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A COMMON AGENDA**

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Indirect expropriation: is the right to regulate at risk?

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In 1962, Professor Christie's influential article in the British Yearbook of International Law entitled "What Constitutes a Taking under International Law"¹ concluded that the question **does governmental interference with the economic activity of a foreigner constitute a taking for which compensation should be paid?** can be determined only on a case-by-case basis. In 2004, Zachary Douglas (now a scholar of University College London) and I revisited this topic and wrote that Professor Christie's conclusion remained valid, observing that "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."²

When we were writing, Mr Douglas and I had not yet seen some important awards, notably *Tecmed*, *CMS v. Argentina*, and *Methanex*. Our conclusion would indubitably have been the same: the question must be determined case by case.

This observation instantly leads us to a fundamental conclusion: international investment agreements that promise compensation for measures tantamount to expropriation will be hopelessly unreliable unless it is accepted that the competent international tribunals have the authority to exercise their judgment in each case. There is no magical formula, susceptible to mechanical application, that will guarantee that the same case will be decided the same way irrespective of how it is presented and irrespective of who decides it. Nor is it possible to guarantee that a particular analysis will endure over time; the law evolves, and so do patterns of economic activity and public regulation.

In a phrase, perfect predictability is an illusion.

¹ 33 BYIL 307 (1962).

² "Indirect Expropriation in Investment Treaty Arbitration," in N. Horn and S. Kröll, eds., *ARBITRATING FOREIGN INVESTMENT DISPUTES: PROCEDURAL AND SUBSTANTIVE LEGAL ASPECTS* 145 (2004).

There is nothing alarming about this. The most sophisticated legal systems, including those of the US and France, have struggled and failed to come up with formulations that would unfailingly give regulators and citizens the ability to predict whether a proposed regulation will lead to compensation for those affected by its dislocations.

So Professor Christie's still-valid conclusion does not mean that there is anything wrong with the way international tribunals operate. And those who fulminate against international awards should understand what they are really saying, and should *be understood* in this way: they want investment disputes to be resolved – if at all – by negotiation and politics, and not by binding adjudication. Accepting *the rule* of law means accepting the outcome of adjudications even when one believes that *a particular rule* of law has been misapplied in a particular case by a particular tribunal.

This explains why we should be unfazed by strident cries for dismantling a valuable system on the alleged ground that a particular decision is wrong – even if we might agree with the criticism as to that particular decision. Professor Christie's conclusion means that such instances would arise no matter how one rearranges the system of adjudication. The only way to ensure that there will be no “bad” decisions is to eliminate adjudication altogether, or to corrupt it by stacking the decks so that the decision-makers will always favour one side or the other – in this case either regulators or property owners.

The fact that perfect predictability is an illusion does not mean that there can be no predictability at all. Hundreds of learned articles have been written about this topic. Their authors have not wasted their time. Proof may be found in the increasing sophistication of international awards (and the greater ease with which one can now identify their inevitable occasional defects).

And none of these observations should suggest for a moment that the task of international arbitrators is to simply reach into the inner recesses of their soul and do whatever they think is right. International adjudication is not the occasion to feel exhilarated by omnipotence fantasies, or to assume the mantle of a wise village elder. International tribunals have an obligation to apply relevant treaties in accordance with international canons, and to evaluate facts with due regard to established principles and the weight of dominant trends in the decided cases. When deciding hard cases, adjudicators need to be *especially* conscious of principles of fairness and justice,³ and the sense of respect for the mainstream of past decisions which the legal order requires in order to preserve its fabric of integrity.

The recent *Methanex* award alone goes a long way toward justifying the conclusion that investment arbitrations are not putting at risk the right to regulate. This was a long-awaited award. A Canadian company sought to hold the US liable under NAFTA, to the tune of hundreds of millions of dollars, because the State of California had destroyed a profitable business by banning the use of a certain fuel additive. The US argued, in defence, that the Californian ban was a legitimate exercise of regulatory power to prohibit the marketing of a production which was dangerous to public health.

Before considering the outcome of the case, it is worth noting some process-related features which help explain the extraordinary degree of interest it attracted.

³ The words “fairness and justice” are not in themselves an invitation to decide on the basis of personal intuitions. To the contrary, they have – to refer to an important national legal system – built up a significant core of meaning in a number of decisions since the US Supreme Court placed these words at the heart of its decision in *Penn Central Station Co. v. New York City*, 438 US 104 (1974) (no compensation following an ordinance preventing the construction on top of Grand Central Station in the interest of historic preservation). The tests elaborated in this case can be traced forward into Annex B of the 2004 US Model BIT.

First, the case was conducted with a high degree of transparency, and the arbitral tribunal accepted submissions from interest groups.

Secondly, the presentations of both parties were extremely able, as can be determined by reading the written pleadings and the transcript of the hearings.

Thirdly, the award is a model of a legal scholarship and insight, delivered by a unanimous tribunal comprised of well-known arbitrators at the height of their personal authority and intellectual powers. It is difficult to imagine that an imaginary appellate jurisdiction, or for that matter any standing international court, could present a panel more qualified to deal with this acute controversy. Nor would it make sense to complain that the tribunal did not benefit from the viewpoint of an arbitrator recruited from the developing world who would have been more sensitive to the concerns of capital-importing countries: the opposing interests of both sides in this case represented developed countries; the capital-importing country was the United States; and the investor's claim was defeated.

To reach its conclusion that “the Californian ban was made for a public purpose, was non-discriminatory, and was accomplished by due process,” and that “from the standpoint of international law, “it was a lawful regulation and not an expropriation,”⁴ the arbitral tribunal found that the ban was “motivated by the honest belief, held in good faith and on reasonable scientific grounds, that MTBE [the controversial additive] contaminated groundwater and was difficult and expensive to clean up.”⁵

It follows that even when the investor has suffered the total destruction of a business, a state may escape any obligation to pay compensation under international law, and international arbitrators are prepared to give national authorities considerable discretion in making policy choices.

To do full justice to *Methanex*, or indeed to any other important case, would require more than the available time. Instead of embarking on a description of individual awards, I will rather propose the barebones of some conclusions emerging from this jurisprudence *in statu nascendi*.

1. The grounds on which a property owner adversely affected by regulation may be entitled to compensation are becoming much clearer. First among these is the notion of “reasonable investment-backed expectations” – not my favourite phrase but so often repeated that it cannot be ignored. Many will prefer the *Methanex* formulation: “specific commitments ... given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.”⁶ Obvious examples of such expectation-creating commitments are contracts and licences. But there are other circumstances, presumably exceptional, where “policies in force earlier might have created legitimate expectations both of a procedural and substantive nature.”⁷
2. To escape liability under international law, the relevant regulation must be legitimate and bona fide; it will fail that test if the stated objective is shown to be false, as in *S.D. Myers* when a Canadian

⁴ Methanex Corp. v. United States of America, Award of 5 August 2005. At Part IV, Chapter D, para. 15.

⁵ At Part III, Chapter A, para. 102.

⁶ At Part V, Chapter D, para. 7.

⁷ Francisco Orrego Vicuña, “Regulatory Authority and Legitimate Expectations: Balancing the Rights of the State and the Individual under International Law in a Global Society,” 5/3 INT. L. FORUM 188 (2003).

restriction was revealed not to be motivated by environmental concerns, but rather a stratagem to protect national business interests.⁸

3. Regulatory acts must be consistent with due process. An inquiry into the public benefit would violate due process if it is perfunctory, one-sided, or otherwise skewed against the investor. More obviously, the forfeiture of a licence on the grounds of failure to respect the conditions of licence is unjustifiable if the licensee is given no opportunity to justify its conduct. And the cancellation of a license is not necessarily a regulatory act at all.
4. These restrictions on the power to regulate without giving compensation would be impotent if they could be swept aside by self-serving declarations. The state whose conduct is in question cannot “decide” that (i) there was no commitment to the investor, (ii) the regulation was bona fide, or (iii) due process was respected. As Professor Christie put it: “A State’s declaration that a particular interference with an alien’s enjoyment of his property is justified by the so-called ‘police power’ does not preclude an international tribunal from making its own independent determination of this issue.”
5. In many cases a claimant may seek recovery under several additional grounds, most commonly discrimination or a denial of fair and equitable treatment. When recovery is granted on such alternative grounds, the discussion of indirect expropriation may be obiter. If so, it is far preferable for arbitral tribunals to state that it is unnecessary to decide the expropriation claim, rather than seek to comfort losing respondents – “giving them something” – by declaring that there was no expropriation. Such obiter dicta may have an unintended and unfortunate effect on international jurisprudence, and create difficulties in entirely different contexts where the issues of discrimination and fair and equitable treatment do not arise, such as an investor’s claims under an expropriation insurance policy governed by international law.
6. While it is tempting to import notions from the international law of human rights dealing with deprivations of property and violations of due process, there can be no assumptions about the perfect correspondence between instruments devised for quite different purposes. Human rights conventions deal with rights of individuals that are inalienable whether or not the concerned individuals have chosen to subject themselves to a given national system. Investment treaties contemplate the rights of *foreigners*, who as such have both advantages and disadvantages. On the one hand, they may choose not to enter the country with their investments; hence the relevance of commitments made to them by the state is heightened. On the other hand, once they have committed, especially in the case of small or medium-sized investors, or even large investors who have come only for a sole project, they may suffer from their lack of citizenship status; hence a heightened sensitivity to violation of due process by officials who may be tempted to shift losses to parties lacking political influence.

Nor is it justified to leap to conclusions about the normative force of UN-generated documents like the ILC draft Articles on State Responsibility. No matter their quality of exposition and logic, they are the product of deliberation by persons elected by the UN General Assembly who have no statutory duty to act independently of their governments. What proportion of the UN’s 191 member States may be said to have governments broadly representative of their people? It is not for me to answer the question, just to ask it. It falls to those who would seek to attribute to such documents the status of a source of law to shoulder the burden of proving the affirmative. No one, it seems, has confronted, let alone overcome, Professor Allott’s powerful challenge to the ILC’s work in his

⁸ S.D. Myers Inc. v. Canada, Partial Award, 13 November 2000.

article, “State Responsibility and the Unmaking of International Law.”⁹ As a method for *limiting* the power of states – as opposed to *establishing* it – this should be read with the same caution as a security manual for chicken coops drafted by a fox. If anything, it is reliable in a negative sense, e.g. when it can be said that *even* this text acknowledges state responsibility in a particular circumstance.

7. The magical formula for deciding claims of indirect expropriation is the international lawyer’s equivalent of proving Fermat’s Last Theorem.¹⁰ The one who finds it would be justly famous – but unlike the case with respect to the proof of the Theorem, no one has done so yet. Most attempts founder quickly; they tend to degenerate into sterile or tautologous obsessions with nomenclature. For example, it may be tempting to suggest that a government which acts to procure public *benefits* should pay compensation for their acquisition, but when it acts to prevent a *harm* no compensation should be due. But as Professor Michelman wrote, almost as long ago as Professor Christie, outlawing billboards next to highways may be equally classified as the prevention of a harm (a nuisance) or as acquiring a benefit (increased safety).¹¹ Similar conceptual dead ends appear if one imagines that the solution lies in distinguishing between cases where the state acts as *purchaser* or as *policy-maker*, or whether or not there has been an *appropriation* by the State,¹² or whether the deprivation has met some standard of *comprehensiveness*.¹³

Justice Scalia of the US Supreme Court, I hope, discouraged more than one would-be author of the magical formula when he wrote that the ease of articulating regulatory purposes is so great that the use of such criteria “amounts to a test of whether the legislature has stupid staff.”¹⁴

8. It is unacceptable to ignore national law in the absence of an international norm. An international treaty may provide for the protection of contracts, property, or other private-law rights, but international law does not define such rights; one must look to national law. If an alleged *contract* has been annulled by national authorities competent to do so in accordance with due process of law, international law is powerless to find a contract to be expropriated;¹⁵ if a national law does not consider a *lease* to be “property” but rather a contract, it is difficult to see how an investor invoking a treaty which calls vaguely for the protection of “property” (as opposed to “assets” explicitly

⁹ 29 HARVARD INTERNATIONAL LAW JOURNAL 1 (1988). See Zachary Douglas, *infra* Note 14, pp. 184-193.

¹⁰ $x^n + y^n = z^n$ has no non-zero integer solutions for x , y , and z when $n > 2$.

¹¹ F.I. Michelman, “Property, Utility, and Fairness: Comments on the Ethical Foundations of ‘Just Compensation’ Law,” 80 HARV. L. REV. 1165 (1967).

¹² This quickly leads to tortured reasoning, such as insisting that the cancellation of a permit is tantamount to its appropriation because the state has put itself in the position to grant it anew. In his brave bid to promote this approach, Professor Andrew Newcombe argues his way resolutely into a corner, and finds himself reduced to arguing that cases such as *Metalclad*, *CME v. Czech Republic* and *Tecmed S.A.*, involving “state approval of investment activity in question and then subsequent state interference, ... can be analogized to a form of indirect government appropriation of the investment in question,” “The Boundaries of Regulatory Expropriation in International Law,” ICSID REVIEW 1, at 16 (2005). Verily there is no end to what one might “analogize,” and birds are like aeroplanes because both have wings, but reaching for such analogies is unlikely to contribute to solving problems relating to either avian flu or traffic congestion at Heathrow.

¹³ Why should farmer Jones be compensated for his lost hectare but not farmer Smith, just because farmer Smith had a bigger estate? Why should company A be compensated for the loss of its gambling business but not company B, just because company B also operated a bakery business?

¹⁴ *Lucas v. South Carolina Coastal Council*, 112 S. Ct. 2886, at 2898 (1992). The proposed dichotomy in that case was “harm/benefit.”

¹⁵ Compare *Azinian* and *WENA*, two awards which seem irreconcilable.

defined as including “contractual rights”) can enlist any international law definition in support of his cause.¹⁶

9. One may well wonder whether any substance is left in the purported distinction between legal and illegal takings. It is difficult to resist the temptation to conclude from the decided cases that for practical purposes all takings become licit under international law once compensation has been paid.¹⁷ If this is so, the only important distinction is between (1) property deprivations by regulations which are licit only if they are accompanied by sufficient compensation, and (2) those which are licit even in the absence of any compensation.

An alternative would be to discern three conceptual possibilities:

- (1) a valid exercise of police powers which gives no right to compensation irrespective of the resulting deprivation;
- (2) a taking which is unjustifiable (because it contradicts undertakings or otherwise lacks bona fides);
- (3) a taking which gives rise to liability only because the non-payment of compensation imposes an unproportional burden on the victim.

This triple distinction will be controversial. The difficulty arises under (3). (2) is straightforward: the loss must be made good. But (3) requires international tribunals to redo the regulator’s work, and establish what *part* of the deprivation represents the gap between the actual loss and the threshold of tolerable proportionality. While this concept would give arbitrators greater flexibility, and would make the outcome less of an all-or-nothing proposition, it increases the discretionary ambit of arbitral authority to a degree which may be deemed unwise or indeed unpalatable.

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By way of conclusion, I would observe that the Convention Establishing the Multilateral Investment Guarantee Agency, which will soon have 180 signatory States, defined in Article 11(a)(ii) the insurable event of expropriation as: “any legislative or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment.” The same provision goes immediately on to define exceptions: “non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories.” This hardly sounds like the paralysis of regulation. But there is much in the word *normally*. I would suggest that it is not normal to regulate in contradiction of justifiably perceived commitments. Nor is it normal to regulate while ignoring due process. Nor obviously is it normal to use regulatory enactments or conduct as a pretence of form serving as a cloak for the pursuit of hidden objectives. Nor finally is it normal for a state to be the judge of the international licitness of its own refusal to compensate.

¹⁶ See Zachary Douglas, “The Hybrid Foundations of Investment Treaty Arbitration,” 74 BYIL 151 (2004), an article which has quickly established itself as indispensable.

¹⁷ For an attempt to deal a death blow to the pointless confusion which the *Chorzów Factory* case continues to generate, see Jan Paulsson, “Ghosts of *Chorzów*,” in Todd Weiler, ed., INTERNATIONAL INVESTMENT LAW AND ARBITRATION 777, esp. 789 (2005).