OPENING A PANDORA'S BOX IN INVESTMENT ARBITRATION: REDEFINING THE MURKY BOUNDARIES OF COMPENSABLE INDIRECT EXPROPRIATION AND NON-COMPENSABLE REGULATION

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I wish to thank the Almighty God for granting me the strength to undertake this study

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Lastly, I dedicate this study to my family. I thank them for their continuous support throughout my undergraduate journey.

Declaration

I, TIMAMY MDATHIR ISSA, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.

Signed: .....M.I.T.....

Date: 8 January 2021

This dissertation has been submitted for examination with my approval as University Supervisor

Signed: .....  .....

Mabuti Mutua James

Abstract

The concept of expropriation has developed over the years to include not only the outright taking, but also regulations whose effect is tantamount to expropriation. This is referred to as indirect expropriation. As a result of this concept, regulations whose effect deems the investment redundant would still require the investor to be compensated. However, at the same time, there is need to appreciate that states have the right to regulate. This right stems from their sovereignty. Consequently, when a state enacts a regulation in the exercise of this right, they do not need to pay compensation to investors. This illustrates two competing interests: on one hand, regulations which are equivalent to expropriation and require compensation and on the other, there are regulations which are within the states' right to regulate that do not require compensation. How is this distinction drawn? This remains a problematic issue in investment law to date.

This study seeks to draw this distinction. Following a through in-depth analysis of the concept of indirect expropriation and the states right to regulate, this study will demonstrate that the three approaches established by arbitral tribunals fail to correctly draw this distinction. The sole effect approach fails to take into consideration the states right to regulate, while the police powers approach fails to consider the investors protection against expropriation. Furthermore, the tribunals taking up the proportionality approach also fail to capture important factors which also makes drawing the line between these two concepts problematic. To address this conundrum, this study will propose a proportionality test with specific factors that ought to be considered. These include a genuine public welfare purpose, reasonableness, procedural justice and investor's legitimate expectations. These factors cater for both the interests of the investors and the states. Undoubtedly, such an analysis will create a fairer outcome in drawing the distinction between the two concepts. This will not only create certainty but also help in legitimising the system.

List of Abbreviations

Association of Southeast Asian Nations	ASEAN
Bilateral Investment Treaties	BITs
Common Markets for Eastern and Southern Africa	COMESA
Energy Charter Treaty	ECT
European Court of Human Rights	ECtHR
International Centre for Settlement of Investor Disputes	ICSID
International Institute for Sustainable Development	IISD
International Court of Justice	ICJ
Multilateral Investment Treaties	MITs
Organisation for Economic Co-operation Development	OECD

List of Arbitral Awards and Cases

AWG Group Ltd v The Argentine Republic, Award, UNCITRAL (9 April 2015).

Chemtura Corporation v. Government of Canada, Award, UNCITRAL (2 August 2010).

Crystallex International Corporation v. Venezuela, ICSID, Award, (4 April 2016).

Germany v Poland, Judgment, Permanent Court of International Justice (25 May 1925).

Marion Unglaube v Republic of Costa Rica, Award, ICSID (16 May 2012).

Methanex Corporation v. USA, Final Award, UNCITRAL (3 August 2005).

Metaclad Corporation v The United Mexican States, Award, ICSID (30 August 2000).

National Grid PLC v. The Argentine Republic, Award, UNCITRAL (20 November 2008).

Norway v United States of America, Award, Permanent Court of Arbitration (13 October, 1922).

Occidental II Exploration and Production Company v. Ecuador, Award UNCITRAL, (1 July 20014).

Patrick Mitchell v The Democratic Republic of Congo, Annulment Award, ICSID (1 November 2006).

Philip Morris v Uruguay, ICSID, Award, (17 September 2016)**.**

Pope and Talbot Inc v The Government of Canada, UNCITRAL, Award (26 November 2002).

Starrett Housing Corporation v Iran, Award, Ad-hoc tribunal (14 August 1987).

S.D. Myers, Inc. v. Canada, Partial Award, UNCITRAL (30 December 2002).

Siemens A.G. v The Argentine Republic, ICSID, Award, (17 January 2007).

Tecnicas Medioambientales Tecmed, S.A. v. The United Mexican States, ICSID, (5 March 2007).

List of Legal Instruments

Energy Charter Treaty

The Statute of the International Court of Justice

Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens

Organisation for Economic Co-operation Development Draft Convention on the Protection of Foreign Property

UK model BIT

France model BIT

India model BIT

Vienna Convention on the Law of Treaties

CHAPTER ONE: INTRODUCTION

1.1 Setting the Scene

The number of Bilateral Investment Treaties (BITs) has been on the rise across the world.[1] These are treaties between two countries aimed at protecting investments made by investors of both countries in the respective host states.[2] They protect the investors from government actions such as expropriation.[3] They also guarantee fair and equitable treatment, national treatment amongst other interests.[4] Of interest to this study is the protection of investors against expropriation. Expropriation in the context of foreign direct investment may be defined as a form of political risk where a host government seizes a company's assets without fair compensation.[5] It is an undisputed rule in international law that any form of expropriation requires compensation.[6] However, over time disputes on direct expropriation which entail the outright 'taking' of the investor's property have been replaced by indirect expropriation.[7]

Indirect expropriation may be explained as the interference by the state, of the investor's property by putting in place a measure which affects the enjoyment of the benefits from the investment even when the legal title of the property is not affected.[8] While this may be distinguished from direct expropriation as the ownership of the property is not interfered with, there is a striking similarity between the two. In both forms of expropriation, the investors are unable to enjoy the benefits of their property.[9] Consequently, due to the same effect occasioned

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[1] Marshal F, Yu V, 'Investors' obligations and host state policy space' 2nd Annual Forum for Developing Country Investment Negotiators, Marrakech, 2 November 2010, 2.

[2] Dolzer R, Schreuer C, *Principles of International Investment Law*, 2 ed, Oxford University Press, Oxford, 2012 2.

[3] International Institute for Sustainable Development, *Assessing the impact of Investment Treaties,* 2009, 3.

[4] International Institute for Sustainable Development, *Assessing the impact of Investment Treaties,* 2009, 3.

[5] Schreuer C, 'The concept of Expropriation under ETC and other investment protection treaties' Social Science Research Network, 2005, 2.

[6] Schreuer C, 'The concept of Expropriation under ETC and other investment protection treaties' Social Science Research Network, 2005, 1.

[7] International Institute for Sustainable Development, *Indirect expropriation,* 2012, *2.*

[8] Marist B, 'Indirect expropriation and the right to regulate' Organisation for Economic Co-operation Development, Working papers on international investment law, 2017, 2-< http://www.oecd.org/daf/inv/investment-policy/working-papers.htm> on 8 June, 2020.

[9]Marist B, 'Indirect expropriation and the right to regulate' Organisation for Economic Co-operation Development, 3.

through the enactment of the regulation without necessarily 'taking' of the property, there is a need for states to compensate the investors even in the latter circumstances.[10]

On the flip side, there is need to appreciate the fact that states -owing to their sovereignty, always have the right to regulate affairs in their states even when they may affect the investors interest without paying compensation.[11] This right to regulate is expressed as inherent to the sovereignty of the state.[12] Consequently, this gives rise to two competing interests namely; the investor's right to be compensated when their interests has been expropriated directly or indirectly and at the same time reserve the right of the state to regulate its affairs. Finding the balance between these two interests has generated a heated academic debate.

A number of arbitral decisions can be used to illustrate this. For example, in the *Starrett Housing Corporation v Iran*,(hereinafter *USA v Iran)* the issue was whether Iran's regulatory actions of putting the American Company under state management amounted to expropriation.[13] The arbitral tribunal held that even though state management did not outrightly take the investment the action still amounted to expropriation.[14] Consequently, Iran had to compensate the corporation.[15] From the analysis of the tribunal, one can conclude that in assessing whether Iran was liable the tribunal looked at the effect of the measure put in place. This gave rise to the sole-effect test which determines when indirect expropriation requires compensation on the basis of the effect it has on the investment.

At the same time, some tribunals have approached this issue differently by relying on the police doctrine test instead. As illustrated in *Methanex v USA,* the tribunal held that the state will not be liable for any regulation put in place for as long as it is for public purpose, non-discriminatory and enacted through due process.[16] This had the effect of establishing that, regardless of the effect the regulation had on the investor, for as long as the three criteria have

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[10] United Nations Conference on Trade and Development, *Expropriation,* 2012, 17.

[11] Zamir N, 'The Police Powers Doctrine in International Investment Law' 14(1) *Manchester Journal of International Economic Law*, 2017, 318.

[12] Viñuales J, 'Sovereignty in Foreign Investment Law', in Douglas Z, Pauwelyn J and Viñuales J (eds) *The foundations of Investment law,* Oxford University Press, Oxford, 2014, 326.

[13] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, (1987).

[14] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, (1987).

[15] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, 1(987).

[16] *Methanex Corporation v United States of America*, (1976).

been met the action was not compensable.[17] Still, some tribunals have also differed with this approach and instead preferred the proportionality test. As explained in *Tecnicas Medioambientales Tecmed, S.A. v. The United Mexican States*[18], (hereinafter *Tecmed v USA*) entails balancing the public purpose behind the regulatory measure with the effect the measure has on foreign investment.

From the brief introduction above and as appreciated by the OECD report, the boundaries of what amounts to indirect expropriation are still murky.[19] Furthermore, there is still uncertainly as to what instances warrant the state to be exempted from paying compensation for the indirect expropriation. These uncertainties are what this paper seeks to address. Indeed, clarity will go a long way in increasing the legitimacy of the system.

1.2 Statement of the Problem

Arbitral tribunals should be able to correctly balance the tension between the right of the states to regulate their internal affairs and at the same time preserve the investors right to compensation. At the moment, all laws in place are silent on what exactly amounts to indirect expropriation. Further, as alluded before, the tribunals have also held differently in establishing compensable indirect expropriation claims. In *USA v Iran* the tribunals established the sole effect doctrine test, in *Methanex v USA* the tribunals established the police doctrine test, while in *Tecmed v USA* the tribunals introduced the proportionality test. Undoubtedly, this uncertainty adversely affects the legitimacy of the system. This study seeks to fill in this lacuna in the law and bring clarity in the jurisprudence. This will be achieved by defining what amounts to indirect expropriation and establishing a test to guide tribunals in assessing compensable and non-compensable indirect expropriation claims.

1.3 Significance of the Study

This research seeks to bring clarity in legal reasoning and increase the legitimacy of the system for all the stakeholders including the states, foreign investors and the arbitrators. This will be achieved through clearly expounding on what amounts to indirect expropriation. This will in turn assist the states and the foreign investors when coming up with the bilateral investment

[17] Titi C, Police powers doctrine and international Investment law in Gattini A, Tanzi A and Fontanelli F (eds) *General principles of international investment arbitration*, 2018, 8.
[18] *Tecnicas Medioambientales Tecmed, S.A. v. The United Mexican States*, (2007).
[19] United Nations Conference on Trade and Development, *Expropriation,* 2012, 21.

treaties in so far as they can clearly outline the respective rights and duties of both parties. Similarly, through establishing a test on when indirect expropriation is compensable and non-compensable, the arbitrators may resort to this test when faced by this issue. This will create uniformity and certainly in the legal system thereby increasing its legitimacy.

1.4 The Aim and the Objectives of the Study

The aim of this study is to establish a test that balances the interests of the investors and those of the state, which will be used to assess instances when indirect expropriation is compensable and when it is not.

Consequently, this study has the following objectives:

- Delineate the extent of indirect expropriation.
- Interrogate the extent to which states are permitted to regulate their affairs which affect the interest of the investors.
- Critic the arbitral decisions establishing the sole effect test, the police power test and the proportionality test.
- Establish a viable test for compensable and non-compensable indirect expropriation that will restore the investors legitimate expectation without jeopardising state sovereignty.

1.5 Research Questions

- What are the circumstances that can be deemed to amount to indirect expropriation?
- How far can the states regulate its affairs when the investors interests are affected?
- What are the defects in the current tests (sole effect test, the police power test and the proportionality test) in assessing compensable indirect expropriation?
- What is the best test that can be used to balance these two competing interests?

1.6 Hypothesis

The current tests used to assess whether indirect expropriation is compensable are insufficient, as they fail to strike a proper balance between preserving state sovereignty while maintaining the investor's legitimate expectation.

1.7 Theoretical Framework

i) The Contract theory

This theory was propounded by Oliver Hart and Bengt Holmstrom. Broadly, the contract theory provides that for a contract between two parties to be efficient, there is a need to provide each

party with the right incentives to work effectively together.[20] In the context of investment law, this theory applies in so far as states commit to protecting the property rights of the foreign investors so as to incentivise more investors coming to the state to promote development. As explained by Oliver, majority of the contracts are entered are incomplete for two reasons; these are: the inability to anticipate all the future events when drafting the contract, and the asymmetrical information between the two parties.[21] As such, the only incentive the contract has to offer is the allocation of control rights. Consequently, this theory has the effect of shifting the analysis of the contracts from the perspective of after an alleged breach to the perspective of the contract design.[22] Further, since the allocation of control rights is the incentive to enter into the contract in the first place, this theory proposes that the asset owners should have the control rights.[23]

Applying this theory to foreign direct investment, the contract in question would be the BITs created between the two states. Just as was the case in contracts, BITs are also faced with two issues; the inability to anticipate all future events and asymmetry of information between the host state and the investor. Consequently, there is a need to prevent the analysis of the BIT after an alleged breach and instead, look into the BIT at the time of its design. Indeed, for any state to enter into this agreement, the state has to ensure that the limitation it places on its sovereignty is surpassed by the benefits that will accrue from the investment, that is, the participation constraints on the state must be met. On the other hand, the investors incentive to enter into the agreement will be based on the guarantee of the control rights to the assets in question.

This theory will thus influence this study in so far as it informs the extent to which the state may be permitted to regulate their affairs which affect the interests of the investors. As per the theory, since states had met the participation constraints upon entering into the agreement and only novel circumstances that were impossible to anticipate would warrant regulation affecting the investors. In addition, this theory also influences the study as it establishes the legitimate expectation of control that the investor has. This will be crucial in critiquing the tests already in place and in establishing the more viable test.

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[20] Scott R, 'The law and economics of Incomplete contracts' 2 (1), *Annual Review of Law and Science*, 2006 280.
[21] Scott R, 'The law and economics of Incomplete contracts' 281.
[22] Scott R, 'The law and economics of Incomplete contracts' 283.
[23] Scott R, 'The law and economics of Incomplete contracts' 285.

ii) The principal-agent theory

This theory was developed by Barry Mitnick and provides that delegation of any function by the principal to the agent has a cost referred to as the 'agency loss'.[24] This agency loss may be defined as the difference between the consequences of delegation for the principal and the best possible consequences. Agency loss is zero when the agent acts in such a way that is consistent with the actions of the principal himself.[25] As the theory was further expounded on it was revealed that agency loss is minimised when the principal and the agent share the common interest and when the principal is knowledgeable enough to know about the actions of the agent in determining whether they serve their interest.[26]

In the context of investment law, the agency theory applies in so far as the parties agree on who to elect as the members of the arbitral tribunal to resolve disputes between them. As such, the arbitrators are the agents of both the state and the foreign investor as they both take part in their election. Consequently, there is a need for the arbitrators to ensure that they act in such a way that that they minimise agency loss. This can only be achieved when the arbitrators are able to balance between both the rights of the state and the investor to produce the best outcome.

This theory will thus influence the study by illustrating how the current tests used by arbitral tribunals increase the agency loss. For example, it demonstrates that the sole effect test is insufficient as it mainly focusses on the foreign investor failing to encompass the interest of the state. Similarly, this theory illustrates the inadequacy of the police power test as it only puts emphasis on the state and not the investor. Finally, this theory also illustrates the loopholes in the current proportionality test as it only focusses on balancing between the two interests without interrogating important factors such as necessity and reasonability. This theory hence buttresses the need for a revised test that will strike a better balance between the two competing interests so as to minimise the agency loss.

1.8 Research Methodology

This study will use the doctrinal methodology. This approach involves reviewing existing primary sources such as various legal instruments and cases. Further it also involves

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[24] Aken A, 'Control mechanisms in international investment law' in Douglas Z, Pauwelyn J and Viñuales J (eds) *The foundations of Investment law,* Oxford University Press, Oxford, 2014, 413.
[25] Aken A, 'Control mechanisms in international investment law' 414.
[26] Aken A, 'Control mechanisms in international investment law'414.

interrogating secondary sources such as books, law journals and reports. Unique to this study, this paper will conduct a comparative study of arbitral decisions establishing the sole effect, police and the proportionality tests. This comparative study will be used to illustrate the loopholes in each test and will inform the new test to be established.

1.9 Literature Review

As alluded in the paper before, this study seeks to elaborate on what exactly amounts to indirect expropriation and thereafter establish instances when it is compensable. At the moment, scholars have different perspectives as to what amounts to indirect expropriation. This issue has sparked divergent view since, the understanding given to indirect expropriation has a direct impact on the extent to which states can exercise their regulatory functions. Therefore, this study will seek to review literature that demystifies the concept of indirect expropriation and the concept of sovereignty in investment law. In addition, since finding the balance between these two competing interests has brought uncertainty amongst arbitral tribunals. This study will also review literature that establishes and analyses the sole effect, police and the proportionality tests to evaluate their effectiveness.

There have been a number of attempts to clarify what amounts to indirect expropriation. The first attempt was made through the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens. Article 10(5) provides that it shall be not considered wrongful for a state to deprive the alien of full enjoyment of the investment if the state executes a law in specific instances such as public order, health and tax laws.[27] This article has the effect of making all other public purposes compensable indirect expropriation unless they fit in the specific criteria.

Similarly, Article 3 of the OECD Draft Convention on the Protection of Foreign Property, attempts to explain what amounts to indirect expropriation but just like the Harvard Draft fails to clearly draw the line between indirect expropriation (compensable) and lawful regulation (non-compensable).[28] The clearest articulation of what indirect expropriation is may be found in the Restatement Third of Foreign Relations Law of the United States. It provides that a state

[27] Article 10(5), *Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens*, not entered into force.

[28] Article 3, *Organisation for Economic Co-operation Development Draft Convention on the Protection of Foreign Property,* not entered into force.

will be guilty of expropriation when it subjects the alien property to a measure that unreasonably interferes with the effective enjoyment of the alien's property.[29]

Authors in this field of law have resorted to the Vienna Convention on the law of Treaties to elaborate on the meaning of indirect expropriation when provided for in a BIT.[30] Other authors are of the view that the definition attached to this term varies depending on the measure in question and the provision in the BIT.[31] On the extreme end, other authors maintain that the whole concept of indirect expropriation should be done away with to eradicate the uncertainties.[32] Similarly, a number of reports have also been prepared by the International Institute for Sustainable Development (IISD) and the Organisation for Economic Co-operation and Development (OECD). While these reports explain how murky the boundaries of indirect expropriation are, they fail to give a guide on the same.[33]

Conflicting with the concept of indirect expropriation is the concept of lawful regulation. As explained by Jorge Viñuales, the fact that a state is sovereign, guarantees its permanent control over its natural resources.[34] Consequently, a state always retains police powers over the affairs in the state. When states exercise these police powers, they are exempted from paying compensation even when the investments of foreign investors are affected.[35] This is deemed necessary, since the state ought to be able to conduct its functions without fear of being sued.[36] While there is no dispute as to the states regulatory power there is controversy as to how far these powers extend. Some authors are of the view that purpose of investment agreements needs to be reframed.[37] These agreements should no longer aim at protecting investors. Instead,

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[29] Bernhardt R, 'Restatement of the Law Third: The Foreign Relations Law of the United States' 86(3), *American Journal of International law,* 1992, 610.

[30] Ranjan P, Indirect expropriation in international investment law and article 31 (3) (c) of the VCLT: A critique of Philip Morris v Uruguay, 8(1) *Asian Journal of International Law* 2018, 123.

[31] Dolzer R, 'Indirect expropriations: New developments' 11(1), *New York University Environmental Law Journal,* 2004, 89.

[32] Isakoff P, 'Defining the Scope of Indirect Expropriation for International Investments' 3(2) *Global Business Law Review,* 2013, 200.

[33] Organisation for Economic Co-operation Development, Indirect expropriation and the right to regulate, Working papers on international investment law, 71.

[34] Viñuales J, 'Sovereignty in Foreign Investment Law' 324.

[35] Viñuales J, 'Sovereignty in Foreign Investment Law' 327.

[36] Zamir N, 'The Police Powers Doctrine in International Investment Law' 320.

[37] Isakoff P, Defining the Scope of Indirect Expropriation for International Investments, 206.

they should aim at promoting sustainable development.[38] This grants the state the mandate to intervene in so far as the investment goes contrary to this aim.

In a bid to strike the balance between these conflicting interests, arbitral tribunals have also established tests. For example, in *USA v Iran*, the arbitral tribunal held that even though state management did not involve ownership the action still amounted to expropriation, holding that Iran was liable for the damages.[39] This established the sole effect doctrine test. This test provides that the tribunal should looks at the effect of the measure on the investor.[40] Should the effect reach a certain thresh-hold regardless of the motive of the state a finding of expropriation is unavoidable.[41] While some authors applaud this view, it has received an equal share of criticism for neglecting the police powers of the states.[42]

As a result, some tribunals have preferred the police power test as held in *Methanex v USA*.[43] This test provides that for as long as the measure put in place by the state is for the public purpose, non-discriminatory and enacted following the due process, the state is exempted from compensation.[44] This test has been accepted by many authors as it is in line with the customary law on the sovereignty of the state.[45] However, it has also been criticised as it implies that the difference between expropriation and regulation is solely based on public purpose.[46]

Another test is the proportionality test as explained in *Tecmed v USA* and expounded in *Philip Morris v Uruguay.*[47] This test seeks to balance the public purpose behind the regulatory measure with the effect that the measure has on foreign investment.[48] While, this test has been accepted by many as it tries to balance between the two competing interests,[49] it has also been criticised. This is because, tribunals have relied on Article 1 of the European Convention on

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[38] Isakoff P, Defining the Scope of Indirect Expropriation for International Investments, 189.
[39] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, (1987).
[40] *Ethyl Corporation v Government of Canada* (1998).
[41] Mostafa B, 'The sole effect Doctrine, police powers and indirect expropriation under International law' 15(1) *Australian International Law Journal*, 2008, 276.
[42] Titi C, 'Police powers doctrine and international Investment law' 9.
[43] *Methanex Corporation v United States of America*, (1976).
[44] *Methanex Corporation v United States of America*, (1976).
[45] Zamir N, 'The Police Powers Doctrine in International Investment Law' 318.
[46] Mostafa B, 'The sole effect Doctrine, police powers and indirect expropriation under International law' 277.
[47] *Philip Morris v Uruguay*, (2017).
[48] Ranjan P, Indirect expropriation in international investment law and article 31 (3) (c) of the VCLT: A critique of Philip Morris v Uruguay, 8(1) *Asian Journal of International Law* 2018, 123.
[49] Rajput A, Indirect Expropriation in International Law, 5(2) *Asian Journal of International Law*, 2015, 413.

Human Rights to justify its application, yet the treaty in question does not fall under the legal framework of investment law.[50] Further, the tribunals apply proportionality *stricto sensu* without interrogating necessity and reasonability tests which are equally important.[51]

The brief analysis of the existing literature demonstrates that what amounts to indirect expropriation and the extent of state sovereignty is still uncertain. Further, while the tests used by the various arbitral tribunals may be commendable, interrogating the existing literature has also demonstrated that they still have loopholes. As a matter of fact, the existing literature buttresses the need for a better test that will be more efficient. This demonstrates that the aim of this study is in line with the existing literature.

1.11 Limitation of the study

The literature on indirect expropriation is mainly Eurocentric, consequently the findings of the study may not fully reflect the position of other schools of thought. In addition, this study was to be done in a limited period of time and as a result

1.12 Chapter Breakdown

This study has five chapters. This first chapter is the introduction. It introduces the problem the study seeks to address by highlighting in brief, the circumstances that brought about the issue at hand. Further, it also explains the current position of the existing authors on this issue. The second chapter explains the concept of indirect expropriation by explaining how it emerged, the attempts to codify it and how it is manifests itself in older investment treaties (pre-2011) and more recent treaties (post 2011). Finally, this chapter analyses the arbitral attitude towards this concept to establish the test tribunals use to make a finding of indirect expropriation.

The third chapter seeks to understand the concept of the states right to regulate by analysing the sovereignty which is the conceptual underpinning of this right. Thereafter, it will interrogate how far states can rely on sovereignty to regulate investors even when a BIT or MIT protects the investor against indirect expropriation. With the findings of the previous chapters in mind, the fourth chapter seeks to compare the three different tests established by

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[50] Ranjan P, 'Using the Public Law Concept of Proportionality to Balance Investment Protection with Regulation in International Investment Law: A Critical Appraisal' 3(3) *Cambridge Journal of International Law and Comparative Law,* 2014, 860

[51] Ranjan P, 'Using the Public Law Concept of Proportionality to Balance Investment Protection with Regulation in International Investment Law, 862.

the arbitral tribunals to find a balance between circumstances that amount to indirect expropriation and those that are a state's right to regulate. This chapter will demonstrate that the current tests used by arbitral tribunals are flawed and a new approach is required for the success of the system.

The fifth chapter draws lessons from the loopholes in the previous test and explains a better test that the arbitral tribunals can resort to when faced by this conundrum. Finally, this study will give a meaningful conclusion that resolves the current tension between investor's rights and state sovereignty.

CHAPTER TWO: DELINEATING THE CONCEPT OF INDIRECT EXPROPRIATION

2.1 The emergence of indirect expropriation from direct expropriation

Traditionally, investors were protected against the outright taking of the investment they have made by the host state.[52] This taking was open and deliberate, with the state taking part in the seizure of the investment or mandating the transfer of title.[53] Consequently, this form of expropriation was readily identifiable. A recent example of this would be the nationalization of the oil industry in Venezuela.[54] Due to the overt taking by the government, there is an established principle in customary international law prohibiting this form of expropriation unless four requirements are met. These are: the expropriation was for a public purpose, enacted in a non-discriminatory, complies with the due process of law and provides the investor with prompt, adequate and effective compensation.[55] This form of expropriation is usually unambiguous and easily identifiable and is referred to as direct expropriation.

Over the years, the concept of expropriation has evolved to include not only the outright taking by the state but also other actions that have the same effect as expropriation. This relates to actions by the state which interfere with the use of the property or with the enjoyment of benefits arising from the property even when the legal title of the property has not been affected.[56] This form of expropriation has been coined as indirect expropriation and has become rampant in the recent years.[57] However, to date, the standard for indirect expropriation still remains nebulous especially since, there is a wide array of potential state actions that could constitute indirect expropriation.[58] This calls for significant line drawing issues. In doing so,

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[52] Dolzer R, Schreuer C, *Principles of International Investment Law*, 2 ed, Oxford University Press, Oxford, 2012 2.

[53] Fortier L, Drymer S,' Indirect expropriation in the law of international investment: I know it when I see it or caveat investor' 19(2) *Foreign Investment Law Journal*, 2004, 299.

[54] Isakoff P, 'Defining the Scope of Indirect Expropriation for International Investment' 3(2) G*lobal Business Review* Global, 192

[55] Rajput A, *Regulatory Freedom and Indirect Expropriation in investment Arbitration*, Wolters Kluwer Publishers, Oxford, 2018, 72.

[56] Barklem C, 'The Concept of Indirect Expropriation its appearance in the international system and its effect in the regulatory activity of the governments' 11(21), *Civil Law Journal*, 2011, 36.

[57] Fortier L, Drymer S, 'Indirect expropriation in the law of international investment' 298.

[58] Investor State Dispute Settlement Report, *Investment Law a Changing Landscape*, 2005, 45.

there is a need to analyse the history of the emergence of the concept of indirect expropriation to understand what this concept sought to redress.

The first time this concept was discussed was in the matter regarding the controversy of the United Kingdom and the Kingdom of Two Scillies.[59] In this dispute, the UK in 1838 granted a company exclusive rights in the extraction of sulphur.[60] They thus enjoyed a monopoly. On the basis of this decision, the other companies in the UK filed for compensation since the monopoly affected their rights resulting to economic loss.[61] Consequently, compensation was awarded regardless of the fact that the other companies had not been taken by the UK government but rather because of the indirect interference the grant of the monopoly had in enjoying the economic benefits.[62] This demonstrates the emergence of the concept of indirect expropriation as the courts were willing to award compensation even when there has been no taking. This concept emerged further in the case of *German interest in Polish Upper Silesia*, where the Permanent Court of International Justice affirmed that the Polish Government had unlawfully expropriated contractual rights of the Contractor by interfering with the rights of use, experiment, patents and licenses.[63] This case further demonstrates the concept of expropriation going beyond the physical seizure of assets.

Within the realm of investment law in particular, the USA by virtue of the International Claims Act of 1949, put in place the International Claims Commission which was established to decide on compensation claims of American Nationals when they had been taken by governments of host states.[64] The Commission in the *Alberta Bela Reet* dispute noted that Hungary was liable for expropriation as their actions restricted the free use of the property even though the title of the property was not interfered with.[65] This decision, together with many others confirmed the

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[59] Barklem C, 'The Concept of Indirect Expropriation its appearance in the international system and its effect in the regulatory activity of the governments' 32.
[60] International Institute for Sustainable Development, *Best practices indirect expropriation,* 2012, 23.
[61] Christie C, 'What constitutes a taking of property under international law?' 312.
[62] Christie C, 'What constitutes a taking of property under international law?' 312.
[63] Permanent Court of International Justice, Eighth Ordinary Session, Judgment Number 6 of 1925.
[64] Friedberg S, 'Unjust and outmoded – the doctrine of continuous nationality in international claims' 4(5) *International lawyer* 2002, 840.
[65] Giorgetti C, 'International Claims Commission Righting Wrongs After Conflict' Richmond Repository, 2017, 34.

Commission's position that the transfer of title was not a *sine que non* requirement for expropriation.[66] This formed the foundation for the concept of indirect expropriation.

While there was consensus as to the fact that expropriation went beyond the taking by the state-direct expropriation, there was still uncertainty as to what exactly amounts to indirect expropriation. In a bid to address this, there were efforts to codify the law on indirect expropriation which will be discussed below.

2.2 Attempts to the codification of the concept of indirect expropriation- was it successful?

The first attempt to the codification of the concept of indirect expropriation was in the Harvard Draft Convention on the International Responsibility of States for Injuries and Aliens.[67] While the document did not primarily address the rights of the investors, it was the first document to widen the scope of the definition of expropriation to include:

> *'A taking of property includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy or dispose of the property within a reasonable period of time after the inception of such interference'.*[68]

This shows a clear shift in the definition of expropriation to include not only the taking but also any unreasonable interference of the investment. Furthermore, Article 5 gave the concept even more clarity by equating the uncompensated taking of an alien and deprivation of the use or enjoyment of an alien arising from the conduct of the host state.[69] The effect of this provision is to confirm that even when property has not been taken, deprivation of the use or benefits of the investors also requires compensation. Unfortunately, the Harvard Convention was never adopted and hence there were still more efforts to try and codify the concepts.[70]

The next attempt to codify the law was through the OECD Draft Convention on the Protection of Foreign Property which aimed at strengthening international economic organisation.[71] In

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[66] Giorgetti C, 'International Claims Commission Righting Wrongs After Conflict' 34.

[67] Sohn L and Baxter R, 'Responsibility of States for Injuries to the Economic Interests of Aliens: Draft Convention on the International Responsibility of states for Injuries to Aliens' The *American Journal of International law* 55(3), 1961, 548.

[68] Sohn L and Baxter R, 'Responsibility of States for Injuries to the Economic Interests of Aliens' 549.

[69] Christie C, 'What constitutes a taking of property under international law?' 312.

[70] Barklem C, 'The Concept of Indirect Expropriation its appearance in the international system and its effect in the regulatory activity of the governments' 9.

[71] OECD Draft Convention on the Protection of Foreign Property, *Commentary*, 2007, 21.

particular, Article 3 of the Draft Convention provided that 'no party shall take any measures depriving, directly or indirectly of his property a national of another party unless it is done for a public purpose, enacted in a non-discriminatory, complies with the due process of law and provides the investor with prompt, adequate and effective compensation'.[72] This Convention further buttressed the recognition of indirect expropriation.

However, while these Draft Conventions gave recognition to the concept of indirect expropriation, they failed to establish what exactly amounts to indirect expropriation.[73] This loophole was further translated in majority of the various BITs and Multilateral investment treaties (MITs). In making this analysis, the investment treaties will be divided into two-time periods; those drafted pre 2011 which account for the majority of the treaties and majority of the disputes arising from the same. The second period relates to treaties drafted after 2011 which have more efforts in defining what amounts to indirect expropriation but still suffer ambiguity. To demonstrate this, this section will first discuss the provisions of investment treaties pre-2011 followed by an analysis as to how the tribunals have addressed the ambiguity. This will then be followed by an analysis of treaties post 2011, while there have been no disputes filed on the basis of these treaties, this section will demonstrate the ambiguities and the potential disputes that could arise.

2.3 Investment treaties pre-2011

The investment treaties drafted at this time were characterised by the fact that they generally referred to the concept of indirect expropriation without defining the circumstances that would give rise to this. To demonstrate this a number of investment treaties will be analysed.

The 1994 Energy Charter Treaty (ECT), which is a multilateral investment treaty governing the investments in the energy sector provides a good example. Article 13 of this treaty provides that investment of investors shall not be nationalised or expropriated or subjected to a measure having effect equivalent to nationalisation or expropriation.[74] This illustrates that the ECT does recognise the concept of indirect expropriation by addressing all other measures whose effect is equivalent to nationalisation or expropriation. However, while the ECT recognises this, it

[72] Article 3, OECD Draft Convention on the Protection of Foreign Property.
[73] Kriebaum U, and Reinsch A 'Property Right to International Protection' 7(2) *Max Plank encyclopaedia of Public International law*, 2015, 19.
[74] Article 13, *Energy Charter Treaty*, 1994.

fails to establish the circumstances or factors that amount to indirect expropriation.[75] The resultant effect of this is the fact that many disputes arising from this treaty pertain to whether the measure in question amounts to indirect expropriation.

Such treaty wording has been the norm in investment law with majority of the countries reflecting the same treaty provision. For example, Article 5 of the UK model BIT,[76] Article 4 of the France model BIT,[77] Article 5 of the India model BIT[78] all make reference to indirect expropriation without making reference to what is meant by the term. The France BIT for example, makes reference to 'other measures whose effect would be the direct or indirect dispossession of the investment' but still fails to expound on the same.[79] Hence, this is not only a problem in the said treaties, but rather, this is a problem bedevilling almost all investment treaties.

As a result of the vagueness in the investment treaties, arbitral tribunals are left to discern what amounts to indirect expropriation.[80] The following are the factors taken into consideration by the arbitral tribunals in assessing whether there has been indirect expropriation.

I) *Severe economic impact*- Most arbitral tribunal consider the effect of the government measure on the viability of the venture.[81] This means that, tribunals take into consideration the financial implications of the investment that have arisen as a result of the government measure. The more severe the economic implication, the more likely the government measure will amount to expropriation. Conversely, where the government measure has not resulted into severe economic loss such as when only the profitability of the venture is affected, the tribunals have been reluctant to make a finding of indirect expropriation.[82]

To illustrate this difference, the award in *Pope and Talbot* and in *Starrett Housing* are instructive. In *Starrett Housing*, the tribunal came to the finding that there was an expropriation despite the fact that there was no outright taking, on the basis that the Iran had largely interfered

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[75] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space?' 60(2), *Harvard International law Review* 2019, 392.
[76] *UK model BIT*, 2008.
[77] *France model BIT*, 2006.
[78] *India model BIT*, 2003.
[79] Article 4, *France model BIT*, 2006.
[80] Rajput A, *Regulatory Freedom and Indirect Expropriation in investment Arbitration,* 103.
[81] OECD Working Papers on International Investment, Indirect Expropriation and the Right to Regulate in international Investment, 2014, 21.
[82] Fortier L, Drymer S, 'Indirect expropriation in the law of international investment' 19.

with the commercial viability of the venture to a point that it was no longer commercially viable even if Iran had not interfered with the ownership of the property.[83] On the other hand, in Pope and Talbot the tribunal found that the introduction of export quotas resulted in a reduction of profits for the company, through sales abroad were not entirely prevented and the investor was still able to make profits.[84] The tribunal noted that mere interference is not expropriation; but rather s significant degree of fundamental rights of ownership is required for the measures to be deemed as expropriation.[85] This analysis reveals that economic impact ought to be severe.

II) *Duration of the regulation* -Another criterion arbitral tribunal pay attention to is the period of through which the regulation has been put in place.[86] The longer the period the measure by the government lasts the more likely a finding that there has been indirect expropriation. For example, in *SD Myers v Canada*, the tribunal noted that since Canada's measure was temporary there can be no finding of indirect expropriation.[87]

III) *Control of the investment*- The tribunal also considers who is in control of the investment, such that where the investor remains in control of the investment the more likely the tribunal will find that the measure falls short of the indirect expropriation standard.[88] For example, in *National Grid v Argentina* the tribunal found that the actions by the Argentine government did not amount to indirect expropriation since the investor was still in control of the investment and was involved in the day to day running of the business.[89]

IV) *State's intention*- The tribunal also considers the state's intention in enacting the measure. Where an investor is able to demonstrate that the state enacted a measure without a legitimate public interest, the more likely the tribunal is to find that the measure amounted to expropriation.[90] For example, in *Methanex v USA*, the tribunal found that the enactment of the

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[83] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, 1987.
[84] *Pope and Talbot Incorporation v The Government of Canada*, (2002).
[85] *Pope and Talbot Incorporation v The Government of Canada*, (2002).
[86] Dolzer R, 'Indirect expropriations: New developments' 89.
[87] *SD Myers v The Government of Canada*, (2002).
[88] Henckels C, indirect expropriation and the right to regulate; revisiting proportionality and analysis and the standard of review in investor- state arbitration, *Journal of International Economic Law,* 2012, 53.
[89] *National Grid v Argentina*, (2014).
[90] Schreuer C, 'The concept of Expropriation under ETC and other investment protection treaties' Social Science Research Network, 2005, 2.

measure was not based on a legitimate public interest and hence the tribunal found the measure to amount to indirect expropriation.[91]

From the above analysis it is clear that arbitral tribunals have attempted to shed more light on government measures that will be tantamount to indirect expropriation. However, as this paper will demonstrate such an approach still remains problematic. This is because, first, the investor-state dispute settlement system lacks a system of precedence.[92] As a result, tribunals are not bound by the decisions of the previous arbitral tribunals. The resultant effect of this is that different arbitral tribunals take into consideration different circumstances in assessing what amounts to indirect expropriation which aggravates the uncertainty of this concept.[93] For example, in *Starrett Housing* the tribunal failed to take into consideration other circumstances and only focussed on the effect a government measure has on the investor. For as long as the investor is able to show that they have suffered harm as a result of the measure this tribunal and a few others have been willing to award compensation. On the other hand, some tribunals look at circumstances such as control and duration of a measure implemented by the state for example in *Siemens v Argentina* the tribunal noted that the measures amounted to expropriation on the basis that projects were postponed and later cancelled.[94] This problem affects the very legitimacy of the investor-state dispute settlement system.

The obvious way forward would be to establish specific considerations in determining whether there is indirect expropriation. However, this exercise is by no means easy. This is because, in further assessing the root cause of this problem, it would be clear that the definition of what amounts to indirect expropriation directly affects the state's sovereign right to regulate.[95] If the concept of indirect expropriation were to be viewed from the investor's lens, then the arbitral tribunal risk paralysing the states sovereign right to regulate. On the other hand, arbitral tribunals may give states a wide margin of discretion that would allow them to enact measures

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[91] *Methanex v United States of America,* (2007).

[92] Schill S, 'Ordering Paradigms in international investment law: Bilateralism Multilateralism-Multilateralization', in Douglas Z, Pauwelyn J and Viñuales J (eds) *The foundations of Investment law,* Oxford University Press, Oxford, 2014, 326.

[93] Rajput A, *Regulatory Freedom and Indirect Expropriation in investment Arbitration*, 107.

[94] *Siemens v Argentina* ICSID, 20008.

[95] Cotula L, 'Regulatory takings, stabilization clauses and sustainable development' OECD Global forum of international investment law, Session Number 2.6, 2008, 6 <https://www.oecd.org/investment/globalforum/40311122.pdf > 24 May, 2020.

even when they render the investment redundant.[96] This question is crucial as when the measure amounts to indirect expropriation the investor is awarded compensation, however, where the measure is as a result of the sovereign right to regulate, compensation is not necessary.

With the failure of the investment treaties pre-2011 which account for over 95% of the existing BITs[97] and which also give rise to the most disputes, to expound on the specifics of indirect expropriation, proves that there is a need for clarity in the existing jurisprudence to ensure that states are not accorded a high level of deference that would essentially go against the very protection the investment treaty sought to do.[98]

2.4 Investment treaties post-2011

Some of the investment treaties negotiated after 2011 have sought to address this problem by attempting to delineate what amounts to indirect expropriation. Out of 2185 investment treaties only 185 treaties have such provisions which seek to clarify what amounts to indirect expropriation. Such clauses either take the form of a carve out clause or a contextual clause or a model that adopts a hybrid of the two.[99] While having such provisions is commendable, as this section will demonstrate, these clauses still remain flawed. In illustrating this, provisions in the relevant BITs will be analysed.

Carve out clauses refer to clauses that exclude certain regulatory measure from amounting to indirect expropriation. They are usually of two types, those that generally exclude government measure for public purpose.[100] For example, Article 6(2) of the Bangladesh- Turkey BIT provides that 'non-discriminatory legal measures designed and applied to protect legitimate public welfare objectives, such as health safety and environment, do not constitute indirect expropriation'.[101] The other type of carve our clauses lay down conditions for regulatory

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[96] Rajput A, *Regulatory Freedom and Indirect Expropriation in investment Arbitration*, 136.
[97] United Nations Conference on Trade and Development, *Report on the Investor State Dispute Settlement System*, 2014, 71.
[98] Barklem C, 'The Concept of Indirect Expropriation its appearance in the international system and its effect in the regulatory activity of the governments' 9.
[99] Salacuse J, 'Investment treaty exceptions, modifications and termination' 14(2) *Oxford Journal of international law,* 8.
[100] Newcombe A, 'General exceptions in international investment agreements' 8th Annual World Trade Organization Conference, London, 13 and 14 May 2008, 12.
[101] Article 6(2), *Bangladesh -Turkey BIT*, 2018.

actions to not constitute indirect expropriation. For example, Article 7(4) of the 2016 Austria-Kyrgyzstan BIT provides that:

> 'Non-discriminatory measures of a Contracting Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation, except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith'

The other type of treaty clause is the contextualization model which provides that the examination of indirect expropriation requires a case by case fact-based analysis of various factors which include economic impact of the measure, the legitimate expectations of the investor and the character of the government measure.[102] This approach has been employed in Article 8 (3) of the ASEAN-India Investment treaty which provides that to assess whether an action amounts to indirect expropriation, the process should be a factual inquiry which looks into other factors including economic impact of the investor although this as a stand-alone factor is not sufficient to establish expropriation, whether the government breaches prior commitments given to the state, the character of the government measure including its object and whether it is proportional.[103] Finally, other investment treaties employ a hybrid of the carve out model and the contextualization model.[104]

Despite such efforts, these models still present a number of problems. As regards the contextualisation clauses they are problematic as they allow different BITs make reference to different factors.[105] For instance; Colombian BITs fail to list the character of the measure as one of the factors to consider when assessing whether the government measure amounts to indirect expropriation.[106] In the same vein, other BITs for example those by Canada list the character of the measure as one of the factors but fail to expound on what exactly amounts to

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[102] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 33.
[103] Article 8 (3), *ASEAN-India BIT*, 2014.
[104] El-Kady H and Rwananga Y, 'Morocco's new innovative BIT and police considerations' June 20, 2020 < https://www.iisd.org/itn/en/2020/06/20/moroccos-new-model-bit-innovative-features-and-policy-considerations-hamed-el-kady-yvan-rwananga> accessed on 12 September, 2020.
[105] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 33.
[106] Colombia model BIT, 2011.

'character of the measure'.[107] This also creates uncertainty. Other BITs also incorporate concept of proportionality and reasonability in assessing the measure without establishing how these concepts ought to be analysed.[108]

In the same breath, carve out clauses are also problematic. For instance, majority of the carve out clauses, as seen in the Austria BIT make reference to 'rare circumstances' but fail to expound on what exactly amounts to such circumstances. There is also ambiguity as to what amounts to regulatory action despite many carve out clause referring to the same.[109] One of the contentious issues in this regard is whether judicial decisions are also protected by the carve out clauses. Finally, all the curve out clauses refer to legitimate public welfare objectives.[110] While this may seem like a clear provision a number of nuances arise as to whether actions like price stabilisation, climate change fall within the same umbrella of legitimate public welfare objectives.[111]

From the analysis above it is clear that the concept of indirect expropriation is yet to be well understood in both the investment treaties before and after 2011. However, to fully understand this concept there is a need to also understand the concept of regulation by the state. This is because these interests are competing and a proper balance ought to be found. Only then, will the study be able to establish when a regulation amounts to indirect expropriation or when it is lawful. As such, the next section will analyse the concept of sovereignty under investment law to appreciate how far states can regulate measures within their state. These discussions will then inform the discussion on drawing the line between compensable indirect expropriation and non-compensable regulation.

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[107] Canada model BIT, 2012.

[108] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 33.

[109] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 33.

[110] Sattorova M, 'International investment law, renewable, energy and national policy making: on green discrimination, double regulatory squeeze and the law of exceptions' in Bjorklund K (ed), *Yearbook on international investment law and policy,* Oxford University press, Oxford, 2013, 438.

[111] Rajput A, *Regulatory Freedom and Indirect Expropriation in investment Arbitration*, 136.

CHAPTER THREE: ANALYSIS OF STATE POLICE POWERS IN INVESTMENT LAW

3.1 Sovereignty as the conceptual underpinning of police powers

States are independent actors at the international level.[112] By the fact that these states have a defined population, a fixed territory and are able to enter into legal relations with other states, they are sovereign.[113] This brings about a number of implications. First is that states are able to regulate within its own borders. Through their legislative, administrative and judicial bodies, states are free to adopt, maintain, and enforce the measures necessary for the advancement of its public policy goals.[114] Secondly, it is also in the expression of sovereignty that states have the ability to enter into international investment treaties and in doing so undertake investor protection obligations.[115]

However, unlike investor protection obligations which are delineated in investment treaties, the states right to regulate is grounded in sovereignty[116] - a concept which has been accepted as part of customary international law.[117] This difference is paramount as it demonstrates that the right to regulate is a legal implication of customary international law and not an exception based on an agreement. As such, regardless as to whether the right to regulate is expressed in investment treaties, it remains inherent to the states and may be exercised at any time.

To fully understand the parameters of police powers there is a need to appreciate how this concept emerged. This term emerged from a Greek word which made reference to the policy of the civil government. Adam Smith's Lectures on Jurisprudence point to the fact that States will always be keen on promoting their wealth. In doing so, there is need for regulation with respect to trade, commerce and agriculture which fall under the ambit of police.[118] This concept was further expounded by Vattel who observed that individuals operating in an economy are

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[112] Brownlie I*, Principles of International Law*, 4th ed Oxford university Press, New York, 2012, 33.
[113] Zadeh A, International Law and the criteria of statehood, Tilburg University Faculty of law, Department of International and European Law, L.L.M Thesis Public International law, 2005, 22.
[114] Titi C, *Police powers doctrine and international investment* in Gattini A, Tanzi A, and Fontanelli F (eds) 'General Principles of International Investment Arbitration', Brill, 2018, 3.
[115] Viñuales J, 'Sovereignty in Foreign Investment Law' 324.
[116] Fraga M and Reetz P, *Public purpose in international law: rethinking regulatory sovereignty in the global era,* Cambridge University Press, Cambridge, 2015, 56.
[117] United Nations Conference on Trade and Development, Expropriation, United Nations Publication, 2011, 79.
[118] Smith A, *Lectures on Jurisprudence*, Clarendon Press, New York, 1978, 5.

not free as they remain bound by the laws of police made by the sovereign.[119] To illustrates this concept, he uses the following example:

> 'If vineyards are multiplied to too great an extent in a country which is in want of corn, the sovereign may forbid the planting of the vine in fields proper for tillage; for here the public welfare and the safety of the state are concerned. When a reason of such importance requires it, the sovereign or the magistrate may oblige an individual to sell all the provisions in his possession above what are necessary for the subsistence of his family and may fix the price he shall receive for them. The public authority may and ought to hinder monopolies and suppress all practices tending to raise the price of provisions.'[120]

Vattel's example illustrates that states remain with the inherent right to regulate in the interest of the public, even when they adversely affect the rights of aliens. This approach to police powers has subsequently been affirmed by various courts.[121] For example, the Permanent Court of International Justice in the matter concerning *Certain German Interests in Polish Upper Silesia* noted that even when treaties do not give states certain prerogatives over the assets of an alien, the rules of general international law are still applicable.[122] The resultant effect of this decision was that states were allowed to regulate over matters that would affect aliens regardless of the treaty provisions.[123] Similarly, the International Court of Justice in *Nicaragua v Columbia* established a non-exhaustive list of economic activities that states may regulate as a result of their sovereignty.[124] This leaves no doubt that states exercise their police powers as a consequence of their sovereignty.

3.2 Customary International law as the originator of police powers and its relevance in investment law

The previous section has demonstrated that police powers are exercised as a result of sovereignty which is an accepted norm of customary international law. However, as established in the preceding section investment law is based on investment treaties that take the form of BITs or MITs. As such there is need to establish the place of customary international law norms

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[119] Vattel E, The law of Nations, Liberty fund publication, 2008, 255.
[120] Vattel E, The law of Nations, Liberty fund publication, 2008, 255.
[121] This was upheld in courts as was seen in *Certain German Interests in Polish Upper Silesia*, PCIJ Series A Number 7, (1926) 22.
[122] *Certain German Interests in Polish Upper Silesia*, (1926).
[123] Viñuales J, 'Sovereignty in Foreign Investment Law' 327.
[124] Territorial and Maritime dispute *Nicaragua v Columbia*, ICJ General List Number 124, 2012, para. 80.

such as police powers in investment law and the need for recognising this concept in legitimising the system.

Investment law does not operate in a vacuum and as such it remains largely influenced by public international law.[125] Hence, the sources of law for investment disputes are also guided by Article 38 (1) of the International Court of Justice (ICJ) statute which stipulates that the sources of law shall include treaties and conventions, customary international law, general principles of law, judicial decisions (though not binding) and teachings of the most qualified scholars.[126] The ramification of this provision is that both investment treaties that protect investors from indirect expropriation and the states right to regulate that stems from customary international law are both applicable principles in investment disputes.

In fact, the states right to regulate is essential in guaranteeing the legitimacy of the investment law system.[127] This is because, originally, this mechanism was primarily put in place to settle commercial law disputes of private law character, however, overtime, the tribunals are now adjudicating over public law matters affecting the rights of the public in the host states.[128] This problem, coupled with the absence of a single international treaty governing investment law has brought the investor-state dispute settlement mechanism under a lot of criticisms on the basis that, it is unequipped to settle public law matters.[129]

Indeed, some countries have even taken action on the basis of these criticism by terminating their BITs and MITs while others are publicly retreating from investment arbitration.[130] For instance, South Africa is strategically terminating all of its BITs with the aim of introducing domestic legislation to govern foreign investments.[131] In the same vein, Indonesia has already discontinued 17 out of the 64 international investment agreements while Nicaragua and

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[125] Baetens F, 'When international rules interact :international investment law and the law of armed conflict' 7 April 2011< https://www.iisd.org/itn/en/2011/04/07/when-international-rules-interact-international-investment-law-and-the-law-of-armed-conflict/> Accessed on 1 December, 2020

[126] Article 38, statute of the International Court of Justice.

[127] Ranjan P, 'Indirect expropriation in international investment law' (2018) 13.

[128] Cotula L, Do investment treaties unduly constrain regulatory space' 2 (1), *Questions of international law,* 2015, 20.

[129] Cotula L, Do investment treaties unduly constrain regulatory space' 20.

[130] Kollamparambi U, 'Why developing countries are dumping investment treaties' University of Witwatersrand Conversation of Africa, 23 March, 2016--<https://www.google.com/amp/s/theconversation.com/amp/why-developing-countries-are-dumping-investment-treaties-56448> accessed on 22 August, 2020.

[131] Butler N and Subedi S, 'The future of international investment regulation: Towards a world Investment organisation' 64(1), *Netherlands International Review*, 2017, 45.

Venezuela are soon to follow suit.[132] Other states such as Bolivia and Ecuador have even denounced the 1965 ICSID Convention.[133] This demonstrates the correct understanding and protection of police powers is not only important for states but also necessary in legitimising and in the continuity investor-state dispute settlement system.

States are keen to protect their police powers as this remains the only avenue, they may use to protect the rights of the public.[134] More often than not, as states sign investment treaties, they guarantee various protections to the investor including protection from both direct and indirect expropriation.[135] Nonetheless, states still want to be able to regulate within their territory especially when the rights of the public are in danger. Failure to guarantee this would result in a phenomenon identified as 'regulatory chill' where states are unduly restricted from enacting any regulations.[136] As such it is imperative to protect this right to incentivise states so that they may continue entering into MITs and BITs.[137] By the same token, states need to remain accountable to their obligation under the investment treaties. This includes refraining from indirect expropriation which is the only possibility that guarantees flow of investments within their states.[138] This illustrates an interface between investment promotion and regulatory space. At the heart of this interface, is the fact that public-interest regulation may adversely affect investments and hence ought to be reasonably restricted[139]- an inquiry which remains controversial to date.[140]

3.3 Treaty norm v Customary norm – is there a hierarchy?

As alluded to in the previous section, police powers come into play in investment law as a result of customary international law. Hence, regardless as to whether the police powers are expressed in the investment treaties, states may still invoke their right to regulate. However, an

[132] Butler N and Subedi S, 'The future of international investment regulation, 45.
[133] Butler N and Subedi S, 'The future of international investment regulation, 45.
[134] Shirlow E, 'Deference and indirect expropriation analysis in international investment law: observations in current approaches and framework for future analysis' 29(3*) Foreign investment law journal,* 2018, 599.
[135] United Nations Conference on Trade and Development, Expropriation, United Nations Publication, 2011, 21.
[136] Cotula L, 'Do investment treaties unduly constrain regulatory space' 20.
[137] World Investment Report, 2019, 156.
[138] Kyrivoi Y, 'Can regulatory freedom justify indirect expropriation in investment arbitration' Investment treaty forum of the British Institute of international and comparative law, London, 20 June 2019, 6.
[139] United Nations Conference on Trade and Development, Expropriation, United Nations Publication, 2011, 21.
[140] Cotula L, 'Do investment treaties unduly constrain regulatory space' 20.

issue arises when a treaty provision and the customary norm seem to conflict. To illustrate this contention, the following example (hereinafter '*the example'*) is instructive.

A BIT provides that state A will not enact regulations that will amount to indirect expropriation (makes the investment redundant) of investor B's investment. At the same time, state A still has the right to regulate in the interest of the public without paying compensation. Investor B on the basis of the guarantee against indirect expropriation in the BIT, invests in the coal energy sector. However, overtime, State A experiences climate change effects and enacts a regulation to phase out coal power plants in a bid to combat climate change effects. Yet, in doing so B's investment will be deemed redundant. In such an instance, an issue arises as to whether the treaty norm protecting the investor from indirect expropriation or the customary international law standard of right to regulate should take precedence.

To understand whether Article 38 of the ICJ statute creates a hierarchy there is a need to look into the preparatory documents to understand the intention of the drafters. During the drafting of this particular Article, there was a suggestion that the sources listed should be considered in that particular order, with treaties prevailing over the rest.[141] This proposal was however rejected and consequently, the order in which the sources are stipulated is considered to be of no legal relevance.[142] The absence of a formal hierarchy in the sources should not conceal the fact that some judgers, arbitrators and even academics prefer a particular sources over the others.[143] As such, it is prudent to evaluate the rationale for the primacy of treaties or customs and the impact such an outcome would have in the field of investment.

3.3.1 Treaty primacy thesis

Legal reasoning inevitably gives rise to a hierarchical form of reason which establishes superior and inferior sources.[144] As such, this has brought about views that treaties are the 'most important' 'most fundamental' 'dominant' source of international law.[145] This view is based on two arguments. **First** is that although treaties and customs enjoy normative equivalence,

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[141] Akehurst M, The hierarchy of sources of international law, *British year book of international law* 47(1), 1974, 275.
[142] Akehurst M, The hierarchy of sources of international law, 276.
[143] Ghouri, A 'Determining Hierarchy Between Conflicting Treaties: Are there Vertical Rules in the Horizontal System?', 235(2) *ASIAN Journal of International Law* (2012), 27.
[144] Prost M, 'Hierarchy and sources of international law; a critical perspective'26(1) *European Journal of International* law 2008, 32.
[145] Thirlway H, *The sources of International law,* Oxford University Press, Oxford, 2 ed, 2019, 12.

treaties take priority as a matter of procedural order.[146] This is evidenced by the fact that judges and arbitrators' resort to treaties first when making their decisions.[147] The justification for this procedural primacy is the fact that treaties owing to their written character confers a greater degree of certainty and precision.[148] Unlike customary international law which requires evidence of consistent state practice which can be difficult to establish,[149] treaty provisions are usually more elaborate.[150]

Similarly, treaties enjoy primacy on the notion that states, by concluding treaties are purposely opting out of general international law to establish their own *lex specialis* in a given area of cooperation.[151] This notion has been recognised in various existing laws. For example, the 1907 Hague Convention explicitly provided that 'if the question of law to be decided is covered by a treat in force between [the parties], the Court is governed by the provisions in the said treaty. In the absence of such provisions, the Court shall apply the rules of international law'.[152] Though this sequencing was not repeated in the ICJ statute, the ICJ has itself stated on several occasions that 'rules of international law can, by agreement, be derogated from in particular cases or as between particular parties and that in general, treaty rules being *lex specialis*, it would not be appropriate that a State should bring a claim based on customary-law rule if it has by treaty already provided means for settlement of such a claim.[153]

The **second** reason for such a claim is based on the legitimacy of the treaty law making process.[154] Treaty making is premised on the freedom of contract in so far states are free to sign up to a treaty and are not coerced to do so.[155] In addition, states still have a say in the content of the agreement and may even limit the application of certain provisions through reservations.[156] Moreover, states may also withdraw from treaties as illustrated by the Latin American Countries withdrawing from ICSID. Treaty making is thus, in principle, a conscious,

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[146] Thirlway H, *The sources of International law, 12.*
[147] Prost M, Hierarchy and sources of international law; a critical perspective, 32.
[148] D'Amato A, Treaties as a source of general rules of international law, Faculty working papers, Paper 120, 10.
[149] D'Amato A, Treaties as a source of general rules of international law, 11.
[150] Brownlie I, Principles of public international law, 78.
[151] *Continental Casualty Company v The Argentina Republic* (2008) para. 168.
[152] Prost M, Hierarchy and sources of international law; a critical perspective, 33.
[153] *Continental Casualty Company v The Argentina Republic (*2008) para. 168.
[154] Boyle A and Chinkin C, *the making of international law,* Oxford University Press, Oxford, 2007, 125.
[155] Boyle A and Chinkin C, *the making of international law, 125.*
[156] Article 19, *Vienna Convention on the Law of Treaties*, 1969.

deliberative process respectful of State consent and contractual autonomy. It is also, to an extent, subjected to democratic scrutiny.[157]

Should treaty provisions then take precedence in investment law? While there are reasonable justifications for treaty primacy, the same may not be applicable under investment law. This is based on the uncertainty of the various concepts which require more elaboration that may be found in customary international law.[158] In addition, BITs by their very nature as contracts, cannot capture all the possible circumstances especially when dealing with matters of a sovereign state.[159] Hence it is crucial that states have a certain level of flexibility in regulation which can be justified in customary international law.[160] *The example* above demonstrates that the treaty protects the investor from indirect expropriation without clearly delineating what is meant by that concept. As such, resorting to customary international law is necessary to shed more light on the treaty provision and the extent to which states may regulate. This illustrates that treaty provisions cannot take supremacy over customary international law provision.

3.3.2 Customary primacy thesis

On the flip side, there exist scholars who are of the opinion that Customary International law should take precedence over treaty law.[161] This assertion is based on two justifications. First, is the ability of customary law to generate universally applicable norms.[162] Whilst treaties have the potential to be universal, this remains a rare occurrence.[163] Moreover, with the flexible mechanisms accorded in treaties in the form of reservations, treaties are rarely universally applicable.[164] As such, it is only through customary international law that universal norms may be applicable with only the persistent unambiguous objector being excluded from the application of this norm. [165] Hence, they ought to be deemed superior as it is the consensus of all sovereign states.

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[157] Prost M, Hierarchy and sources of international law; a critical perspective, 34.
[158] Prost M, Hierarchy and sources of international law; a critical perspective, 34.
[159] Prost M, Hierarchy and sources of international law; a critical perspective, 34.
[160] Cotula L, 'Do investment treaties unduly constrain regulatory space' 22.
[161] Prost M, Hierarchy and sources of international law; a critical perspective, 35.
[162] Baker R, 'Customary international law in the 21st century; old challenges and new debates' *European Journal of International Law* 21(1), 2010, 175.
[163] Prost M, Hierarchy and sources of international law; a critical perspective, 34.
[164] Baker R, 'Customary international law in the 21st century' 175.
[165] Brownlie I, Principles of public international law, 209.

The second justification for the primacy of customary international law is the fact that custom is able to create law in the proper sense of the term whilst treaties only create rights and obligations.[166] This view was put forward by Fitzmaurice, who was of the opinion that treaties should only be considered as contracts and cannot give rise to international law.[167] Consequently, he concludes that principles of customary international law should take precedence over terms in treaties.[168] While the justifications for customary international law taking precedence seem to hold water, the same may not be applicable in investment law. In investment disputes parties involved are a state and an investor -who do not have equal bargaining power.[169] If such states were allowed to resort to customary international law principles at the expense of voluntary treaty provisions they ascribed to, the investor-state dispute settlement system will be flawed. Investors will be reluctant to invest in other countries as they will barely have any protection.[170] As such, for the success of the system it is imperative that states remain accountable to treaty provisions.

The analysis above has shown that the success of the investor-state dispute settlement system requires both treaty provisions – in this case protection against indirect expropriation and customary principles- police powers to be taken into consideration without one taking precedence over the other. With this conclusion in mind, the next section will analyse the arbitral attitude towards the concept of police powers in investment treaties before 2011 and after 2011. This discussion will then help critique the existing tests that seek to draw a balance between the two concepts in the next chapter.

3.4 Arbitral attitude towards the concept of police powers

3.4.1 Investment treaties pre-2011

As suggested in the paper before, investment treaties before 2011 were rather ambiguous. Just as with the concept of indirect expropriation, these MITs and BITs failed to explicitly recognise the states right to regulate.[171] Consequently, arbitral tribunals would rely on customary

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[166] Fitzmaurice G, 'Some problems regarding the formal sources of international law' in Koskenniemi M (ed) *Sources of international law* Taylor and Francis Publishers, 2000, 18.
[167] Fitzmaurice G, 'Some problems regarding the formal sources of international law' 18.
[168] Fitzmaurice G, 'Some problems regarding the formal sources of international law' 18.
[169] Allee T and Peinhardt C, 'Bilateral investment treaties and bargaining over dispute resolution' 54(1), *International studies quarterly*, 2010, 13.
[170] World Investment Report, 2018, 31.
[171] Titi C, *Police powers doctrine and international investment,*13.

international law to assess whether states had the right to regulate in that matter and the extent of this right.[172] The analysis below demonstrates regulations that were deemed to be the lawful exercise of police powers.

In the *Iran- United States Claims Tribunal,* it was noted that the United States was rightfully exercising its police powers when it terminated the investor's liquor license.[173] The tribunal stated that 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 is not designed to cause the *alien to abandon the property* to the State or to sell it at a distress price (*emphasis mine*).[174] This tribunal laid down the conditions for states to successfully invoke police powers which are; there must be a public purpose which is recognised in customary international law, the law must not be discriminatory and must not be done following the due process.

As regards the first condition, the public purpose for which the state is regulating ought to be genuinely recognised under customary international law.[175] Generally these actions include; regulating in the realm of taxation, health, safety, defence against external threats, a forfeiture to punish or suppress crime and economic regulation through preventing and prosecuting monopolistic and anticompetitive practices; protecting the rights of consumers; implementing control regimes through licenses, concessions, registers, permits and authorizations.[176] For instance, in *Philip Morris v Uruguay*, the state actions which involved enacting a regulation that was aimed at protecting the public against the harm caused by tobacco was upheld. This is because the law aimed at guaranteeing the health of the people.[177] The problem that arises when relying on customary international law for the exercise of police powers is that, not all forms of regulation have gained customary international law status. Contemporary issues such as environmental protection is yet to gain customary international law status.[178] As such, a

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[172] Viñuales J, 'Sovereignty in Foreign Investment Law' 331.
[173] *Iran- United States Claims,* 1981.
[174] *Iran- United States Claims,* 1981.
[175] Schepel H, 'Recasting rules and exceptions on the relationship between regulatory sovereignty and international investment law' Investment treaty news' 10 August 2016 --< https://www.iisd.org/itn/en/2016/08/10/recasting-rules-and-exceptions-on-the-relationship-between-regulatory-sovereignty-and-international-investment-law-harm-schepel/> accessed on 12 September, 2020.
[176] Viñuales J, 'Sovereignty in Foreign Investment Law' 331.
[177] *Philip Morris v Uruguay,* (2017).
[178] Titi C, *Police powers doctrine and international investment*, 14.

regulation aimed at protecting the environment even when done for a public purpose may still be deemed as expropriation as was seen in *Unglaube v Costa Rica*.[179]

As regards the second condition, the law must not be discriminatory in its application in such a way that it is a disguised protective measure by the state. For instance, if a state bans a certain substance, the ban should affect all the investors and not only foreign investors. This matter was in contention in *Methanex v USA* where USA banned MTBE -a type of gasoline additive. The investor who was Canadian claimed that the ban was discriminatory since, the type of gasoline additive was largely found in Canada while their United States counterparts did not rely on the same.[180] The tribunal however found that, the USA was justified to ban the additive as there was scientific evidence showing the harm it caused to human health.[181] The tribunal disagreed with the Claimant on the basis that that there was no faulty evidence for it to infer that the evidence merely provided a convenient excuse for the hidden regulation of methanol producers.[182]

Finally, the regulation must be enacted following the due process of law. This connotes that the enactment of the law is not at the whim of the Government bur rather it is as a result of the lengthy process of law-making within that country.[183] There should be no wilful disregard of the law when enacting the regulation in question.[184] Once the state is able to demonstrate that the ordinary process of law making was followed, the regulation meets the final criteria of lawful exercise of police powers.[185] Various arbitral tribunals have been keen to uphold this power of the state. However, the problem arises when the investor claims that the regulation is tantamount to expropriation. This problem is what the next chapter seeks to do- strike a balance between police powers and indirect expropriation.

3.4.2. Investment treaties post 2011

As implied in the previous chapter, investment treaties post 2011 seek to delineate the extent of indirect expropriation and that of lawful regulation. A hallmark in these investment treaties

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[179] *Unglaube v Costa Rica,* (2012).
[180] *Methanex Corporation v United States of America*, (1976).
[181] *Methanex Corporation v United States of America*, (1976).
[182] *Methanex Corporation v United States of America*, (1976).
[183] *Azurix Corp v. Argentina,* Award, (2003).
[184] *Azurix Corp v. Argentina,* Award, (2003).
[185] Titi C, *Police powers doctrine and international investment*, 15.

is their express recognition of police powers.[186] For instance, Article 20 paragraph 8 of the Investment Agreement for the Common Market for Eastern and Southern Africa (COMESA) provides that 'Consistent with the right of states to regulate and the customary international law principles on police powers, bona fide regulatory measures taken by a Member State that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, shall not constitute an indirect expropriation under this Article.[187]

While the treaty above and the other treaties make reference to police powers, they do so *ex abundati cautela,* as the state is still able to rely on the customary international law.[188] This was made clear by the ICJ in the *Nicaragua case*, when it noted that treaty and customary rules operate distinctly and autonomously, even when they have similar or identical content.[189] Specifically, it emphasized that incorporation into a treaty does not have the effect of 'supplanting' customary norm.[190] Consequently, such treaty provisions are autonomous to customary international law.[191] This development is advantageous to state for two reasons First, it gives states two basis for invoking police powers and secondly, it eliminates uncertainty as regards the place of police powers in investment law. Despite such efforts in enshrining police powers in treaties, the right to regulate might still remain problematic. This is due to the vague treaty language such as 'except in rare circumstances', 'public welfare' which remain debatable.[192] As such, the next chapter will seek to critique the existing balance used by arbitral tribunals in drawing the line between indirect expropriation and police powers and thereafter propose a way forward.

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[186] Gazzini T, 'The 2016 Morocco-Nigeria BIT: An important contribution to the reform of investment treaties' Investment treaty news, September 26 2017 < https://www.iisd.org/itn/en/2017/09/26/the-2016-morocco-nigeria-bit-an-important-contribution-to-the-reform-of-investment-treaties-tarcisio-gazzini/> accessed on 13 October, 2020.

[187] *Article 20,* Investment Agreement for the Common Market for Eastern and Southern Africa, 2016.

[188] Viñuales J, 'Sovereignty in Foreign Investment Law' 331.

[189] *Territorial and Maritime dispute Nicaragua v Columbia*, ICJ General List Number 124, 2012.

[190] *Territorial and Maritime dispute Nicaragua v Columbia*, ICJ General List Number 124, 2012.

[191] Viñuales J, 'Sovereignty in Foreign Investment Law' 333.

[192] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 33.

CHAPTER FOUR: BALANCING THE COMPETING INTERESTS; HAVE ARBITRAL TRIBUNALS BEEN SUCCESSFUL?

In a bid to establish a balance between the two competing interests discussed in the chapters before, various arbitral tribunals have taken different approaches in interpreting investment treaties before 2011. This chapter seeks to analyse the various approaches taken by the arbitral tribunals and assess how successful the jurisprudence has been in creating certainty and legitimacy in the state investor dispute settlement.

4.1 The Sole effect Approach

Under this approach, the balance between when a regulation amounts to expropriation or is the states right to regulate is determined exclusively by the degree to which the government measure affects the investors' interests.[193] According to this doctrine, additional factors such as the purpose of the measure or the intention of the government should not be considered.[194] The origin of this approach is in customary international law[195] as affirmed in the *Norwegian Shipowners' Claims* which is a dispute concerning contracts for ship construction.[196] The USA was to construct ships for Norway.[197] However, during the process of construction, the ships got damaged as a result of the requisition of ships in the USA shipyard during World War I.[198] Despite the ships getting damaged during war, the arbitral tribunal noted that 'whatever the intentions may have been, the United States took the contracts, and as such they were expected to compensate the Norwegian investors as they had been adversely affected'.[199] Consequently, despite the genuine public welfare that the USA sought to protect, they were obligated to compensate the investors.

This approach has been affirmed by a number of arbitral tribunals.[200] For example, this approach was used in *Starrett Housing, Patrick Mitchell Annulment case* and *Tippets*. In *Starrett Housing* for instance, the tribunal noted that expropriation occurs when property rights

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[193] Mostafa B, 'The sole effect Doctrine, police powers and indirect expropriation under International law' 277

[194] Csernus M, 'The sole effect doctrine' Jus Mundi, 15 December 2020 --< https://jusmundi.com/en/document/wiki/en-sole-effect-doctrine> accessed on 20 December, 2020.

[195] Csernus M, 'The sole effect doctrine' Jus Mundi, 15 December 2020 --< https://jusmundi.com/en/document/wiki/en-sole-effect-doctrine> accessed on 20 December, 2020.

[196] *Norwegian Ship Owners' Claim, Norway v USA* Permanent Court of Arbitration Award, (1922).

[197] *Norwegian Ship Owners' Claim, Norway v USA* Permanent Court of Arbitration Award, (1922).

[198] *Norwegian Ship Owners' Claim, Norway v USA* Permanent Court of Arbitration Award, (1922).

[199] *Norwegian Ship Owners' Claim, Norway v USA* Permanent Court of Arbitration Award, (1922).

[200] Titi C, *Police powers doctrine and international investment*, 7.

'are rendered so useless that they must be deemed to have been expropriated regardless of the state's motivation in enacting the measures.[201] In the same breath, in the *Tippets* case the tribunal observed that 'the intent of the government is ***less importan***t than the effects of the measures on the owner, and the form of the measures of control or interferences is less important than the reality of their impact'.[202] Moreover, in the *Patrick Mitchell Annulment case,* it was observed by the tribunal that 'a practice of arbitrators — at present a majority of them — in international investment disputes' is to have 'reference only to the effect of the measure for the investor, without taking into account the purpose sought by the expropriating authority.'[203] The ramifications of these observation is that the effect the measure has on the investor should take precedence over the states right to regulate.

What this doctrine does, is to discount the states right to regulate.[204] As a result, for as long as the measure adversely affects the investor, the state ought to pay compensation.[205] This doctrine overlooks the states right to regulate despite it being the cornerstone of investor-state dispute settlement.[206] This not only creates uncertainty in the jurisprudence but also threatens the legitimacy of the system as states are of the opinion that the system fails to accommodate them.[207] In fact, as alluded elsewhere in this study, this approach has been one of the factors causing states to terminate the MITs and BITs. This illustrates that the sole effect approach has failed to strike a proper balance between the states right to regulate and indirect expropriation.

4.2 The Police Powers Approach

Amidst the backlash against the sole-effect doctrine, other arbitral tribunals developed the police power approach to remedy this. This approach denotes that any measure which is within the state's police powers resulting in a loss to the investor does not constitute indirect expropriation.[208] Accordingly, it does not give rise to an obligation to compensate.[209] This

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[201] The *Starrett Housing Corporation v Government of the Islamic Republic of Iran*, 1987.
[202] *Tippetts v TAMS-AFFA Consulting Engineers of Iran,* 1984.
[203] *Patrick Mitchell v The Democratic Republic of Congo,* 2006.
[204] Organisation for Economic Co-operation Development, *Indirect expropriation and the right to regulate*, Working papers on international investment law, 75.
[205] Titi C, *Police powers doctrine and international investment*, 8.
[206] Viñuales J, 'Sovereignty in Foreign Investment Law' 331.
[207] Butler N and Subedi S, 'The future of international investment regulation, 45.
[208] Zamir N, 'The Police Powers Doctrine in International Investment Law' 322.
[209] Kyrivoi Y, 'Can regulatory freedom justify indirect expropriation in investment arbitration' 7.

approach is of the view that the state's police powers cannot be compromised as it is an expression of its sovereignty.[210]

A number of arbitral tribunals have been guided by this approach. Among them include, *Methanex v USA* where the tribunal observed that any measure that is a non-discriminatory, for a public purpose and enacted following due process is not deemed expropriation.[211] More recently, In *AWG v Argentina,* another case that buttresses this approach, articulated that not all measures that hinder the investor in some way amount to expropriation.[212] In fact, governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing political, economic or social considerations.[213] Such changes regardless of the fact that they make certain activities less profitable or even uneconomic to continue do not give rise to an obligation to compensate.[214] Furthermore, in *Chemtura v Canada* a dispute concerning the Canadian ban on lindane which adversely affected the investor as he was unable to operate, was held not to amount to indirect expropriation and hence no compensation.[215] The basis of this decision was the fact that the regulation was motivated by the developments in the scientific field illustrating the harm caused by lindane and was therefore a valid exercise of police powers.[216]

While this approach is commendable in so far as it takes into consideration the interests of the state, it fails to accommodate the interests of the investor.[217] Any regulation may be justified under the purview of police power even at the investors' detriment.[218] Such an approach would in the long run adversely affect the investor-state dispute settlement system as investors would lose faith in this system. In fact, even the contract theory appreciates that by entering into the BITs and MITS states waive some regulatory rights to protect the investors. Accordingly, there

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[210] Viñuales J, 'Sovereignty in Foreign Investment Law' 333.
[211] *Methanex Corporation v United States of America*, 1976.
[212] Zamir N, 'The Police Powers Doctrine in International Investment Law' 322.
[213] *AWG Group v The Argentine Republic*, 2015.
[214] *AWG Group v The Argentine Republic*, 2015.
[215] *Chemtura Corporation v The Government of Canada*, 2010.
[216] *Chemtura Corporation v The Government of Canada*, 2010.
[217] Ranjan P, Indirect expropriation in international investment law and article 31 (3) (c) of the VCLT: A critique of Philip Morris v Uruguay, 125.
[218] Schepel H, 'Recasting rules and exceptions on the relationship between regulatory sovereignty and international investment law' Investment treaty news' 10 August 2016 --< https://www.iisd.org/itn/en/2016/08/10/recasting-rules-and-exceptions-on-the-relationship-between-regulatory-sovereignty-and-international-investment-law-harm-schepel/> accessed on 12 September, 2020.

is need for an approach that takes into consideration not only the states interest but also the investor. Against such a background, a new approach emerged in a bid to strike a better balance between investors and states.

4.3 The Proportionality Approach

The proportionality approach seeks to redress the problem in the sole-effect and police powers approach.[219] Instead of putting the states interest over the investor or the vice-versa, this approach seeks to look at the totality of the circumstances in making a finding of compensable expropriation or lawful regulation.[220] This approach seeks to find the right balance between investment protection and police powers. While this approach was indeed a step in the right direction, there still remains a lot of room for development.[221] As will be demonstrated shortly, the proportionality test remains problematic for two reasons. First, is the fact that many at times tribunals make reference to the proportionality test without expounding on what exact factors they take into consideration.[222] Secondly, even when a few tribunals expound on these factors, there is a lot of inconsistency owing to the fact that different tribunals look into different elements thereby causing uncertainty in the system.[223]

The proportionality approach was first appreciated in *Tecmed v Mexico*[224] where the tribunal noted that:

> 'after establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider whether such actions or measures are proportional to the public interest

[219] Ranjan P, 'Using the Public Law Concept of Proportionality to Balance Investment Protection with Regulation in International Investment Law, 862.
[220] Kingsbury B and Schill W, 'public law concepts to balance investor's rights with the state regulatory actions in the public interest' Social Science Research Network, 2017, 3.
[221] Shirlow E, 'Deference and indirect expropriation analysis in international investment law: observations in current approaches and framework for future analysis' 29(3*) Foreign investment law journal,* 2018, 599.
[222] Brabandere E and Cruz P, 'The role of proportionality in international investment law and arbitration: a system specific perspective' *Nordic Journal of International law*, 89(4), 2020, 474.
[223] Brabandere E and Cruz P, 'The role of proportionality in international investment law and arbitration: a system specific perspective' *Nordic Journal of International law*, 89(4), 2020, 477.
[224] *Técnicas Medioambientales Tecmed S.A v The United Mexican States*, 2003.

> presumably protected thereby and to the protection legally granted to investment'[225]

While the tribunals recognised the principle of proportionality it failed to expound on what the analysis entailed. In fact, many tribunals often provide little detail on their reasoning.[226] Instead, most tribunals applying the proportionality approach justify this on the basis of common sense, observing that it is necessary to balance certain rights or that a specific measure must be proportional or applied reasonably. [227]

Some arbitral tribunals such as that of *PL Holdings Sàrl*[228] and *Occidental II*[229], have employed the European Court of Human rights test of proportionality. This test entails an analysis as to whether the measure put in place is legitimate and suitable of the restrictive measures in light of alternatives and restrictions that the measures bring about.[230] In these disputes, the tribunal concluded that the measure put in place by the states fell short of the proportionality test as they were politically motivated hence were not suitable.[231] Similarly, in the *Continental Casualty* award, the tribunal applied a similar test and added another tier which was whether the state had a less restrictive alternative.[232]

However, as noted by Brabandere and Cruz, many arbitral tribunals relying on the proportionality approach have rejected the ECtHR approach. In place of the factors considered in that approach, tribunals opt for more direct elements of proportionality.[233] These include various factors such as whether the state could have adopted other less restrictive alternatives,[234] whether there was factual or scientific evidence to support the measure taken up by the state,[235] whether the measures implied significant changes in the domestic

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[225] *Técnicas Medioambientales Tecmed S.A v The United Mexican States*, 2003.
[226] Islam R, 'Proportionality as a tool for balancing competing interests in investment disputes' Academia.edu, 2013, 3.
[227] Leonhardsen E, 'looking for legitimacy: Exploring proportionality analysis in investment treaty arbitration' 21.
[228] *PL Holdings Sàrl v Republic of Poland, 2014.*
[229] *The Occidental Mining Group v The Republic of Ecuador* II, 2015.
[230] Dolzhikov A, 'The European court of human rights proportionality approach, 28.
[231] *The Occidental Mining Group v The Republic of Ecuador* II, 2015.
[232] *Continental Casualty v The Argentine Republic*, 2009.
[233] Brabandere E and Cruz P, 'The role of proportionality in international investment law and arbitration: a system specific perspective' 481.
[234] *SICAR v The Kingdom of Spain,* 2018 para. 657.
[235] *Stadtwerke München GmbH, RWE Innogy GmbH v The Kingdom of Spain*, 2019, para. 256, 323-327,

legislation,[236]and whether the measures were suitable to the policy objectives behind them.[237] As alluded before, the state investor dispute settlement system lacks a centralised system to develop a uniform test. As a result, whether the proportionality approach should be applied and what factors ought to be considered are at each tribunals discretion. This has engendered a proportionality approach which fails to correctly capture all the necessary factors crucial to create the proper balance sought.

4.4 The Better Approach

Having analysed the three approaches developed to strike this balance; it is safe to conclude that the proportionality approach is the better approach in achieving this. This is because, unlike the other approaches which prioritise one interest over the other, this approach looks at both interests in light of various factors.[238] Nonetheless, as alluded in this section, the proportionality approach as applied today still remains problematic. As such, the next chapter will give recommendations on a better understanding of the proportionality approach based on the findings of the study. Furthermore, despite the fact that there have been no disputes instituted on the basis of investment treaties post 2011- and therefore no analysis of jurisprudence, the next chapter will recommend the best way to draft carve out clauses and contextual clauses that Kenya and other countries should adopt. This will eliminate any ambiguities and will help bring further clarity in the system.

[236] *Saluka investment v the Czech Republic* 2006 para 255.
[237] *SICAR v The Kingdom of Spain,* 2018 para. 657.
[238] Titi C, *Police powers doctrine and international investment*, 8.

CHAPTER FIVE: RECOMMENDATIONS AND CONCLUSION

This chapter aims at giving the best way forward to resolve the tension between compensable indirect expropriation and non-compensable regulation. The findings of this study will be elaborated on to justify the need for a new test that will redefine this murky boundary. On the basis of these findings, the next section will propose the way forward for both investment treaties pre-2011 and post 2011. This will then be followed by a meaningful conclusion.

5.1 Findings of the study

From the analysis done this study has made the following findings; first, that the concept of indirect expropriation refers to regulations enacted by the state whose effect renders the investment redundant. Though having emerged recently, this concept is recognised in investment law and requires compensation. While older treaties (pre-2011) made no express reference to this concept more recent treaties (post 2011) have recognised the obligation against indirect expropriation. However, it still remains uncertain it is affected by the states' right to regulate.

Secondly, in a bid to establish how far states may regulate, this study found that states have a right to regulate that is enshrined in customary international law. As such, whether BITs or MITs make reference to this right, states are still able to invoke it. However, due to the emerging concept of indirect expropriation, not all regulation for a public purpose will be justified under this right. Such a conclusion will render the obligations in BITs and MITs redundant. As such, there is need to establish a balance between compensable indirect expropriation and non-compensable regulation.

Thirdly, this study sought to assess the various approaches taken by tribunals and how effective they have been in striking the balance. Despite, the commendable efforts by the tribunals, this study found that the different approaches remain flawed in finding the balance. The sole effect approach obliterates the states' right to regulate while the police powers approach ignores the investor protection in the BITs and MITs. While the proportionality approach attempts to restore the balance between the two approaches it still remains flawed due to uncertainty of factors that ought to be considered.

Finally, this study makes the finding that there is a need to modify the proportionality test so as to restore balance between the two competing concepts. This will not only create certainly but also help legitimise the system. This test is discussed in the subsequent section.

5.2 A remedy for investment treaties pre-2011: A new understanding of the proportionality approach

Indeed, the proportionality approach is the better approach in so far as it takes both the interest of the state and those of the investors. However, what it fails to do is, to capture all the important factors necessary to strike a proper balance. As such, this study proposes the following factors as crucial in the proportionality approach. First, a genuine public welfare purpose to guarantee that the regulation put in place serves a public purpose. Secondly, reasonableness of the regulation in so far as the regulation does not inconvenience the investors no more than necessary. Third is procedural justice which guarantees that the laws are not enacted at the whim of the governments but instead they follow the process of law making. Finally, are the expectations of the investor which ought to be appreciated. Each of these factors will be discussed in detail in the subsequent section.

5.2.1 A genuine public purpose

Before a finding of compensable expropriation or non-compensable regulation, the tribunal ought to consider whether the regulation serves a genuine public purpose.[239] This means that, the purpose for which the regulation is enacted, is a public purpose recognised not only in that particular state but also in international investment law.[240] While others may argue that states have the right to determine what forms public purpose.[241] Based on the findings of this study, such an argument fails to hold water. This is because, the basis of the police powers doctrine is customary international law and as such, the public purpose also ought to be recognised under the same law (customary international law) and not domestic law. This will help limit the scope of measures under public purpose while at the same time ensure that states do not enact protectionist measures under the guise of public purpose. Hence, arbitral tribunals should assess whether the measure is for a public purpose recognised in international law or only by the domestic law of that state. A finding that regulation is for a purpose recognised under customary international law tilts the balance to a finding of non-compensable regulation as opposed to compensable expropriation. The converse is also true.

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[239] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 32.

[240] Fraga M and Reetz P, *Public purpose in international law: rethinking regulatory sovereignty in the global era,* 23.

[241] Butler N and Subedi S, 'The future of international investment regulation, 45.

In addition to the assessment above, tribunals also ought to consider the primary motive the state had in enacting the measures. It is insufficient for the state to enact a regulation that adversely affects the investor with a public purpose motive being only an additional motive to another.[242] Rather, the public purpose ought to be the primary reason. For example, this study is of the opinion that the finding in *Gold Reserve v Venezuela* was flawed.[243] This is because, the tribunal justified a regulation that was politically motivated simply because it also addressed an environmental concern.[244] However, this should not be allowed as it is an avenue for states to go against their obligations in MITs and BITs. This finding is also supported by the contract theory which recognises the need to limit public purpose regulation. Therefore, a finding that a regulation is enacted with a different primary motive, even if also motivated by a public purpose, would lead to a finding of compensable expropriation. A finding of non-compensable regulation will only be made where the regulation is primarily motivated for a public purpose.

5.2.2 Reasonableness

This analysis entails a conjunctive two-tier test involving first, a direct correlation between the measure put in place and the policy sought.[245] Secondly, it entails an assessment as to whether there is any other less restrictive means.[246] As regards, the first part of this test, there ought to be evidence scientific or factual, to demonstrate that the measure enacted will achieve the public policy purpose.[247] This was established in *Philip Morris v Uruguay*, where the tribunal made a finding that the measure put in place was reasonable as there was scientific evidence published by a reputable body- the World Health Organisation as to harm caused by tobacco.[248] With such evidence, it was clear that the regulation enacted was reasonable. Hence a finding that a regulation is backed by evidence results to a finding on non-compensable regulation while the lack of evidence leads to a finding of compensable expropriation. In addition, the tribunal also ought to analyse whether the measure enacted was the least restrictive to the investor. If there were other measures that were less restrictive to the investor than the one

[242] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 32.
[243] *Gold reserve v Venezuela*, 2017.
[244] *Gold reserve v Venezuela*, 2017.
[245] *PV investors v Spain*, 2020.
[246] Dolzer R, The law of investment treaties, 365.
[247] *Philip Morris v Uruguay,* 2016.
[248] *Philip Morris v Uruguay*, 2016.

employed by the state there is more likelihood for a finding of compensable expropriation than non-compensable regulation. The converse is also true.

5.2.3 Due process

In making the analysis as to whether the law enacted is in exercise of states' right to regulate or amounts to indirect expropriation, there is need to also assess the process in which the law was enacted.[249] Each state has its procedure, be it in the enactment of a law or a measure, that ought to be followed. Consequently, for a measure to be within the umbrella of regulation thereby exempted from compensation, there is a need for the proper procedure to be followed. This was reflected in the *Metaclad v Mexico* award, where the tribunal held that Mexico's denial of permit lacked a timely, orderly or substantive basis and thus tantamount to expropriation.[250] Hence, when due process is followed the tribunal will more likely make a finding of non-compensable regulation. On the flip side, where there is no due process, the more likely finding will be compensable expropriation.

5.2.4 Reasonable expectations of foreign investors

The final factor to be considered in finding the balance between these two competing interests, is whether the investor had legitimate expectations based on specific commitments made by the state.[251] This factor requires the tribunal to look into what guarantees the state gave the investors at the time of making the investment.[252] If such commitments were made, then the measure put in place will not be justified under the states' right to regulate and instead will amount to expropriation which will require compensation.

Originally, investor expectations were taken into consideration by tribunals in the assessment of the fair and equitable treatment standard.[253] However, this study on the basis of the contract theory, proposes that it is important to include this factor in making a finding of expropriation or regulation as it sheds more light in the context in which the investment was made. Where a government makes written commitment to the investor, whether by contract, licence or other

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[249] Brownlie I, *Principles of public international law*, 78.
[250] *Metaclad v Mexico*, 2007.
[251] Zu Ying, 'Do Clarified Indirect Expropriation clauses in Investment treaties preserve environmental regulatory space? 32.
[252] Potesa M, 'Legitimate expectations in investment treaty law: understanding the roots and limits of this controversial concept' 28(1) *Foreign Investment law journal*, 2013, 104.
[253] OECD Report, Indirect expropriation and the right to regulate, 2004, 17.

legal documents, they remain bound. As such, measures that breach these commitments will amount to expropriation and require compensation as the state voluntarily limited its regulatory scope. In fact, relatively new investment treaties such as the Burkina Faso- Canada BITs have recognised the need for analysing reasonable expectations in making a finding of indirect expropriation.[254] However, it is important to note that, for such expectations to be generated the commitments ought to be specific, given by a person in authority and reasonable in and of themselves.

These four factors ought to be taken together and analysed in light of the facts at hand. Only then, will a proportionality approach which strikes a proper balance be achieved.

5.3 A remedy for investment treaties post-2011; Bringing clarity to clarified clauses

As established in the second chapter of this study, investment treaties post 2011 have taken steps to clarify the concept of indirect expropriation through carve out clauses, contextual clauses or a hybrid of the two.[255] However, these investment treaties still remain ambiguous due to vague terms used in these provisions such as 'public welfare', in 'rare circumstances' amongst others.[256]

This study proposes that investment treaties should adopt a hybrid of carve out clauses and contextual clauses which should read as follows:

> *The determination of whether a measure or series of measures of a Contracting Party constitute indirect expropriation requires a case-by-case, fact-based inquiry considering their interference in light of the reasonable and distinguishable expectations concerning the investment, evidence at hand and whether the state had other less restrictive alternatives.*
>
> *For greater certainty, whether an investor's investment-backed expectations are reasonable depends in part, on the specificity of the commitments and extent of regulation in the relevant sector. For example, an investor's expectations that regulations will not change are less likely to be reasonable in a heavily regulated sector than in a less heavily regulated sector.*

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[254] Article 8, Burkina Faso- Canada BIT, 2015.

[255] Korzun V, 'The right to regulate in investor state arbitration: slicing and dicing regulatory carve outs', Published, JD thesis, Fordham University school of law, New York, 2016, 395.

[256] Newcombe A, 'General Exception clauses in international investment agreements' 22.

In making such a determination, there should be regard to the fact that non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives recognised in customary international law do not constitute expropriation or nationalization.

Such a provision aims at balancing both the interests of the investors and those of states. Further, due to the specific language employed, it eliminates any ambiguities that could otherwise arise. Countries such as Kenya, that are seeking to enter into more BITs and MITs, should adopt such an approach to avoid any potential disputes.

5.4 Conclusion

This study sought to resolve the tension between compensable indirect expropriation and non-compensable regulation. The second chapter began with an analysis of the concept of indirect expropriation to understand its place in the investor state dispute settlement system. While there exist efforts in delineating the exact contours of this concept, this has proven problematic owing to the fact that it is intricately connected to the concept of states' right to regulate. As such, the subsequent chapter analysed this concept of regulation. This chapter, aware of the fact that not all regulations may be justified under the states right to regulate, analysed when states can invoke this right. These two chapters presented the conundrum the study sought to address, which is when a regulation is compensable indirect expropriation and when it is non-compensable. Finding this balance is important for the success of the system.

Despite this fact, as demonstrated in the fourth chapter, tribunals are still grappling with this issue. In fact, each of the three approaches remains inefficient in drawing the line between these two concepts. It is for this reason, that this study proposes a proportionality approach which encompasses the following critical factors, a genuine public welfare purpose, reasonableness, procedural justice and investor's legitimate expectations. This study is of the opinion that analysis of such factors will revolutionise the system by creating a proper balance between these two-competing interests. In addition, if tribunals will stand guided by this conclusive test, there will also be certainty in the system. Lastly, the sample hybrid clause provided, will serve as an example for future treaties being drafted and at the same time be the basis for the amendment of treaties post- 2011.

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