Dewi Ekaristi**

Abstract

Customary International Law has granted a protection of foreign direct investment from being expropriated. Various investment treaties have also included the provisions of protection from expropriation. International law recognizes two basic concepts of expropriation, namely direct and indirect expropriation. Indirect expropriation is a measure, taken by a State, which deprives the foreign investor of its property or its benefits, although it does not affect the transfer of property. However, international law also recognizes lawful state measures or state police power, which does not raise the duty of compensation even if it, to some extent, has the similar effect to expropriation. The difficult conundrum is to distinguish between indirect expropriation and lawful state measures for which no compensation is due. Although there is no universal threshold to differentiate indirect expropriation and lawful state measures, international conventions, investment treaties practice, scholars and practices in arbitral tribunal have provided the consistent patterns in characterizing it. This article will observe and elaborate the characters of lawful state measures which do not amount to a bona fide expropriation.

Intisari

Hukum Internasional memberikan perlindungan bagi investor asing dari tindakan pengambilalihan properti. Perjanjian-perjanjian investasi juga kerap menuliskan ketentuan perlindungan dari pengambilalihan oleh pemerintah. Konsep pengambilalihan yang dikenal dalam hukum internasional meliputi pengambilalihan langsung dan tidak langsung. Pengambilalihan tidak langsung adalah tindakan (berupa kebijakan) yang diambil oleh pemerintah yang mencederai hak milik investor asing, tanpa perlu adanya pengalihan atau transfer hak milik. Namun hukum internasional juga mengenal konsep regulasi yang sah, yang mungkin memiliki efek merugikan bagi investor asing, namun tidak termasuk tindakan pengambilalihan. Pertanyaannya adalah bagaimana menentukan kondisi dimana sebuah kebijakan dianggap pengambilalihan secara tidak langsung, dan kapan hal tersebut dianggap kebijakan yang sah tanpa ada kewajiban membayar kompensasi atas kerugian investor asing. Meskipun tidak ada standar internasional yang mengikat untuk menentukan hal ini, namun berbagai perjanjian-perjanjian internasional, praktek perjanjian investasi asing, akademisi, dan praktek penyelesaian sengketa di arbitrase telah menunjukkan pola yang konsisten mengenai hal ini.

Keywords: Expropriation, Indirect Expropriation, State measure.

Kata Kunci: Pengambilalihan, Pengambilalihan tidak langsung, Tindakan Negara

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** 2011;-; Faculty of Law, Universitas Gadjah Mada; Yogyakarta, Indonesia.

A. The Concept of Expropriation

In order to protect the property of foreign investor, various investment treaties have included the provisions of protecting the investment from being expropriated by the Host State. Expropriation itself is defined as the seizure of private property by government, involving the payment of compensation. (Vyuptakes, 2006) The concept of expropriation was once clear, which is the act of physical taking of foreign property. In the early period, takings involved the direct seizure of physical property belonging to foreign investor, thus no issue of identification arises. Later, we find another characteristic in the form of taking which does not affect the right of possession of physical property. A progressive expansion of the concept of expropriation has made it difficult to characterize whether an act by a State constitutes as an expropriation and rises the duty of compensation.

The formulations in investment treaties refer to three types of taking: direct, indirect, and anything tantamount to taking, or equivalent to taking. (Sornajana, 1994) However, in practice, there also others terms such as creeping expropriation, de facto expropriation, regulatory expropriation, or partial expropriation. The developed concept of expropriation has raised certain issues like the type of expropriation, the issue of compensation, or even a more basic question whether the law grants its protection of the taking in certain scope.

Customary International law recognizes two forms of expropriation: (i) direct form of expropriation in which the state openly and deliberately seizes property, and/or transfer title to private property to itself or a state-mandated third party, and (ii) indirect expropriation in which a government measure, although not on its face effecting a transfer of property, results in the foreign investor being

deprived of its property or its benefits. (Newcombe, 2009)

The form of direct expropriation has now become very rare and almost impossible in practice. Expropriation nowadays is in the form of indirect, through a government measure which in some extent inflicted adverse effects to property interest, also known as regulatory expropriation. These types of taking is not visibly recognizable as expropriation, the proof is very casuistic or case by case basis. There is no general and binding threshold in international law to establish the condition of when the indirect expropriation has occurred. However, there are many case laws, doctrines, and international treaties as guidance to determine the existence of expropriation within a government measure.

The question arises how does and should international law distinguish between expropriation and “legitimate” regulation for which no compensation is due. International law recognizes lawful state measures or also known as state police power, which do not raise the duty of compensation to the host State. Thus, the term of state measure and state police power will be interchangeable within this paper.

B. Indirect Expropriation and Government’s Regulatory Power

Middle East Cement Shipping and Handling Co. v Egypt describes indirect expropriation as measures taken by a state the effect of which is to deprive the investor of the use and benefits of his investment even though he may retain nominal ownership of the respective rights. Furthermore, the tribunal in *Lauder v. Czech Republic* added that such taking does not involve an overt taking but effectively neutralizes the enjoyment of property. In conclusion, expropriation could also occur through interference by a state in the use of

that property or with the enjoyment of the benefits even when the property is not seized and the legal title to the property is not affected (OECD, 2004).

However, international law recognizes the government right to regulate as the basic attribute of sovereignty (Mann, 2002), thus not all state measures interfering with property is an expropriation. As Brownlie stated, “state measures, prima facie a lawful exercise of powers of governments, may affect foreign interest 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.” Furthermore, according to Sornarajah, non-discriminatory measures related to anti-trust, consumer protection, securities, environmental protection, land planning are non-compensable takings since they are regarded as essential to the efficient functioning of the state.

Practices within the Tribunal Suez Inter Agua v. Argentine Republic opines that in evaluating a claim of expropriation, it is important to recognize a State’s legitimate right to regulate and to exercise its police power in the interest of public welfare and not to confuse of that nature with expropriation. UNCTAD Series on Issues in International Investment Agreement II supported this case finding police power measures as an act taken by States in the exercise of their right to regulate in the public interest that may lead to effects similar to indirect expropriation but at the

same time are not classified as expropriation and do not give rise to the obligation to compensate those affected. Thus, measures adopted within the scope of any state’s regulatory power in the interest of public welfare, even if to some extent may lead to effect similar to expropriation, does not constitute as an expropriation and does not rise the duty of expropriation.

C. Bona Fide Public Welfare Objectives Requirement

The requirement of public benefits may be a little tricky, as to some extent may justifies the government’s regulatory expropriation, but also at the same time, it is one of the requirement of the legality of expropriation.

Various investment treaties have included the public purpose as one of the requirement for a legal expropriation. The term itself is quite vary, the most generally found is “public purpose”², but some are using “public benefit”³, “public welfare objectives”⁴, “public interest”⁵ or a “public necessity”⁶. Many of these formulations are equivalent in their scope and may be a result of different legal cultures and languages. (UNCTAD, 2012) However, as a general rule, mere public interest does not provide a sufficient reason for non-compensation. (Newcombe, 2005)

International law authorities reflected in international investment instruments such as The Energy Charter Treaty (Article 13), NAFTA 9(Article 1110), MIGA Convention (Article 11 (a) (ii)), US Third Restatement (§712 (g)), and the Harvard Draft (Article 10(5)), they have regularly concluded that no right to compensation arises for reasonably necessary regulations passed

² See Austria-Croatia BIT (1997), Mexico-United Kingdom BIT (2006), Japan-Lao People’s Democratic Republic BIT (2008), Canada – Colombia FTA (2008), Canada-Slovakia BIT (2010)

³ See Egypt-Germany BIT (2005), Germany – Pakistan (2009)

⁴ See Colombia –India BIT (2009)

⁵ See Netherlands – Oman BIT (2009), China – Peru FTA (2009)

⁶ See Peru – Singapore FTA (2008)

for the “protection of public health, safety, morals or welfare”. (Christie, 1962)

However, other practice such as tribunal within *ADC Affiliate Ltd v. Hungary* stipulates that even if a State has fulfilled the public benefit requirement, it does not affect the nature of the measure of the compensation to be paid for the taking. Furthermore, the tribunal in *Santa Elena v. Costa Rica* has asserted the statement above by stating that it does not alter the legal character of the taking for which adequate compensation must be paid. Tribunal in *Santa Elena*, *Azurix*, and *ADC Affiliate Ltd* all indicate that even if a regulation (environmental or otherwise) resulted in an expropriation is enacted for the genuine benefit of the public; this does not excuse the State from its obligation under customary international law to compensate the foreign investor for its losses.

As bona fide public purpose is an important element in determining a lawful state measure, thus we must first assess how the public purpose requirement can be classified as bona fide. Public purpose is a very significant factor in characterizing a government measure as falling within the expropriation sphere or not, is whether the measure refers to the State’s right to promote a recognized “social purpose” or the “general welfare”. 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”. There is no general and binding threshold in international law of how a public purpose is qualified as bona fide. Literally, bona fide defines as in or with good faith; honestly, openly, and sincerely; without deceit or fraud (Black’s Law, 1990), or genuine, real, without intention to deceive. (Oxford, 2000) The case of *Liberian Easter Timber Corporation (LETCO) v. Liberia* is using the standard of bona fide public

purpose, but it did not specify the meaning. The Tribunal held that the taking was not for a bona fide public purpose as it was granted to other foreign companies that were “good friends” of the Liberian authorities. Arbitral Tribunal in *ADC v. Hungary* stipulates that “public interest” requires a “genuine” interest of the public. In *ADC v. Hungary*, Tribunal concludes that there was no genuine public interest as Respondent has never articulated any public interest justification before (during or after the taking) and the financial purpose backing the expropriation reported in Hungarian press and attributed to officials of the Hungarian Government is not sufficient to be a public interest justification.

Those Tribunals do not explicitly establish the threshold of bona fide public purpose, however, seeing from the case above, it can be concluded that a public purpose must be purely and genuinely aim for the public, it must also be conducted in good faith and there must not be any private or individual intention. The taking of the property must be motivated by the pursuance of a legitimate welfare objective, as opposed to purely private gain or an illicit end. Even the slightest purpose of benefiting certain party can eliminate the whole public welfare objective.

D. Economic Impact of Government Action

The economic impact such as some diminishment in the value of the investment is another element to define whether governmental regulatory action is expropriatory. Under a state’s police powers, the taking of property by a State is lawful even if the property owner may suffer significant losses without giving rise to state responsibility.

In addressing the issue of expropriation, there are quantitative requirements developed by arbitral

tribunal for indirect expropriation. In case of UNCITRAL Pope and Talbot and also Revere Copper and Bross Inc., the tribunal found that regulatory deprivation has occurred where government environmental regulation has totally wiped out the value of an investment. (Marlles, 2007)

Furthermore, Wälde and Kolo (2001) opines that an government regulation “which effectively or totally renders the investment/property [of a foreign investor] without an economically beneficial use or imposes on the owner a special sacrifice in favour of the community at large is compensable.

Practices in arbitral tribunal are a mix of both non-specific investment treaties related to expropriation provision and customary international law. They are faced with a dispute in which government regulations have deprived the foreign investor of less than the total value of its investment. Expropriation occurs only if the deprivation is total or substantial. In Pope & Talbot v. Canada, the Tribunal found that “under international law, expropriation requires a ‘substantial deprivation. The tribunal in *MS Gas Transmission Co. v. Argentina* has asserted this statement by stating that expropriation has occurred if investor has suffered a substantial deprivation or the regulations has had a devastating effect on the investment.

Besides the requirement of substantial deprivation, the degree of interference with the property rights must be examined. The CMS Tribunal, referring to *Metalclad Corporation v. Mexico* explained that substantial deprivation relates to incidental interferences with the use of property which have the effect of depriving the owner, in whole or in significant part, of the use or reasonable to-be-expected economic benefit of property. Thus in summation, a total deprivation of value, like in *Metalclad*, appears to always fulfill the necessary

requirement, while partial deprivations of value must be either “substantial” in nature, or of “devastating effect”.

The conception of expropriation as applied in numerous cases involves the deprivation or impairment of all, or a very significant proportion of an investor’s interest. It requires a complete or very substantial deprivation of owner’s rights in the totality of the investment, the tribunal in Pope and Talbot Interim Award rejected expropriation claims where a claimant remained in possession of an ongoing business, as in this case, tribunal rejected a claim that the disputed measures interfered with the claimants’ business sufficiently to constitute an expropriation where claimant continued to make profitable exports of logs.

In addition, tribunal in *Feldman v. Mexico* has strengthened the statement above by stipulating,

“[H]ere, as in Pope & Talbot, the regulatory action (enforcement of longstanding provisions of Mexican law) has not deprived the Claimant of control of the investment, CEMSA, interfered directly in the internal operations of CEMSA or displaced the Claimant as the controlling shareholder. The Claimant is free to pursue other continuing lines of export trading, such as exporting alcoholic beverages, photographic supplies, or other products ... although he is effectively precluded from exporting cigarettes. Thus, this Tribunal believes there has been no “taking” under this standard articulated in Pope & Talbot, in the present case.”

Furthermore, to similar effect, the tribunal in *Glamis Gold* found following,

“[A] panel’s analysis should begin with determining whether the economic impact of the complained of measures is sufficient to potentially constitute a

taking at all: "[I]t must first be determined if the Claimant was radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto ... had ceased to exist." The Tribunal agrees with these statements and thus begins its analysis of whether a violation of Article 1110 of the NAFTA has occurred by determining whether the federal and California measures "substantially impair[ed] the investor's economic rights, i.e. ownership, use, enjoyment or management of the business, by rendering them useless. Mere restrictions on the property rights do not constitute takings."

Those NAFTA tribunals above are acting in accordance with Article 1110 of The NAFTA which stipulates "NAFTA Parties may not directly or indirectly nationalize or expropriate an investment of an investor of another party in its territory [...]". Thus it requires a complete or very substantial deprivation of owner's rights in the totality of the investment, and rejected expropriation claims where a claimant remain in possession of ongoing business.

Besides the NAFTA Tribunals, the ICSID tribunals have also rejected expropriation claims involving significant diminution of the value of a claimant's property where the claimant nevertheless retained ownership and control. Tribunal within *CMS Gas Transmission Company v. Argentina* rejected a claim of expropriation where the claimant retained full ownership and control of the investment, even though its value was reduced by more than ninety (90) percent. In addition, *LG&E v. Argentine Republic* similarly stated that interference with the investment's ability to carry on its business is not satisfied where the investment continues to operate, even if profits are diminished.

UNCITRAL tribunal within the case of *Grand River v. USA* is referring to those ICSID cases above and concludes that an act of expropriation must involve "the investment of the investor" as a whole. In circumstances involving an investment that remain under the investor's ownership and control, expropriation claim fails for failure to establish expropriation.

In summation, to suffice the claim of expropriation within the government measure, the economic impact caused must be total or substantial, and the investor must suffer loss of ownership or loss of control towards the investment. Arbitral tribunals have clearly established that those two conditions must be cumulatively fulfilled. The control argument indicates that it required the taking of the whole property for an expropriation to be occurred. The ability to continue to operate the business, although the profit is diminished, is one of the indications of retaining the control towards investment.

E. Non-Discriminatory Manner

The non-discriminatory requirement is a standard element both in customary international law and in most treaty provisions in addressing regulatory expropriation. Investment treaties such as MIGA Convention (1985), codification such as US Third Restatement (1987), and the Harvard draft have added the non-discriminatory clause as one of the condition of non-compensable regulatory measures. However, the non-discriminatory requirement cannot stand alone, this is asserted in *The Pope and Talbot* tribunal rejected Canada's argument that non-discriminatory regulation cannot be expropriatory, holding that a blanket exception for regulatory measures would create a "gaping loophole in international protections against expropriation". Thus, the non-discriminatory manner must be

examined overall by also considering all the conditions stated above. It may sound that non-discriminatory manner is an additional requirement, but still it is very important to be assessed.

Pursuant to the case of *GAMI Investments v. Mexico* and *ADC v. Hungary*, a non-discriminatory action can be seen from the goal of the policy, whether it is applied in a discriminatory manner where there are different treatments to different parties or as a disguised barrier to equal opportunity.

Breach of non-discriminatory manner can be found in the case of *Ethyl Corporation v. Canada* (1998), the Canadian government passed legislation which banned the internal transport and the import of the manganese-based compound (MMT) due to health concerns. Ethyl Corporation was the only producer of gasoline containing MMT. The company alleged breach of the obligation not to discriminate on ground of nationality, breach of the obligation not to require performance requirement and expropriation of its property right and goodwill. The government of Canada then agreed to rescind the ban on the additive, to pay \$19million of compensation to the company and issue a statement confirming that MMT does not affect health or environment.

With regards to the non-discriminatory requirement, in the case *Chemtura v. Canada*, the Tribunal had concluded that a measure taken by a State within its mandate, in non-discriminatory manner, does not constitute expropriation. Furthermore, the arbitral tribunal in *Saluka v. Czech Republic* states that,

“States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide

regulations that are aimed at the general welfare.”

Thus, a legitimate measure within a State’s regulatory authority when conducted in a non-discriminatory manner does not constitute as an expropriation and does not give the duty of compensation.

F. Conclusion

The concept of expropriation mostly in practice is in the form indirect expropriation within a government measure, also known as regulatory expropriation. However, international law recognizes lawful state measures, or state police power, which does not raise the duty of compensation.

International law recognizes the government right to regulate as basic attribute of international law. By that means not all state measures which have adverse effects toward foreign investment is classified as an expropriation. Customary international law stipulated that State has the legitimate rights to regulate and to exercise its police powers in the interest of public welfare, even if it may have the effect of expropriation, it does not constitute as expropriation and does not raise the duty of compensation.

After recognizing the State’s right to regulate, then we must assess the public welfare objective requirement within a government measure. There is a controversy whether the interest of public itself can justify a government action as non-expropriatory. Although investment treaties and scholar tend to agree with it, practices in arbitral tribunal stated otherwise. By that means, the purpose of public interest is not the only requirement to define whether an expropriation has occurred or not. However, as important matter, it must be assessed how does a public purpose is bona fide. Based on practices in cases such as *LETCO v. Liberia*, *ADC v. Hungary*, it can be concluded that the public purpose must be

genuinely aim for the public, conducted in good faith and there must not be any individual or private intention.

Another conundrum in defining regulatory expropriation is the economic impact of government action. NAFTA jurisprudence and ICSID Tribunals have assessed that an expropriation occurred where a government measure has substantially or totally wiped out the value of the investment. In addition, the investor must also suffer loss of ownership and loss of control towards the investment. Those conditions are cumulative fulfilled in order to suffice the claim of expropriation. Practices within *Grand River v. USA*, *LG&E v. Argentina*, and *CMS v. Argentina* rejected

claim of expropriation when the investor retain ownership and control, even if the investment value is substantially deprived.

The last but not least important, is the non-discriminatory manner. The existence of non-discriminatory manner itself does not automatically justify the expropriation within a government measure. It must be examined overall by considering other conditions stated above. This is supported by *Pope and Talbot* tribunal which rejected Canada's argument that non-discriminatory regulation cannot be expropriatory. Non-discriminatory manner is an additional clause; however, it is still important to be assessed.

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