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*Indirect Expropriation in Investment Treaty Arbitrations***The views expressed in this article are exclusively those of the authors and do not necessarily reflect the opinions of Freshfields Bruckhaus Deringer or its clients.*

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I Introduction

There is no mechanical formula to determine when measures attributable to the Host State breach the dividing line between legitimate regulation and compensable indirect expropriation. This has provoked one distinguished arbitrator to reflect with realism that:

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> [i]t all depends on the specific facts and circumstances of the case, particularly the gravity and length of the interference, the rights of the parties under a contract or general legislation, and even cultural elements that define shared expectations. (1)

True enough, state measures that can potentially impact upon an investor's rights in its investment are too varied to fit into a neat formula. The test for indirect expropriation undoubtedly must be flexible enough to keep a pace, for example, with the new realities of major investment in privatized public services as states retreat from their role as providers to assume a more regulatory function. But it is also imperative that states be in a position to make rational and informed decisions in the public interest concerning measures that might have an impact on foreign investment activity and their ability to do so would be severely undermined if the circumstances giving rise to expropriation defied any generalization. Just like investors, states also have a strong interest in legal certainty.

The only practicable solution was articulated by Professor Christie in one of the first of the significant studies of indirect expropriations. His article contains several useful pointers of principle on modalities of state interference that might constitute an expropriation, and concludes with the following advice in the final paragraph:

> It is evident that the question of what kind of interference short of outright expropriation constitutes a 'taking' under international law presents a situation where the common law method of case by case development is pre-eminently the best method, in fact probably the only method, of legal development. (2)

The fact that we are no closer to a precise definition of indirect expropriation some forty years after Professor Christie's study only reinforces this insight. The only real guidance with respect to the threshold of interference for state measures affecting investments is the product of inductive generalizations from the findings of international tribunals and domestic courts as to the factual circumstances that give rise to a compensable taking.

The alluring prospect of universal formulae has, since time immemorial, captured the imagination of the best minds of the day. Our little corner of human endeavour is no exception. Many eminent tribunals have attempted to expound succinct definitions of indirect expropriation. As a result of their efforts, we now have a vast array of two-line definitions that can be employed to defend almost any position along the spectrum. Just as the quest for the alchemic formula no longer attracts research funding, the search for

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the chimerical perfect rule on indirect expropriation need not preoccupy counsel and arbitrators. The more arduous but realistic approach suggested by Professor Christie is the way forward.

There is now a wealth of material to draw upon for making inductive conclusions on the rules for a compensable taking in addition to the early decisions of international courts and tribunals reviewed by Professor Christie. International tribunals operating under bilateral and multilateral investment treaties render a steady stream of awards dealing with the prohibition against uncompensated expropriation - a substantive provision of all investment treaties. Other international tribunals with jurisdiction over an investment agreement between an investor and the Host State also have occasion to rely on the customary international law on expropriation. The Iran/US Claims Tribunal has generated a vast body of jurisprudence on compensable takings that has been subjected to careful analysis by several writers. (3) The recognition of interests in property as a human right in international treaties such as the European Convention on Human Rights has led to a

growing number of precedents dealing with subtle forms of state interference in property rights. The decisions of national courts, and in particular the precedents of the US Federal Courts on the Fifth Amendment to the Constitution, are also highly instructive. (4)

Insights from decisions handed down by disparate fora cannot, however, be thrown into a single stew for subsequent analysis. There are important distinctions to be made between each source of precedent. The Iran/US Claims Tribunal, for instance, has jurisdiction to award compensation on a different basis from expropriation for 'other measures affecting property rights' that do not necessarily amount to an expropriatory taking. And Article 1 of the First Protocol of the European Convention of Human Rights
P 148 combines the right to the 'peaceful enjoyment of one's possessions' with the ● prohibition against the deprivation of the possessions of natural or legal persons.

The objective of this modest contribution is to identify three points of controversy in the decisions of investment treaty tribunals on expropriation. The first is the distinction between a factual taking attributable to the state that does not create international responsibility, on the one hand, and the breach of an obligation not to expropriate, on the other. The second is the nature of rights to property that can be the object of an indirect expropriation. The third is the test for a 'regulatory' expropriation.

II The Distinction between a Taking and an Expropriation

Investment treaty awards sometimes appear to confuse two distinct analytical steps for a finding of expropriation by conflating the questions as to whether there has been a taking attributable to the Host State and whether the Host State is under an obligation to compensate that taking. The first stage of the analysis should focus on the nature or magnitude of the interference to the investor's property interests in its investment caused by measures attributable to the Host State to determine whether those acts amount to a taking. The second stage should determine whether this taking or interference rises to the level of an expropriation by reference to the relevant treaty standard. If this second stage results in a finding of expropriation, it remains for consideration whether it is nonetheless lawful because it is for a public purpose, on a non-discriminatory basis, in accordance with due process of law and on payment of fair compensation.

It is possible that the 'taking' terminology for the first stage of the expropriation analysis is partly to blame for this confusion, because, as one commentator has put it, there is a 'simultaneous and therefore ambiguous reference to both fact and legal consequence'. (5) This ambiguity is avoided if one simply remembers that not every taking amounts to an expropriation.

The now notorious passage on expropriation articulated in the case of *Metalclad Corporation v. The United States of Mexico* (6) is particularly noteworthy in this context. After citing Article 1110 of the NAFTA, the Tribunal stated:

> [E]xpropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or
> P 149 obligatory transfer of title ● in favour of the Host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the Host state. (7)

Most commentators have interpreted the Tribunal's words as an endorsement of a 'mere diminution of value' test for expropriation due to the reference to the 'reasonably-to-be-expected economic benefit of property' in the cited passage. (8) Likewise, the Supreme Court of British Columbia emphasized the expansive nature of the formulation in its review of the award in annulment proceedings:

> The Tribunal gave an extremely broad definition of expropriation for the purposes of Article 1110. In addition to the more conventional notion of expropriation involving a taking of property, the Tribunal held that expropriation under the NAFTA includes covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property. This definition is sufficiently broad to include a legitimate rezoning of property by a municipality or other zoning authority. (9)

Although the award could be interpreted in this fashion, another explanation is possible. The key word is 'includes'. Rather than *defining* expropriation, the intention of this statement may well have been to simply list the types of takings that expropriation might encompass, subject to a subsequent determination that the taking in question rises to the level of an expropriation for which Mexico was under a duty to compensate in accordance with Article 1110 of the NAFTA. In other words, the Tribunal might not have been suggesting that a diminution of value caused by actions of the Host State without more constitutes a breach of Article 1110 of the NAFTA.

No definitive pronouncements can be made with respect to the actual position of the

Tribunal in *Metalclad*. Nevertheless, the interpretation offered here seems more consistent with the actual findings of the Tribunal. It is reasonably clear that its decision on Mexico's liability under Article 1110 was not based on a simple causal connection between acts attributable to the State of Mexico and the diminution of value of Metalclad's investment. To this question we shall return in the final section of this paper.

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However one ultimately interprets the Tribunal's statement on expropriation in *Metalclad*, there is undoubtedly an unfortunate ambiguity in the award due to the conflation of the two distinct requirements of an expropriation, *viz*. (i) a taking attributable to the Host State that is (ii) unlawful in accordance with the relevant treaty provision on expropriation or the general prohibition against uncompensated expropriations in customary international law. (It may be that the Tribunal assumed too much of readers, and skipped a step in the expectation that it was implicit.)

This 'fusion fallacy' has produced another unfortunate tendency in investment treaty awards. By focusing exclusively on the existence or otherwise of a taking, tribunals have resorted to subtle variations in the definition of cognizable property interests in order to justify their ultimate conclusion as to whether an expropriation has taken place. Thus, for example, a conservative view of the rights embodied in property in an investment facilitates a finding that the state measure in question did not affect the investor's rights and hence the conclusion that there could be no taking and no expropriation. This is illustrated by the two much-discussed awards in the Czech Republic cases that dealt with precisely the same facts. In *CME Czech Republic B.V. Investments v. The Czech Republic*, (10) where the Czech Republic was found to be liable for expropriation, the definition of property interests was very broad. After dismissing the relevance of the fact that the formal ownership rights to a television licence forming the basis of the investment had never been disturbed by the Czech Media Council's actions, the Tribunal emphasized that '[w]hat was destroyed was the commercial value of the investment'. (11) In other words, the Tribunal invoked an expansive notion of property rights to include its income producing potential. On the other hand, in *Ronald S. Lauder v. The Czech Republic* (12) another Tribunal came to the opposite conclusion by adopting a more restrictive view of the rights attaching to property, focusing on whether the alleged taking had the effect of 'transferring his property or depriving him of his rights to use his property or even of interfering with his property rights'. (13)

What concept of property should underline a tribunal's investigation of the issue of 'taking'?

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III Property Rights Capable of being the Object of a Taking

The preponderance of early international precedents concerned the direct expropriation of alien property. By resorting to direct measures of expropriation, the Host State overtly deprives the alien of the legal rights of ownership to property. Hence the taking can be discerned readily by examining the *lex situs* of that property. Direct expropriations do occasionally find their way into the facts of modern investment treaty cases. For example, in *Middle East Cement Shipping and Handling Co. v. Arab Republic of Egypt*, (14) the claimant was granted a licence for importation and storage of bulk cement at a Suez port for the packing and dispatch of the same within Egypt to the private and public sectors. By a subsequent decree issued by the Ministry of Construction, the rights of the claimant under the licence were effectively revoked and thus there was no dispute between the parties that a direct taking had occurred. (15)

The threshold question of whether a taking has occurred is thus not difficult to resolve in cases of direct expropriation. It is not surprising that the standard of compensation at the quantum phase has been the primary preoccupation of international tribunals in such cases and indeed the focus of a great deal of academic attention over the last fifty years.

The fact that, until quite recently, international tribunals have been predominantly concerned with instances of direct expropriation might also provide the key to explaining the relatively formal definitions, in the early cases, of rights to property capable of being the object of a compensable taking. Direct expropriatory measures produce their effect by depriving the owner of property of the rights to use, possess or dispose that property. The classical triad of legal rights attaching to ownership of property, familiar to civil law codifications, is thus a sufficient analytical platform for acknowledging the type of interference that is typical of direct takings.

Direct expropriations are now overshadowed by the more prevalent paradigm of indirect expropriations, which, notwithstanding the ultimate decision on liability, has featured in investment treaty cases such as *Metalclad Corporation v. The United States of Mexico*, (16) *Antoine Geotz et al v. The Republic of Burundi*, (17) *CME Czech Republic B.V. Investments v.*
P 152 *The Czech Republic*, (18) *Pope & Talbot Inc. v. The Government of Canada*, (19) *S.D. Myers Inc. v. Government of Canada*, (20) *Eudoro Armando Olguín v. The Republic of Paraguay*, (21) *Marvin Feldman v. Mexico*, (22) and *Ronald S. Lauder v. The Czech Republic*. (23)

Indirect expropriations affect property interests in more subtle ways. Legal title to the property is not disturbed. Rather, its income producing potential is somehow diminished by acts attributable to the Host State. This trend has exposed the limitations of a purely legal or formalistic concept of property that is not sensitive to the economic rights or expectations associated with the property. For example, a developer might acquire a plot of land upon which he intends to construct a hotel. The land adjoins a nature reserve of ecological importance. Before construction begins, an environmental study commissioned by the Host State reveals that, in order for the reserve to sustain the habitat of its abundant wildlife, the surrounding land should remain free of major development. One approach to implementing this recommendation would be for the Host State to requisition the developer's land formally, as the Government of Costa Rica purported to do in *Compañía del Desarrollo de Santa Elena, S.A. v. The Republic of Costa Rica*. (24) Such a measure would deprive the owner of the legal rights of ownership to his property. It would constitute a direct taking. Alternatively, the Host State could rezone the land for residential use only. The developer's rights to the use, possession and disposal of his land would at least formally remain intact by the rezoning, yet the income-producing potential of his land has decreased dramatically. In this situation, something of value has definitively been taken by the Host State, yet this interest is not immediately cognizable by an analysis of the owner's rights to the property in terms of the triad of the legal rights of ownership.

Tribunals should therefore give the widest possible scope to the notion of proprietary interests at the first stage of inquiry in order to identify the alleged deprivation to the claimant's interests with the greatest precision possible. Hence, rather than restricting the analysis to the effect of the state measures in question on the triad of ownership rights to the investor's property, a more expansive definition of property interests should be employed. The 'modern understanding' of property advocated by Professor Waelde
P 153 and Dr. Kolo is a good starting point: ●

> [T]he key function of property is less the tangibility of 'things', but rather the capability of a combination of rights in a commercial and corporate setting and under a regulatory regime to earn a commercial rate of return. (25)

Professor Weston's early study of 'constructive takings' suggested an alternative, putting the emphasis solely on the economic interests embodied by the property through the use of the concept 'wealth deprivation':

> [T]he public or publicly authorized imposition of a wealth loss (or blocking of a wealth gain) — at whatever time, by whatever means, with whatever intensity, and for whatever claimed purpose — which, in the absence of some further act on the part of the depriving party, involves the denial of a *quid pro quo* to the party who sustains the deprivation (the component 'wealth' usually being preferred to the more popular 'property' because it refers to all the relevant values of goods, services, and income without sharing the latter's frequent emphasis upon permanence and physicality, or the civil law's stress on 'ownership'). (26)

Investment treaty tribunals have generally favoured a more expansive concept of property rights. By way of example, the Tribunal in *Pope & Talbot* recognized that, although the investor's access to the US softwood market was 'an abstraction', it was 'nevertheless an important part of the "business" of the Investment' so that 'interference with that business would necessarily have an adverse effect on the property that the Investor has acquired in Canada. ... which constitutes the investment.' (27) The *Pope & Talbot* decision is also notable for its satisfying distinction between the taking and expropriation issues, insofar as the Tribunal recognized that the alleged interference did diminish the value of the claimant's investment, but nevertheless did not rise to the level of an expropriation.

In our example of the property developer whose land has been the subject of rezoning by the Host State, his intended use of the land has been frustrated and the capacity of the land to generate a commercial rate of return has been vastly diminished. Something of value has clearly been taken, albeit metaphysically, by the Host State, whether or not it is ultimately found that the Host State is under a duty to compensate that diminution in value. If it is concluded that no such obligation arises, then at least this second stage of the inquiry has proceeded on the most comprehensive and precise examination of the economic affect of the state measure on the property interests in question. This approach
P 154 is preferable to ● a sophistic deduction that the developer's rights or interests in its property remain unaffected by the rezoning.

We thus now turn to the question of when a Host State is liable to compensate an indirect taking.

IV Uncompensable Regulation Versus Indirect Expropriation

In *Metalclad*, the Tribunal held that the conduct of the municipal authority at the site of the investor's landfill project effectively frustrated the project and amounted to an indirect expropriation. The following facts will be assumed to be correct for the purposes

of this analysis. First, the federal government of Mexico authorized a Mexican company, COTERIN, to construct and operate a transfer station for hazardous waste and issued permits to construct and operate a landfill. Second, the state government of San Luis Potosi granted a land use permit to COTERIN for the landfill. Third, officials in the federal government of Mexico represented to Metalclad that COTERIN was able to proceed with the construction and operation of the landfill if all requisite permits under federal state laws had been acquired. Fourth, it was reasonable for Metalclad to assume that the attitude of the Guadalcazar municipal authority at the site of the landfill was ultimately irrelevant due to (i) the representations of the federal government that the necessary approvals had been obtained, (ii) the absence of any precedent for the requirement of a municipal construction permit for any other construction project at the municipality in question and (iii) the fact that exclusive competence for the authorization of hazardous waste landfills rested with the federal government. Fifth, on the basis of the foregoing, Metalclad invested in Mexico by purchasing COTERIN and commenced construction of the hazardous waste landfill.

These findings comport two elements that may justify a finding of indirect expropriation: specific undertakings or representations on the part of the state and legitimate reliance or expectations on the part of the investor. The authorizations and representations given by the Mexican federal government with respect to the putative construction and operation of the landfill were legitimately relied upon by Metalclad in its decision to make its investment in Mexico by purchasing COTERIN. Such inferences support the conclusion that the acts of the Guadalcazar municipal authority transgressed the line of demarcation between uncompensable regulatory measures that may have affected a foreign investment unfavourably and indirect expropriation for the purposes of Article 1110 of the NAFTA.

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The same elements, or the lack thereof, came into play in *Feldman*, where on this occasion the Tribunal dismissed a plea of indirect expropriation. Feldman's investment consisted of a cigarette export business that was established in reliance on a tax rebate policy in Mexico. When Mexico subsequently ended the tax rebate, Feldman was 'no longer able to engage in his business of purchasing Mexican cigarettes and exporting them, and has thus been deprived completely and permanently of any potential economic benefits from that particular activity.' (28) A taking had thus occurred. Still, the Tribunal did not discern a breach of Article 1110 of the NAFTA, because tax laws and regulations are subject to change. Such modifications take place at the peril of the investor in the absence of a specific undertaking to the contrary. The Tribunal considered that it was relevant that Feldman did not seek a binding ruling on its alleged entitlement to the tax rebate from the Mexican courts at any point during its investment activity in Mexico. Such a ruling, if granted in favour of Feldman, would have certainly confirmed that he had a right to the rebate retrospectively but not prospectively. Thus it is unlikely that the subsequent withdrawal of the rebate on a non-discriminatory basis would constitute an indirect expropriation in the circumstances. Feldman had no legitimate expectation to a *status quo* in the Mexican tax regime, and Article 1110 is not an indemnity for 'every business problem experienced by a foreign investor'. (29)

Feldman should be contrasted with *Goetz*, another case involving a revocation of tax exemptions. A Burundian company, AFFIMET (in which the claimant was a shareholder), had requested and obtained a certificate evidencing that AFFIMET's mining activities qualified for the tax and customs free zone. Later, the privileged regime was revoked by the Burundian government for mining activities generally (following the recommendations of an international and independent panel of experts). According to the Tribunal:

> [L]a révocation du certificat d'entreprise franche les a contraints à arrêter toute activité ... ce qui a privé de toute utilité les investissements réalisés et dépouillé les investisseurs requérants du bénéfice qu'ils pouvaient attendre de leurs investissements. (30)

Goetz might be distinguished from *Feldman* in two ways. First, unlike *Feldman*, AFFIMET had applied for and was awarded a specific confirmation of its entitlement to the favourable tax regime, and conducted its investment activities in reliance thereupon.
P 156 This is not, however, an entirely convincing basis for a decision in favour of the investor. The certificate issued by the Burundian government evidencing the qualification of AFFIMET's activities for the tax and customs free zone was simply a general and formal requirement for eligibility under that privileged regime for all enterprises. It could not be construed as either a general or specific promise to a successful applicant that the regime would not be the subject of future amendment. Burundi's decision to exclude mining activities from the regime was, as the Tribunal found, a perfectly legitimate exercise of non-discriminatory regulation and actually brought Burundi's fiscal policy in line with international norms for such regimes.

The second explanation of the Tribunal's finding lies in the unusual formulation in the relevant provision of the bilateral investment treaty between Belgium/Luxembourg and Burundi. Article 4 of this treaty obliges the contracting states to:

> ...ne prendre aucune mesure privative ou restrictive de propriété, ni aucune mesure ayant un effet similaire à l'égard des investissements situés sur son territoire, si ce n'est lorsque des impératifs d'utilité publique, de sécurité ou d'intérêt national l'exigent exceptionnellement, auquel cas les conditions suivantes doivent être remplies:
>
> a) les mesures sont prises selon une procédure légale;
>
> b) elles ne sont ni discriminatoires, ni contraires à un accord particulier ...;
>
> c) elles sont assorties de dispositions prévoyant le paiement d'une indemnité adéquate et effective. (31)

Here is an example of a legislated fusion of 'taking' and 'expropriation', so that any measure taking or restraining property rights must be compensated by the Host State subject to the articulated narrow exceptions. Absent from the provision is any reference to 'expropriation', so the Tribunal, correctly, did not seek to introduce the second stage of the general analysis by investigating whether the taking attributable to Burundi actually constituted an expropriation within the meaning ascribed to that term in international law.

Finally, brief mention should be made of the two NAFTA cases *Pope & Talbot* and *S.D. Myers*. In the former, the Tribunal held that the Canadian government's reduction of the investor's allocation of a fee free quota for the export of softwood lumber to the United States did not amount to an expropriation. Although the basis of the Tribunal's decision
P 157 was that the ● 'degree of interference' represented by the Canadian measure was not substantial enough to rise to an expropriation, the elements of specific undertaking and reliance were notably absent from the investor/state relationship. These elements were also missing in *S.D. Myer*. Canada had passed a regulation prohibiting the export of PCBs to the United States, which deprived the American claimant, whose business was the disposal of PCBs, of the possibility of entering into the Canadian market. Once again, no expropriation was discerned by the Tribunal.

To summarize the tentative conclusion of this section based on the investment treaty cases under review, the prohibition against indirect expropriation should protect legitimate expectations of the investor based on specific undertakings or representations by the Host State upon which the investor has reasonably relied. This is by no means an exclusive test to be applied to all types of alleged indirect expropriations in isolation of other relevant factors. It is, nonetheless, a useful guiding principle that appears to cover many of the situations that have come before modern investment treaty tribunals.

Returning to our hypothetical concerning the property developer, it appears that the rezoning of his property, in the absence of any representations or undertakings by the Host State with respect to the future possibility of a hotel development on the land, would not rise to an indirect expropriation. Investment entails risk, and if the prospect of rezoning had not been ruled out by an undertaking of the Host State, either by representations to the land market at large or in a negotiation between the Host State and the developer, then the latter assumed the risk of that latent possibility in acquiring land adjacent to a nature reserve. It is likely, furthermore, that the market would have factored this risk into the purchase price of the land in question. On the other hand, if the developer had procured a specific undertaking protecting the *status quo* of the zoning classification from the Host State and had relied upon such an undertaking, then these legitimate expectations should be protected by the prohibition against indirect expropriation. Moreover, if such an undertaking was known to the market for land in the vicinity of the nature reserve, then one would expect the purchase price for the land to have been higher as a result.

V Conclusion

It is important to discern the stages that lead to an outcome that may properly be characterized as an expropriation. First, one must consider the nature and extent of the property interests of the investor as recognized by the *lex situs* (in the case of tangible
P 158 property) and determine whether acts ● attributable to the Host State have interfered with these interests in such a manner as to constitute a taking. A wide definition of property interests should inform this first stage of the analysis. The second step is to determine whether, in accordance with the relevant treaty provision and the general rules of international law, the taking engages the international responsibility of the Host State as amounting to an expropriation. Third, depending on the relevant treaty provision, the expropriation may nevertheless be lawful if it was for a public purpose, on a non-discriminatory basis, in accordance with due process of law and on payment of due compensation.

An analysis of reported cases dealing with indirect expropriation, both in the investment treaty context and elsewhere, suggests one possible basis for distinguishing between compensable and uncompensable takings in a regulatory context: the frustration of the investor's legitimate expectations built on a reasonable reliance upon representations and undertakings by the Host State. This is, however, by no means the only test for international responsibility for indirect expropriation. Where the value of an investment has been *totally* destroyed by *bona fide* regulation in the public interest, it may well be

that international law does not allow the Host State to place such a high individual burden on an investor for the pursuit of a regulatory objective for the benefit of the community at large without the payment of compensation. If the land developer considered above as a hypothetical example was prevented by an environmental regulation from building on his land for any purpose, whether commercial or residential, a tribunal may well view the magnitude of the interference as tipping the scales in favour of adjudging an expropriation.

Another theme of this brief paper is that pithy pronouncements on a general 'test' for indirect expropriation that embellish so many decisions of international tribunals are of no great value when considered in isolation of the particular circumstances of the case at hand and other cases with similar fact patterns. Debates on the semantics of these pronouncements should give way to a more rigorous analysis of the factors that produced a finding of indirect expropriation (or the absence thereof) in the jurisprudence extant.

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