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## Defining the Scope of Indirect Expropriation for International Investments

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# DEFINING THE SCOPE OF INDIRECT EXPROPRIATION FOR INTERNATIONAL INVESTMENTS

PETER D. ISAKOFF<sup>†</sup>

## ABSTRACT

*At present, arbitral tribunals have applied a variety of standards to ascertain when indirect expropriation occurs. This article examines the complexities and ambiguities of current indirect expropriation standards and argues that a clear, uniform standard is needed to identify indirect expropriation. Ultimately, this article proposes that arbitral tribunals should only find that indirect expropriation occurs when (i) a state takes actions that substantially deprive the foreign investor of the profitability of its investment, and (ii) the state action was not reasonably predictable to the investor. Part I of this article provides a summary of the current state of expropriation doctrine. Part II exposes the ambiguities of current indirect expropriation standards and outlines several potential solutions that scholars have proposed. Part III offers a succinct, two-part standard for identifying compensable indirect expropriation claims. Part IV applies this proposed standard to the recent PM Asia arbitration.*

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## I. INTRODUCTION

On November 21, 2011, the Australian Parliament passed the Tobacco Plain Packaging Act 2011,<sup>1</sup> which bans trademarked logos from appearing on the packaging of tobacco products.<sup>2</sup> That same day, Philip Morris Asia (“PM Asia”) filed a Notice of Arbitration against the Australian government.<sup>3</sup> It claimed, under the Hong Kong-Australia Bilateral Investment Treaty (“BIT”),<sup>4</sup> that Australia’s plain packaging legislation amounted to an indirect expropriation of PM Asia’s intellectual property and good will.<sup>5</sup>

PM Asia’s claim raises an important issue in international investment law: what exactly constitutes indirect expropriation? While instances where a state forcibly nationalizes foreign investments present clear cases of direct expropriation, claims of indirect expropriation are inherently more nebulous. At present, arbitral tribunals have applied a variety of standards to ascertain when indirect expropriation occurs. This article examines the complexities and ambiguities of current indirect expropriation standards and argues that a clear, uniform standard is needed to identify indirect expropriation. Ultimately, this article proposes that arbitral tribunals should only find that indirect expropriation occurs when (i) a state takes actions that substantially deprive the foreign investor of the profitability of its investment, and (ii) the state action was not reasonably predictable to the investor.

<sup>1</sup> *Tobacco Plain Packaging Bill 2011* (Cth) (Austl.), available at <http://www.comlaw.gov.au/Details/C2011B00128>.

<sup>2</sup> Alison Rourke, *Australia Passes Plain packaging Cigarette Law*, THE GUARDIAN, Nov. 10, 2011, <http://www.guardian.co.uk/world/2011/nov/10/australia-plain-packaging-cigarette-law>.

<sup>3</sup> Philip Morris Asia Ltd. v. Australia, UNCITRAL, Notice of Arbitration (Nov. 21, 2011), available at [http://italaw.com/documents/PhilipMorrisAsiaLimited\\_v\\_Australia\\_NOA\\_21Nov2011.pdf](http://italaw.com/documents/PhilipMorrisAsiaLimited_v_Australia_NOA_21Nov2011.pdf).

<sup>4</sup> Agreement between the Government of Hong Kong and the Government of Australia for the Promotion and Protection of Investments, Austl.-H.K., Sep. 15, 1993, 1748 U.N.T.S. 385, available at <http://www.legislation.gov.hk/IPPAustraliae.PDF>.

<sup>5</sup> Notice of Arbitration, *supra* note 3 at 1.5 (“Australia’s plain packaging legislation virtually eliminates Philip Morris’ branded business by expropriating its valuable intellectual property.”).

Part I of this article provides a summary of the current state of expropriation doctrine. Part II exposes the ambiguities of current indirect expropriation standards and outlines several potential solutions that scholars have proposed. Part III offers a succinct, two-part standard for identifying compensable indirect expropriation claims. Part IV applies this proposed standard to the recent *PM Asia* arbitration.

## II. DIRECT AND INDIRECT EXPROPRIATION: A GENERAL BACKGROUND

Customary international law has long afforded states the authority to expropriate foreign investments, as long as the expropriation: (i) is for a public purpose; (ii) is non-discriminatory; (iii) complies with due process principles; and (iv) provides the investor with prompt, adequate, and effective compensation.<sup>6</sup> While the exact contours of expropriation doctrine are a matter of international treaties, including BITs,<sup>7</sup> the North American Free Trade Agreement (“NAFTA”),<sup>8</sup> the Energy Charter Treaty,<sup>9</sup> and the ASEAN Agreement for the Promotion and Protection of Investments,<sup>10</sup> these treaties outline common principles of expropriation doctrine.<sup>11</sup> Generally, expropriation claims fall into two broad categories: direct expropriation and indirect expropriation. Section A of this Part briefly outlines direct expropriation. Section B examines the scope of non-compensable state police powers, and Section C explores various regulatory activities that could qualify as compensable indirect expropriation.

### A. Direct Expropriation

Cases of direct expropriation are usually readily identifiable<sup>12</sup> and entail overt government taking of a foreign investment.<sup>13</sup> Direct expropriation is usually open

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<sup>6</sup> L. Yves Fortier & Stephen L. Drymer, *Indirect Expropriation in the Law of International Investment: I know it When I See It, or Caveat Investor*, 13 ASIA PAC. L. REV. 79, 81 (2005).

<sup>7</sup> For an overview of expropriation sections of BITs, see CAMPBELL MCLACHLAN QC, LAURENCE SHORE & MATTHEW WEINIGER, *INTERNATIONAL INVESTMENT ARBITRATION: SUBSTANTIVE PRINCIPLES* 275–86 (2007).

<sup>8</sup> North American Free Trade Agreement, Dec. 8, 1993, 107 Stat. 2057 [hereinafter NAFTA], available at <http://www.sice.oas.org/Trade/NAFTA/NAFTATCE.ASP>.

<sup>9</sup> Energy Charter Treaty, Dec. 17, 1994, 2080 U.N.T.S. 100, available at [http://www.encharter.org/fileadmin/user\\_upload/document/EN.pdf](http://www.encharter.org/fileadmin/user_upload/document/EN.pdf).

<sup>10</sup> ASEAN Agreement for the Promotion and Protection of Investments, Dec. 15 1987, 27 I.L.M. 612, available at <http://www.aseansec.org/12812.htm>.

<sup>11</sup> See MCLACHLAN, SHORE & WEINIGER, *supra* note 7, at 268–69 (“[E]xpropriation provisions in treaties, though often similar, sometimes contain distinctions in wording. These distinctions inevitably have provoked discussion as to whether, on the one hand, a substantive difference in meaning should be recognized or, on the other hand, an emphasis on small variations in language (English language) is a misguided approach to the understanding of international law.”).

<sup>12</sup> See *id.* at 8.70 (“The determination of direct expropriation by courts and tribunals does not usually raise conceptual difficulties.”).

<sup>13</sup> See *id.* at 8.69 (“[T]he central element [of direct expropriation] is that property must be ‘taken’ by State authorities or the investor must be deprived of it by State authorities.”).

and deliberate, with the state engaging in outright seizure of foreign-owned facilities or mandating an obligatory transfer of title.

Venezuela's recent nationalizations within the oil industry represent prime examples of direct expropriation. In May 2009, Venezuela's National Assembly passed a law giving its government the authority to take over oil-service contractors, including American and British companies.<sup>14</sup> President Chavez subsequently used the Venezuelan military to seize oil installations, and brought in oil workers from India, Libya, and Iran to operate the expropriated oil rigs and refineries.<sup>15</sup> In recent years, Venezuela has further engaged in the direct expropriation of foreign-owned facilities in a wide range of industries, including steel mills, retail stores, cement-making facilities, and glass-making facilities.<sup>16</sup> At present, Venezuela faces more than a dozen pending expropriation cases under arbitration with the International Centre for Settlement of Investment Disputes ("ICSID").<sup>17</sup>

Because cases of direct expropriation are usually unambiguous and easily identifiable,<sup>18</sup> direct expropriation falls outside the scope of this article. Instead, this article focuses on the nebulous standards for determining indirect expropriation.

### B. State Police Powers

Generally, states do not engage in compensable expropriation when they enact regulations that are "commonly accepted as within the police power of States" as long as the regulation "is not discriminatory . . . and is not designed to cause the alien to abandon the property to the state or sell it at a distress price."<sup>19</sup> Therefore, states do not owe investors compensation for "loss of property or . . . other economic disadvantage resulting from bona fide general taxation, regulation, [and] forfeiture for crime."<sup>20</sup>

The arbitral decision in *Saluka Investments v. Czech Republic*<sup>21</sup> elaborates on the scope of state police powers. In *Saluka Investments*, the claimant acquired 36% of

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<sup>14</sup> Martin Arostegui, *Venezuelan Nationalization Continuing*, THE WASHINGTON TIMES, May 12, 2009, <http://www.washingtontimes.com/news/2009/may/12/nationalization-continuing/?page=all>.

<sup>15</sup> *Id.*

<sup>16</sup> *Chavez Orders Expropriation of Owens-Illinois*, CBS NEWS (Oct. 26, 2010), [http://www.cbsnews.com/2100-202\\_162-6991745.html](http://www.cbsnews.com/2100-202_162-6991745.html)

<sup>17</sup> *Venezuela and International Arbitration: Ick-SID*, THE ECONOMIST (Jan. 19, 2012), <http://www.economist.com/blogs/americasview/2012/01/venezuela-and-international-arbitration>.

<sup>18</sup> See Fortier & Drymer, *supra* note 6, at 290 ("Arbitral tribunals have considered direct expropriation as being relatively easy to recognize: for example, government authorities take over a mine or factory, depriving the investor of all meaningful benefits of ownership and control, or there has been a compulsory transfer of property rights." (internal quotation marks and citation omitted)).

<sup>19</sup> RESTATEMENT (THIRD) FOREIGN RELATIONS OF THE U.S. § 712 comment g (1987).

<sup>20</sup> *Id.*

<sup>21</sup> *Saluka Investments BV v. Czech Republic*, UNCITRAL, Partial Award (Mar. 17, 2006), available at <http://www.pca-cpa.org/upload/files/SAL-CZ%20Partial%20Award%20170306.pdf>.

one of the four major state-owned banks in the Czech Republic during the bank privatization process that occurred in the aftermath of the dissolution of Czechoslovakia.<sup>22</sup> The claimant's bank did not receive state subsidies given to the other three major banks,<sup>23</sup> and the bank was consequently forced into receivership.<sup>24</sup> As the Czech Republic described, the claimant's bank had failed to comply with domestic banking regulations and "endangered the stability of the banking system."<sup>25</sup> Here, the tribunal found that the Czech Republic acted within state police powers, and thus did not owe compensation, because it sought through regulation to promote financial stability.<sup>26</sup>

Arbitral tribunals have struggled to distinguish state police powers from compensable expropriation, especially indirect expropriation.<sup>27</sup> As the *Saluka Investments* tribunal noted, "international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered 'permissible' and 'commonly accepted' as falling within the police or regulatory power of States and, thus, non-compensable."<sup>28</sup> Instead, tribunals have taken an *ad hoc* approach to identifying indirect expropriation.

### C. Indirect Expropriation

State regulatory action can sometimes transcend police powers and rise to the level of indirect expropriation. Nonetheless, arbitral tribunals have faced practical difficulties in distinguishing between non-compensable regulation and compensable indirect expropriation.<sup>29</sup> This Section explores several different types of state actions that can potentially constitute indirect expropriation.

#### 1. Measures Tantamount to Expropriation

The expropriation provisions of many BITs and other international investment treaties reference measures "tantamount to" or "equivalent to" expropriation.<sup>30</sup> This

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<sup>22</sup> *Id.* ¶ 62.

<sup>23</sup> *Id.* ¶ 82.

<sup>24</sup> *Id.* ¶ 136.

<sup>25</sup> *Id.* ¶ 270.

<sup>26</sup> *Id.* ¶ 276.

<sup>27</sup> Fortier & Drymer, *supra* note 6, at 299.

<sup>28</sup> *Saluka Investments*, *supra* note 21, ¶ 263.

<sup>29</sup> *Id.* ¶ 293.

<sup>30</sup> See, e.g., NAFTA, *supra* note 8, at art. 1110.1 ("No party may . . . take a measure tantamount to nationalization or expropriation of such an investment."); Treaty Between the Federal Republic of Germany and Bosnia and Herzegovina Concerning the Encouragement and Reciprocal Protection of Investments art. 4(2), Oct. 18, 2001, I.C.-B.T. 037 ("Investments by investors of either Contracting State shall not be . . . subject to any other measure the effects of which would be tantamount to expropriation."); Agreement for the Promotion and Protection of Investments art. 5, U.K.-Sierra Leone, Jan. 13, 2000, U.K. Foreign & Commonwealth Off. Treaty Series No. 17 ("Investments of nationals or companies of either Contracting Party shall not be . . . subjected to measures having effect equivalent to nationalisation or expropriation.").

language has often been narrowly construed to avoid expanding the definition of expropriation; rather, it is simply meant to include expropriations that occur in substance but not in form.<sup>31</sup> In fact, some arbitral tribunals have treated “measures tantamount to expropriation” as the functional equivalent of expropriation.<sup>32</sup>

The arbitral decision in *S.D. Meyers v. Canada*<sup>33</sup> provides a clear analysis of the definition of “measures tantamount to expropriation.” In *S.D. Meyers*, the American claimant operated a PCB hazardous waste treatment and disposal business in Canada.<sup>34</sup> After Canada passed a law banning the exportation of PCB waste,<sup>35</sup> the claimant alleged that this constituted a measure tantamount to expropriation since the claimant’s business transported PCB waste from Canada to its Ohio facilities for treatment and disposal. In its expropriation analysis, the *S.D. Meyers* tribunal stated that “[t]he primary meaning of the word ‘tantamount’ given by the Oxford English Dictionary is ‘equivalent.’ Both words require a Tribunal to look at the substance of what has occurred and not only at form. . . . [S]omething that is ‘equivalent’ to something else cannot logically encompass more. . . . [T]he drafters of the NAFTA [did not intend to] expand the internationally accepted scope of the term expropriation.”<sup>36</sup> Ultimately, the *S.D. Meyers* did not find that indirect expropriation occurred.

## 2. Regulatory Takings

Arbitrators have frequently found that state regulatory measures can transcend the scope of state police power to constitute compensable expropriation. In this regard, some tribunals have effectively exported to the international arena a doctrine similar to U.S. “regulatory takings” jurisprudence.<sup>37</sup>

For instance, in *Link Trading v. Republic of Moldova*,<sup>38</sup> the claimant imported consumer products into a “free economic zone” (“FEZ”) in Moldova, where it was initially exempt from import duties and taxes.<sup>39</sup> After Moldova later passed a law

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<sup>31</sup> *S.D. Myers, Inc. v. Government of Canada*, UNCITRAL/NAFTA, First Partial Award, ¶ 285 (Nov. 13, 2000), 40 I.L.M. 1408, available at [http://italaw.com/documents/PartialAward\\_Myers\\_000.pdf](http://italaw.com/documents/PartialAward_Myers_000.pdf) (“The primary meaning of the word ‘tantamount’ given by the Oxford English Dictionary is ‘equivalent.’ Both words require a tribunal to look at the substance of what has occurred and not only the form.”).

<sup>32</sup> *Feldman v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award of the Tribunal (Dec. 16, 2002), 7 ICISD Rep. 341, available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587\\_En&caseId=C175](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587_En&caseId=C175).

<sup>33</sup> *S.D. Myers, Inc. v. Government of Canada*, *supra* note 31, at ¶ 142.

<sup>34</sup> *Id.* ¶ 93.

<sup>35</sup> *Id.* ¶ 123.

<sup>36</sup> *Id.* ¶ 286.

<sup>37</sup> Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA’s Investment International “Regulatory Takings” Doctrine*, 78 NYU L. REV. 30, 37 (2003).

<sup>38</sup> *Link Trading v. Republic of Moldova*, UNCITRAL, Final Award (Apr. 18, 2002), available at <http://italaw.com/documents/Link-Trading-Moldova.pdf>.

<sup>39</sup> *Id.* ¶¶ 1–3.

requiring companies in the FEZ to collect taxes from customers at the point of sale,<sup>40</sup> *Link Trading* raised an expropriation claim. The *Link Trading* tribunal, in its expropriation analysis, stated that regulatory measures “become expropriatory when they are found to be an abusive taking. Abuse rises where it is demonstrated that the state has acted unfairly or inequitably toward the investment, where it has adopted measures that are arbitrary or discriminatory in character or in their manner of implementation, or where the measures taken violate an obligation undertaken by the state in regard to the investment.”<sup>41</sup> Under this analysis, the tribunal found that no regulatory taking occurred.<sup>42</sup>

Some scholars argue that international tribunals have inappropriately expanded this doctrine beyond the scope of U.S. “regulatory takings” jurisprudence.<sup>43</sup> For instance, arbitral tribunals sometimes apply a more expansive definition of “property” than under U.S. domestic law.<sup>44</sup> Furthermore, although U.S. courts have held that changes in common law are not regulatory takings, some tribunals have found that the actions of a state’s courts can constitute expropriation of a foreign investment.<sup>45</sup> Additionally, the procedural mechanisms of international arbitration may provide advantages to investors that are not available in domestic U.S. litigation.<sup>46</sup>

### 3. Creeping Expropriation

Indirect expropriation does not necessarily occur through a single state action; instead, it can be the result of a progression of regulatory measures. Even if a particular part of this progression would not independently constitute expropriation, the aggregate effect of such measures could eventually rise to the level of expropriation.<sup>47</sup> Generally, creeping expropriation occurs when a state seeks to

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<sup>40</sup> *Id.* ¶6.

<sup>41</sup> *Id.* ¶ 64.

<sup>42</sup> *Id.* ¶ A.

<sup>43</sup> See Been & Beauvais, *supra* note 37 at 37 (“Although many have argued that NAFTA simply ‘exports’ the U.S. regulatory takings standard into international law, we demonstrate that, in fact, the NAFTA tribunal decisions and dicta significantly exceed U.S. takings protections (already among the most protective in the world) in several respects.” (footnotes omitted)).

<sup>44</sup> *Id.* at 59.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 59–60.

<sup>47</sup> *Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award of the Tribunal (Feb. 17, 2000), 5 ICSID Rep. 153, available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC539\\_En&caseId=C152](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC539_En&caseId=C152); see also *Generation Ukraine Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, ¶ 20.22 (Sep. 16, 2003), available at [http://italaw.com/documents/GenerationUkraine\\_000.pdf](http://italaw.com/documents/GenerationUkraine_000.pdf) (“Creeping expropriation is a form of indirect expropriation with a distinctive temporal quality in the sense that it encapsulates the situation whereby a series of acts attributable to the State *over a period of time* culminate in the expropriatory taking of such property.”).



accomplish the same result as direct expropriation through regulatory measures extending over a period of time.<sup>48</sup>

For instance, the tribunal in *Feldman v. Mexico*<sup>49</sup> analyzed whether tax regulations constituted creeping expropriation. In *Feldman*, the American claimant operated a cigarette resale business in Mexico.<sup>50</sup> The Mexican government passed an excise tax on cigarettes, but after pressure from domestic cigarette producers, later amended the tax to provide rebates to cigarette producers, but not resellers like the claimant.<sup>51</sup> After litigation in Mexican courts, the claimant received rebates for several years,<sup>52</sup> but the Mexican government later reinstated its prohibition on rebates to resellers and required the claimant to repay the approximately \$25 million of rebates he had received.<sup>53</sup>

In *Feldman*, the claimant alleged that the series of tax regulations and reforms constituted creeping expropriation because they sought “to achieve the same result [as an outright taking] by taxation and regulatory measures designed to make continued operation of a project uneconomical so that it is abandoned.”<sup>54</sup> The *Feldman* tribunal declined to find that creeping expropriation occurred, because: (i) ordinary business issues do not constitute expropriation; (ii) NAFTA and customary international law do not require states to permit the exports of cigarettes; (iii) at no point did the tax regulation in question guarantee cigarette resellers the “right” to export cigarettes; and (iv) the claimant’s investment always remained in his control.<sup>55</sup>

### III. THE AMBIGUITY OF CURRENT STANDARDS FOR INDIRECT EXPROPRIATION

At a broad level, “[t]he concept of expropriation is reasonably clear: it is a governmental taking of property for which compensation is required.”<sup>56</sup> Nonetheless, as the previous Part demonstrates, in practice the breadth of potential state actions that could constitute indirect expropriation presents significant line-drawing issues, and international treaties provide little guidance in making these close determinations.<sup>57</sup> Given this doctrinal void, arbitral tribunals have taken a variety of approaches to determine when exactly a state’s actions constitute indirect

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<sup>48</sup> See *infra* note 54 and accompanying text.

<sup>49</sup> *Feldman v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award of the Tribunal (Dec. 16, 2002), 7 ICISD Rep. 341, available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587\\_En&caseId=C175](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC587_En&caseId=C175).

<sup>50</sup> *Id.* ¶ 9.

<sup>51</sup> *Id.* ¶¶ 7–10.

<sup>52</sup> *Id.* ¶ 19.

<sup>53</sup> *Id.* ¶ 21.

<sup>54</sup> *Id.* ¶ 101 (internal quotation marks and citation omitted).

<sup>55</sup> *Id.* ¶ 111.

<sup>56</sup> McLACHLAN, SHORE & WEINIGER, *supra* note 7, at 266.

<sup>57</sup> *Id.* at 267.

expropriation as opposed to non-compensable regulation.<sup>58</sup> Section A of this Part examines various standards that arbitral tribunals have applied to identify indirect expropriation. Section B looks at two potential alternatives to indirect expropriation doctrine.

#### A. *Arbitral Standards for Determining Indirect Expropriation*

Scholars have classified the various standards used by arbitral tribunals to identify indirect expropriation into two general categories: (i) analysis of the effect of the state action on the investor, and (ii) analysis of the purpose of the state action.<sup>59</sup> Within these two categories, tribunals' rationale has varied greatly.

##### 1. Effect on the Investor

Almost every tribunal examines the effect of a state action on the investor when determining whether an investment has occurred. Generally, the leading Restatement on the subject provides a broad test: "[a] state is responsible as for an expropriation of property . . . when it . . . unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property."<sup>60</sup>

Tribunals have applied numerous variations of this test.<sup>61</sup> For example, in *Tecnicas Medioambientales Tecmed SA v. United Mexican States*,<sup>62</sup> the tribunal stated that indirect expropriation occurs when the investor is "radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto . . . had ceased to exist."<sup>63</sup> In *Pope & Talbot v. Canada*,<sup>64</sup> the tribunal provided that "the test is whether that interference is sufficiently restrictive to support a conclusion that the property has been 'taken' from its owner."<sup>65</sup> The tribunal in *Starrett*

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<sup>58</sup> *See id.* ("The definitions of expropriation appearing in investment treaties are of such a generality that they provide little guidance to parties or arbitral tribunals confronted by concrete cases. In the absence of firm guidance, arbitral tribunals have fashioned a variety of tests for assessing whether States are liable for expropriation, which can create both opportunities and uncertainties for parties in circumstances where expropriation arguably has occurred.").

<sup>59</sup> *See generally, e.g.* Fortier & Drymer, *supra* note 6, at 300-17 (providing a detailed analysis of various arbitral standards for determining when indirect expropriation has occurred).

<sup>60</sup> RESTATEMENT (THIRD) FOREIGN RELATIONS OF THE U.S., *supra* note 19, at § 712 comment g.

<sup>61</sup> For an even more extensive list of various standards applied by tribunals, *see* Fortier & Drymer, *supra* note 6, at 300-06.

<sup>62</sup> *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award (May 29, 2003), 43 I.L.M. 133 (2004), *available at* [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC602\\_En&caseId=C186](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC602_En&caseId=C186).

<sup>63</sup> *Id.* ¶ 115.

<sup>64</sup> *Pope & Talbot, Inc. v. Gov't of Canada*, NAFTA/UNCITRAL, Interim Award (June 26, 2000), 7 ICSID Rep. 69, *available at* <http://www.naftaclaims.com/Disputes/Canada/Pope/PopeInterimMeritsAward.pdf>.

<sup>65</sup> *Id.* ¶ 102.

*Housing Corp. v. Government of the Islamic Republic of Iran*<sup>66</sup> formulated the test as interference where investors' "rights are rendered so useless that they must be deemed to have been expropriated."<sup>67</sup> In *Tippetts v. TAMS-AFFA*,<sup>68</sup> the tribunal stated that indirect expropriation occurred when the investor "was deprived of fundamental rights of ownership and it appears that the deprivation is not merely ephemeral."<sup>69</sup> Although some scholars argue that all of these standards are formulations of an overarching "substantial deprivation" standard,<sup>70</sup> the decisions of these various tribunals suggests otherwise. In practice, it appears these tests all contain distinct aspects and are in need of harmonization.

Tribunals also disagree regarding the temporal aspects of compensable indirect expropriation. For instance, the *Tecmed* tribunal held that state action constitutes an indirect expropriation when it is "irreversible and permanent."<sup>71</sup> Conversely, in *Wena Hotels*, the tribunal found that the temporary seizure of hotels for one year constituted an expropriation.<sup>72</sup> The decisions of tribunals further diverge as to whether the state action must deprive the investor of the whole investment, or just a part of the investment. The *S.D. Meyers* tribunal found that an expropriation could occur even when the state action deprived the investor of only part of its investment.<sup>73</sup> On the other hand, the *Iurii Bogdanov* tribunal required deprivation of "the totality or a substantial part of the investment" in order to find compensable indirect expropriation.<sup>74</sup>

Some tribunals, utilizing the "sole effects" test, exclusively examine whether the effect of the government's action was to deprive the investor in whole or significant part of the economic benefits of its investment.<sup>75</sup> Since, at least in theory, almost

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<sup>66</sup> *Starrett Hous. Corp. v. Gov't of the Islamic Republic of Iran*, 4 Iran-U.S. Ck. Trib. Rep. 122 (1983).

<sup>67</sup> *Id.* at 1115.

<sup>68</sup> *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*, 6 Iran-U.S. Cl. Trib. Rep. 219 (1984)

<sup>69</sup> *Id.* at 222.

<sup>70</sup> See Fortier & Drymer, *supra* note 6, at 306 ("It is arguable that these seemingly disparate standards, tests and formulations are but variations on a single theme—as one author contends, the criterion of 'substantial deprivation' could be said to encompass and reconcile all others." (footnote omitted)).

<sup>71</sup> *Tecmed*, *supra* note 62, ¶ 116.

<sup>72</sup> *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case ARB/98/4, Award on Merits, ¶ 131 (Dec. 8, 2000), 41 I.L.M. 896 (2002), available at <http://italaw.com/documents/Wena-2000-Final.pdf>.

<sup>73</sup> *S.D. Meyers*, *supra* note 31, at ¶ 283 ("[I]t would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary.").

<sup>74</sup> *Iurii Bogdanov, Agurdino-Invest Ltd. and Agurdino-Chimia JSC v. Republic of Moldova, SCC, Arbitral Award, ¶ 4.2.5* (Sep. 22, 2005), available at <http://italaw.com/documents/Bogdanov-Moldova-22September2005.pdf>.

<sup>75</sup> See Rudolf Dolzer, *Indirect Expropriations: New Developments?*, 11 NYU ENVTL. L.J. 64, 79-80 (2002) ("What is much more controversial, however, is the question of whether the focus on the effect will be the only and exclusive relevant criterion ("sole effect doctrine"), or whether the purpose and the context of the governmental measure may also enter into the

any government expropriation is for a public purpose, proponents of the “sole effect” test posit that the purpose of the government action should not be taken into account in expropriation analysis.<sup>76</sup> In practice, this leads to an extremely investor-friendly policy. Instead, tribunals should provide some level of additional analysis to distinguish indirect expropriation cases from non-compensable regulation.<sup>77</sup>

## 2. Purpose of the State Action

In lieu of the “sole effect” test, many arbitral tribunals apply a broader standard by examining the purpose of a government action in addition to its effects on an investor. This type of analysis allows arbitrators to take a subjective case-by-case approach, which some scholars believe leads to more custom-tailored decisions.<sup>78</sup>

Some arbitral tribunals, such as the tribunal in *Eudoro A. Olguín v. Republic of Paraguay*,<sup>79</sup> examine whether the purpose of the alleged expropriation was the enrichment of the host state.<sup>80</sup> Nonetheless, this standard is overly inclusive, since almost any state regulatory action could be construed as enriching the host state. Other tribunals, like the tribunal in *Sea-Land Service Inc. v. Iran*,<sup>81</sup> have analyzed whether the government deliberately targeted the investor.<sup>82</sup> This would put an inordinate burden on the claimant to prove that a state acted to deliberately interfere with its operations. State regulatory actions usually at least span across an industry, without targeting a specific investor, so this standard would not recognize many legitimate indirect expropriation claims. Despite the decisions of the *Olguín* and

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takings analysis.”); Fortier & Drymer, *supra* note 6 at 308 (“[S]ome authorities posit that an analysis, or test, of the effect (whether on the investment or the investor) of a governmental measure is all that is required to distinguish regulatory from indirect expropriatory state conduct: a purported regulation becomes an effective expropriation when it interferes unduly with the investment itself or with the investor’s legitimate expectations with respect to the investment.”).

<sup>76</sup> Fortier & Drymer, *supra* note 6 at 309.

<sup>77</sup> Part III.B. of this article provides such a solution by proposing that arbitral tribunals analyze both the effect of a state action on the investor and whether a reasonable investor could have predicted such state action.

<sup>78</sup> See Fortier & Drymer, *supra* note 6, at 313–14 (“Proponents of this theory consider the governmental measure that is the object of the investor’s challenge in a contextual framework that allows, indeed requires, a weighing and balancing of factors including the purpose as well as the effect of the measure. Many commentators and arbitral tribunals have posited that a determination as to the occurrence of an expropriation can only truly be undertaken on a case-by-case basis, in the light of all attending circumstances.”).

<sup>79</sup> *Eudoro A. Olguín v. Republic of Paraguay*, ICSID Case No. ARB/98/5, Award (July 26, 2001), available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC575\\_En&caseId=C171](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC575_En&caseId=C171).

<sup>80</sup> *Id.* ¶ 84.

<sup>81</sup> *Sea-Land Service Inc. v. Iran*, 6 Iran-U.S. Cl. Trib. Rep. 149 (1984).

<sup>82</sup> *Id.* at 166 (“A finding of expropriation would require, at the very least, that the Tribunal be satisfied that there was deliberate governmental interference with the conduct of Sea-Land’s operation, the effect of which was to deprive Sea-Land of the use and benefit of its investment.”).

*Sea-Land Service* tribunals, other arbitral tribunals have appropriately avoided applying these variations of the “purpose” standard.<sup>83</sup>

More often, tribunals examine whether a state action promotes the general welfare.<sup>84</sup> Still, since this type of analysis could overlap extensively with state police powers,<sup>85</sup> its usefulness is limited. Some scholars propose that this analysis could allow regulatory actions beyond the scope of state police powers, as long as they have a strong public welfare purpose.<sup>86</sup> Still, a complete deprivation of property rights would constitute direct expropriation under this standard.<sup>87</sup> Some tribunals, such as the tribunal in *Tecmed*, have engaged in a proportionality analysis, balancing the public welfare purpose of the state action with its effect on the investor.<sup>88</sup> If the effect of the action on the investor is proportional to the public interest protected, these tribunals have found that no compensable expropriation occurred.<sup>89</sup>

Overall, tribunals have taken a wide array of approaches to identify instances of indirect expropriation. While some scholars may argue this provides a flexible approach, it also creates a great deal of uncertainty and may inappropriately categorize some legitimate state actions as indirect expropriation.

### B. Alternatives to Indirect Expropriation

#### 1. An End to Indirect Expropriation?

Some scholars take a radical approach to resolving the ambiguity of indirect expropriation doctrine by proposing that only direct expropriation, involving the “physical invasion or seizure of property, nationalization, or governmental assumption or transfer of control over property,”<sup>90</sup> should be compensable as expropriation.

This drastic limitation of expropriation doctrine may have several concrete advantages. First, it could avoid providing foreign companies with an advantage as

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<sup>83</sup> Fortier & Drymer, *supra* note 6 at 317 (“In sum, the approaches adopted in *Olguín v. Paraguay* and by the majority in *Sea-Land v. Iran* do not seem to reflect the norm. Neither the deliberate targeting of a particular investor nor the objective of enriching the State are generally understood to be included among the criteria for a finding of expropriation.”).

<sup>84</sup> *Id.* (“The determination of whether the purpose of governmental conduct is the promotion of the general welfare is more frequently viewed as a factor to be weighed in the regulation-expropriation balance.”).

<sup>85</sup> See *supra* Part I.A.

<sup>86</sup> See Fortier & Drymer, *supra* note 6 at 319 (discussing the extent of the “purpose test”); G.C. Christie, *What Constitutes a Taking of Property Under International Law?* 38 BRIT. Y.B. INT’L L. 307, 331 (1962) (“The conclusion that a particular interference is an expropriation might also be avoided if the State whose actions are the subject of complaint had a purpose in mind which is recognized in international law as justifying even severe, although by no means complete, restrictions on the use of the property.”).

<sup>87</sup> Fortier & Drymer, *supra* note 6, at 319.

<sup>88</sup> See *Tecmed*, *supra* note 62, ¶ 122 (“There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.”).

<sup>89</sup> *Id.*

<sup>90</sup> Been & Beauvais, *supra* note 37, at 129.

compared to their domestic counterparts.<sup>91</sup> If a regulation is applied to both foreign and domestic companies, indirect expropriation doctrine provides foreign investors with an avenue for seeking compensation that is unavailable to domestic companies. Although this may incentivize foreign investment in developing countries, the same incentives could be created by providing foreign investors with favorable contractual terms rather than through the procedural advantages of investor-state arbitration.

Limiting compensation to direct expropriation claims could allow states to implement beneficial public welfare regulations, such as environmental or health reforms, without the fear of indirect expropriation claims from foreign investors.<sup>92</sup> Nonetheless, eliminating indirect expropriation claims altogether may overreach in pursuit of this goal. Investors sometimes have genuine indirect expropriation claims that merit compensation. An ideal expropriation standard would effectively delineate between non-compensable state regulatory actions and legitimate indirect expropriation claims.

Furthermore, since national governments compensate investors for expropriation claims, rather than the specific state, local, or federal agency responsible for the expropriation, some scholars note that indirect expropriation shifts the balance of power within a nation's political system.<sup>93</sup> Specifically, national governments may either require the agency responsible for the expropriation to internalize the cost of the expropriation award, or they may seek to restrict the scope of the agency's actions to prevent future expropriation liability.<sup>94</sup> Nonetheless, this argument is subject to several critiques. First, imposing the costs of an expropriation award on the responsible agency, or limiting the agency's expropriatory ability, may curb agencies that act outside the scope of their authority. Furthermore, if indirect expropriation doctrine is construed narrowly, the power-shifting effects of the doctrine within a state's government would be limited.

Overall, ending indirect expropriation altogether would have numerous negative externalities and overreaches as a solution to the ambiguities of current indirect expropriation standards. Some state actions amount to compensable indirect expropriation, and arbitrators should utilize a clear standard to delineate between non-compensable regulation and compensable indirect expropriation.

## 2. Fair and Equitable Treatment

Most multilateral investment treaties and BITs provide for the fair and equitable treatment of foreign investors.<sup>95</sup> In recent years, tribunals have increasingly recognized actionable "fair and equitable treatment" claims.<sup>96</sup> This presents an intriguing question of whether "fair and equitable treatment" claims could, or should, take the place of indirect expropriation claims.

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<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 132.

<sup>93</sup> *Id.* at 91, 135.

<sup>94</sup> *Id.* at 135.

<sup>95</sup> See, e.g., NAFTA, *supra* note 8, art. 1105.1 ("Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.").

<sup>96</sup> MCLACHLAN, SHORE & WEINIGER, *supra* note 7, at 201.

“Fair and equitable treatment” extends beyond mere equality between domestic companies and foreign investors, a principle that is more explicitly represented in national treatment clauses and most-favored-nation (“MFN”) clauses.<sup>97</sup> Rather, “fair and equitable treatment” embodies “a standard of justice, very simple, very fundamental, and of such general acceptance by all civilized countries as to form a part of the international law of the world.”<sup>98</sup> In this regard, it sets a minimum level of due process that all foreign investors should receive.<sup>99</sup> Given the broad, encompassing nature of such language, it has been subject to significant interpretation by arbitral tribunals.

Despite the fundamental similarities between “fair and equitable treatment” clauses and expropriation clauses in international investment treaties, “fair and equitable treatment” is not a viable independent alternative to a succinct indirect expropriation doctrine. In the international investment context, “fair and equitable treatment” clauses serve a supplemental role: “the purpose of the clause as used in BIT practice is to fill gaps which may be left by the more specific standards, in order to obtain the level of investor protection intended by the treaties.”<sup>100</sup> Although “[t]he generality of the clause easily lends itself to an expansive view of its reach extending to all corners and aspects of an investment setting,” “it is obvious that the clause is not meant to supplant or replace all other segments of an investment treaty.”<sup>101</sup>

Thus, a clearly-defined standard for indirect expropriation is still needed. “Fair and equitable treatment” clauses in multilateral investment treaties and BITs are only intended to supplement expropriation standards.

#### IV. DEVELOPING A UNIFORM STANDARD FOR INDIRECT EXPROPRIATION ANALYSIS

As demonstrated in Part II of this article, the investment arbitration system requires a clear standard for determining when indirect expropriation occurs. Part III offers such a standard through a two-part test. Arbitral tribunals should only find that indirect expropriation occurs when (i) state actions substantially deprive a foreign investor of the economic use and enjoyment of its investment, and (ii) the state action was not reasonably predictable to the investor.

##### A. Substantial Deprivation

As previously discussed, arbitral tribunals have taken a wide array of approaches in delineating between non-compensable regulation and compensable indirect expropriation.<sup>102</sup> This has led to significant uncertainty and highlights the need for a uniform standard. This article proposes, as the first part of a two-part test, that

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<sup>97</sup> *Id.* at 206.

<sup>98</sup> Elihu Root, *The Basis of Protection to Citizens Residing Abroad*, 4 AM. J. INT’L L. 517, 521–22 (1910).

<sup>99</sup> See MCLACHLAN, SHORE & WEINIGER, *supra* note 7, at 205 (“Seen in this light, the fair and equitable standard gives modern expression to a *general principle of due process* in its application to the treatment of investors.”).

<sup>100</sup> Rudolf Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, 39 INT’L LAW 87, 90 (2005).

<sup>101</sup> *Id.* at 91.

<sup>102</sup> See *supra* Part II.

tribunals should only recognize indirect expropriation claims when government action *substantially deprives the investor of economic use and enjoyment of its investment.*

This standard follows the analysis of tribunals such as the tribunal in *Pope & Talbot v. Canada*. In *Pope & Talbot*, a U.S. lumber corporation brought an expropriation claim against Canada under Chapter 11 of NAFTA.<sup>103</sup> Pope & Talbot owned a wood products company incorporated in Canada that harvested timber to produce softwood lumber.<sup>104</sup> As a result of the Softwood Lumber Agreement, a treaty between Canada and the U.S., Canada adopted the Canadian Export Control Regime, which imposed a fee on lumber exports in excess of statutory levels.<sup>105</sup> Here, the arbitral tribunal ruled for Canada, finding that the regulation did not result in a “substantial deprivation” of Pope & Talbot’s business interests because the limitations on exports did not interfere with the management or operations of Pope & Talbot’s investment.<sup>106</sup> In short, a mere reduction in profits does not rise to the level of expropriation because it is not a “substantial deprivation” of the investor’s use and enjoyment of the investment.<sup>107</sup>

Later tribunals, such as the tribunal in *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, have applied the same analysis as the *Pope & Talbot* tribunal.<sup>108</sup> In *Tecmed*, the Spanish claimant purchased hazardous industrial waste landfill in Sonora, Mexico.<sup>109</sup> Although the claimant was initially granted an

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<sup>103</sup> *Pope & Talbot*, *supra* note 64, ¶ 11.

<sup>104</sup> *Id.* ¶ 4.

<sup>105</sup> *Id.* ¶ 30.

<sup>106</sup> *Id.* ¶ 100.

<sup>107</sup> *Id.* ¶ 101.

<sup>108</sup> Numerous tribunals have followed the lead of *Pope & Talbot* and *Tecmed* by applying a similar “substantial deprivation” standard in their indirect expropriation analysis. For instance, this type of test has been applied in *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award, ¶¶ 262–64 (May 12, 2005), 44 I.L.M. 1205 (2005) (no expropriation); *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, ¶ 191 (Oct. 3, 2006), 46 I.L.M. 36 (2007) (finding no expropriation when due to mere reduction in profits); *Siemens A.G. v. Argentina*, ICSID Case No. ARB/02/08, Award, ¶ 271 (Feb. 6, 2007), available at <http://ita.law.uvic.ca/documents/Siemens-Argentina-Award.pdf> (no expropriation); *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, ¶ 245 (May 22, 2007), available at <http://ita.law.uvic.ca/documents/Enron-Award.pdf> (no expropriation); *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Award, ¶¶ 7.5.11, 7.5.34 (Aug. 20, 2007), available at <http://italaw.com/sites/default/files/case-documents/ita0215.pdf> (finding that expropriation had occurred); *Sempra Energy International v. The Argentine Republic*, ICSID Case No. ARB/02/16, Award, ¶ 284 (Sep. 28, 2007), available at <http://ita.law.uvic.ca/documents/SempraAward.pdf> (no expropriation). For a more detailed analysis of these cases, see Lorenzo Cotula, *Regulatory Takings, Stabilization Clauses, and Sustainable Development* 3–5 (Paper prepared for the OECD Global Forum on International Investment VII), available at <http://www.oecd.org/dataoecd/45/8/40311122.pdf>.

<sup>109</sup> *Tecmed*, *supra* note 62, ¶ 35.



operating license by the Mexican government, renewal of the license was denied, and the government took actions to close the landfill.<sup>110</sup> In its expropriation analysis, the tribunal examined whether Tecmed “was radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto—such as the income or benefits related to the Landfill or to its exploitation—had ceased to exist.” Ultimately, the tribunal found that compensable expropriation had occurred.<sup>111</sup>

Both *Pope & Talbot* and *Tecmed* suggest that while a mere reduction in profit-making ability does not amount to expropriation, regulations that completely defeat the profit-making ability of an investment constitute compensable indirect expropriation. Thus, “substantial deprivation” of the use and enjoyment of an investment entails complete neutralization of the profit-making ability of the investment.

### B. Expectations of the Investor

If an expropriation claim amounts to a “substantial deprivation” of the economic use and enjoyment of an investment, tribunals should next consider *whether the state action was reasonably predictable to the investor*. As scholars have noted, “investment protection is not an insurance policy, and international tribunals have often reminded investors that they bear the normal risks associated with conducting a business.”<sup>112</sup> Some arbitral tribunals have already begun to apply this type of analysis to indirect expropriation cases.

For instance, the arbitral tribunal in *Metalclad Corp. v. United Mexican States*<sup>113</sup> applied such a standard in a case factually similar to *Tecmed*. In *Metalclad*, the claimant purchased a transfer station for hazardous waste in San Luis Potosi, Mexico with the intent of constructing a hazardous waste landfill.<sup>114</sup> The proposed project had already received a federal construction permit, and Metalclad obtained a state construction permit shortly after the purchase.<sup>115</sup> Furthermore, Metalclad received assurances from federal agents that all necessary permits had been acquired.<sup>116</sup> After construction of the landfill had begun, the local government ordered its cessation since Metalclad had not obtained a municipal construction permit.<sup>117</sup> Federal agents assured Metalclad that if it applied for a municipal permit, it would receive the necessary authorization.<sup>118</sup> Metalclad applied for the municipal permit and completed construction, but was denied the municipal permit thirteen months after

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<sup>110</sup> *Id.* ¶¶ 38-45, 110.

<sup>111</sup> *Id.* ¶ 151.

<sup>112</sup> Fortier & Drymer, *supra* note 6, at 307.

<sup>113</sup> *Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (Aug. 30, 2000), 5 ICSID Rep. 212 (2002), available at [http://icsid.worldbank.org/ICSID/](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542_En&caseId=C155)FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC542\_En&caseId=C155

<sup>114</sup> *Id.* ¶¶ 30-36.

<sup>115</sup> *Id.* ¶¶ 37-44.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* ¶ 40.

<sup>118</sup> *Id.* ¶ 41.

its application.<sup>119</sup> Metalclad was prevented from operating the landfill, and the state governor later declared the surrounding land a Natural Area for the protection of a rare cactus, eliminating the possibility of Metalclad operating its facilities.<sup>120</sup>

Here, the tribunal found that Mexico had indirectly expropriated Metalclad's investment because it "depriv[ed] the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property."<sup>121</sup> In its decision, the tribunal focused on, *inter alia*, Metalclad's reasonable reliance on the assurances of the Mexican federal government.<sup>122</sup> Because Metalclad engaged in extensive due diligence by consulting with federal and state authorities, it reasonably expected to be able to construct and operate the landfill. Absent these assurances, the arbitration may have resulted in a different outcome.

Implementing a standard based on whether a regulatory action is reasonably predictable or expected would result in several positive externalities. First, it would protect investors who pursue opportunities in traditionally investor-friendly countries.<sup>123</sup> In that instance, investors would have a reasonable presumption against indirect expropriation. Additionally, the proposed standard encourages due diligence for foreign investments. In *Metalclad*, the claimant obtained regulatory assurances from the Governor of San Luis Potosi, the President of the National Ecological Institute (a federal sub-agency responsible for federal permits), and the General Director of the Mexican Secretariat of Urban Development and Ecology, among others.<sup>124</sup> Foreign investors who engage in little or no due diligence should not receive compensation when reasonable due diligence would have exposed a risk of indirect expropriation.

If due diligence reveals a risk of indirect expropriation, foreign investors can still rely on other risk mitigation measures, such as private insurance. In recent decades, a market has emerged for private insurance against political risks like expropriation.<sup>125</sup> Investors could also seek insurance from U.S. agencies such as the Overseas Private Investment Corporation ("OPIC"), or international agencies such as Multilateral Investment Guarantee Agency ("MIGA").<sup>126</sup> Regardless of whether foreign investors opt to pursue such risk mitigation measures, they could still receive compensation for indirect expropriation under the proposed standard if the state action was not reasonably predictable after due diligence.

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<sup>119</sup> *Id.* ¶¶ 45–50.

<sup>120</sup> *Id.* ¶¶ 46, 59.

<sup>121</sup> *Id.* ¶ 104.

<sup>122</sup> *Id.* ¶ 107.

<sup>123</sup> Fortier & Drymer, *supra* note 6, at 306.

<sup>124</sup> Metalclad, *supra* note 113, ¶¶ 32–33.

<sup>125</sup> See Maura P. Berry, *A Model for Efficient Foreign Aid*, 36 VA. J. INT'L L., 511, 532 (1996) ("In the United States, the first insurance company to venture into the realm of political risk was the American International Group in 1978. Between 1979 and 1981, it was followed by INA, AFIA, and Chubb." (footnote omitted)).

<sup>126</sup> For a more detailed discussion of these agencies, see Been & Beauvais, *supra* note 37, at 111–12.

A potential issue with this proposed standard is that reasonable expectations of indirect expropriation could change over the course of the investment. For instance, a foreign investor may initially reasonably determine that no indirect expropriation risk exists, but recognize the emergence of the risk years later due to changes in the political climate. Tribunals could pursue two options in this instance. First, they could engage in an apportionment analysis, and determine what portion of the investment was made before the risk emerged. Nonetheless, this could prove exceedingly complex in implementation. Instead, tribunals could recognize that regulatory policy changes are a standard business risk, and focus on the reasonable expectations of the investor at the point of investment. This would incentivize investors to either obtain government assurances before investing, like the claimant in *Metalclad*,<sup>127</sup> or seek other risk mitigation measures such as private insurance.

#### V. APPLYING THE PROPOSED STANDARD: A CASE STUDY

The two-part standard suggested in Part III provides a clear framework for identifying compensable indirect expropriation. Part IV now analyzes how this standard could be applied to the recent arbitration filed by PM Asia against Australia. Under the proposed standard, Australia's plain packaging legislation would likely not be considered an indirect expropriation.

##### A. *No Substantial Deprivation*

Australia's Tobacco Plain Packaging Act 2011 likely does not substantially deprive PM Asia of the economic use and enjoyment of its investment in Australia. As the tribunals in *Pope & Talbot* and *Tecmed* suggest,<sup>128</sup> analysis of this standard would depend on whether the plain packaging legislation completely defeats PM Asia's profit-making ability in Australia.

PM Asia first contends that the plain packaging legislation deprives it of the value of its shares since their value is "heavily dependent upon the ability to use the intellectual property on or in relation to tobacco products and packaging."<sup>129</sup> Furthermore, PM Asia also argues that it has been deprived of its "intellectual property and the good will derived from the use of that intellectual property."<sup>130</sup> Despite these claims, PM Asia likely has not been completely deprived of its profit-making ability in Australia.

Although the plain packing legislation interferes with PM Asia's use of its trademarked logo,<sup>131</sup> PM Asia's trademark and other intellectual property are only part of the scope of the investment in Australia. Since PM Asia can still sell tobacco products in Australia, it likely has not been completely deprived of its profit-making ability. PM Asia's strongest argument for indirect expropriation under the proposed

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<sup>127</sup> *Metalclad*, *supra* note 113, ¶¶ 32–33.

<sup>128</sup> *See supra* Part III.A.

<sup>129</sup> *Philip Morris Asia Limited v. Australia*, *supra* note 3, ¶ 7.3.

<sup>130</sup> *Id.*

<sup>131</sup> *See Rourke*, *supra* note 2 ("Under the new laws, approved by the upper house of parliament, no trademark brand logos will be permitted on any packaging of tobacco products, although companies will be able to print their name and the cigarette brand in small, prescribed font on the packets.").

standard would be that its sales in Australia will fall below the point of any profitability. In fact, PM Asia has offered this argument in its preliminary Notice of Claim.<sup>132</sup> The success of this claim, although dubious, would depend on expert analysis of the cigarette market in Australia. Specifically, the parties would likely offer expert opinions regarding the extent to which trademarks and branding impact tobacco sales.

### *B. Reasonable Expectation of Regulations*

Even if PM Asia is able to prove that the plain packaging legislation neutralizes any profitability of its operations in Australia, it would likely lose on the second part of the proposed standard since it could have reasonably predicted that Australia would pass regulations similar to the plain packaging legislation.

Generally, regulations regarding the sale of tobacco products are commonplace among developed nations.<sup>133</sup> Furthermore, although Australia is the first country to implement plain packaging legislation, the concept has a long-standing background. The Toxic Substances Board of New Zealand's Health Department first recommended plain packaging for cigarettes in 1989.<sup>134</sup> Additionally, a Canadian parliamentary committee recommended its legislature pass plain packaging legislation in 1994.<sup>135</sup> In 2010, the European Commission proposed a revision to Directive 2001/37/EC that would include plain packaging requirements,<sup>136</sup> and in recent years similar proposals have occurred in France,<sup>137</sup> Turkey,<sup>138</sup> and the United

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<sup>132</sup> Philip Morris Asia Limited v. Australia, UNCITRAL, Notice of Claim, ¶ 44 (June 21, 2011), available at [http://italaw.com/documents/PhilipMorrisAsiaLimited\\_v\\_Australia\\_NOC\\_22Jun2011.pdf](http://italaw.com/documents/PhilipMorrisAsiaLimited_v_Australia_NOC_22Jun2011.pdf) (“[T]he effect of the plain packaging legislation will be substantially to deprive PM Asia of the commercial value of its investments in Australia.”).

<sup>133</sup> For instance, 21 countries have tobacco tax rates greater than 75% of retail price. Dr. Margaret Chan, Director-General of the World Health Organization, Opening remarks on the fifth anniversary of the WHO Framework Convention on Tobacco Control (Feb. 26, 2010), available at [http://www.who.int/dg/speeches/2010/tobacco\\_control\\_20100226/en/index.html](http://www.who.int/dg/speeches/2010/tobacco_control_20100226/en/index.html).

<sup>134</sup> Martin Johnston, *Black-market Warnings Seen as a Smoke Screen*, NEW ZEALAND HERALD, Apr. 25, 2012, [http://www.nzherald.co.nz/health-wellbeing/news/article.cfm?c\\_id=1501238&objectid=10801213](http://www.nzherald.co.nz/health-wellbeing/news/article.cfm?c_id=1501238&objectid=10801213).

<sup>135</sup> STANDING COMMITTEE ON HEALTH, TOWARDS ZERO CONSUMPTION: GENERIC PACKAGING OF TOBACCO PRODUCTS 29 (1994), available at [http://www.plain-packaging.com/downloads/Canada\\_Standing\\_Committee\\_on\\_Health\\_Report\\_-\\_Toward\\_Zero\\_Consumption\\_Jun\\_94.pdf](http://www.plain-packaging.com/downloads/Canada_Standing_Committee_on_Health_Report_-_Toward_Zero_Consumption_Jun_94.pdf) (“The Committee, therefore, recommends: 1. That the federal government establish the legislative framework required to proceed with plain or generic packaging of tobacco products.”).

<sup>136</sup> EUROPEAN COMMISSION – HEALTH AND CONSUMERS DIRECTORATE-GENERAL, REPORT ON THE PUBLIC CONSULTATION ON THE POSSIBLE REVISION OF THE TOBACCO PRODUCTS

DIRECTIVE (2001/37/EC) 4 (2011), available at [http://ec.europa.eu/health/tobacco/docs/consultation\\_report\\_en.pdf](http://ec.europa.eu/health/tobacco/docs/consultation_report_en.pdf) (focusing on, *inter alia*, “[r]estricting the use of misleading texts, names, and signs on tobacco packaging”).

<sup>137</sup> *Plain Cigarette Packets Considered*, THE CONNEXION (Aug. 11, 2010), <http://www.connexionfrance.com/plain-cigarette-packets-smoking-draft-law-logos-colours-banned-shock-images-view-article.html>.

Kingdom,<sup>139</sup> among other nations. Overall, the international community has displayed a trend toward plain packaging legislation, and tobacco companies like PM Asia should recognize this as an ordinary business risk.

PM Asia's strongest argument for indirect expropriation under this part of the proposed standard is that when it initially entered the Australian market, plain packaging legislation was not reasonably predictable, even if the likelihood of such regulation later became apparent. Nonetheless, although Philip Morris Australia ("PM Australia"), the Australian subsidiary of PM Asia, was incorporated in Australia in 1954,<sup>140</sup> PM Asia did not formally acquire PM Australia until February 23, 2011,<sup>141</sup> well after the plain packaging legislation had been proposed.<sup>142</sup> PM Asia could also argue that, because plain packaging legislation was debated for several decades without implementation, it reasonably expected that countries would not enact such regulations. Nonetheless, unlike the claimant in *Metalclad*,<sup>143</sup> PM Asia received no ostensible assurances from the Australian government that such regulations would not occur. Consequently, while PM Asia may contend that it could not have reasonably predicted the plain packaging legislation, its argument is significantly weaker than the claimant's position in *Metalclad*.

### C. Preventing the Decline of Investor-State Arbitration

In April 2011, Australia announced in a Trade Policy Statement that it will no longer pursue investor-state dispute resolution clauses in international treaties.<sup>144</sup> In the Trade Policy Statement, Australia openly alluded to the *PM Asia* arbitration as a catalyst for this policy reform when it stated "[t]he Government has not and will not accept [investor-state dispute resolution] provisions that limit its capacity to put health warnings or plain packaging requirements on tobacco products."<sup>145</sup>

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<sup>138</sup> Benjamin Harvey, *Turkey Working on Cigarette Branding Ban Law, Milliyet Says*, BLOOMBERG, Sep. 7, 2011, <http://www.bloomberg.com/news/2011-09-07/turkey-working-on-cigarette-branding-ban-law-milliyet-says.html>

<sup>139</sup> U.K. DEPARTMENT OF HEALTH, HEALTHY LIVES, HEALTHY PEOPLE: A TOBACCO CONTROL PLAN FOR ENGLAND 21 (2011), *available at* [http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH\\_124917](http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH_124917) ("The Government will . . . consult on options to reduce the promotional impact of tobacco packaging, including plain packaging, before the end of 2011.").

<sup>140</sup> Philip Morris Asia Limited v. Australia, *supra* note 3, at ¶ 4.1.

<sup>141</sup> Philip Morris Asia Limited v. Australia, UNCITRAL, Australia's Response to the Notice of Arbitration, ¶ 6 (Dec. 21, 2011), *available at* [http://italaw.com/documents/PhilipMorrisAsiaLimited\\_v\\_Australia\\_Response\\_to\\_NOA\\_21Dec2011.pdf](http://italaw.com/documents/PhilipMorrisAsiaLimited_v_Australia_Response_to_NOA_21Dec2011.pdf).

<sup>142</sup> Australia announced its plans for plain packaging legislation on April 29, 2010. *Id.* at ¶ 5.c.

<sup>143</sup> *See supra* notes 113–120 and accompanying text.

<sup>144</sup> AUSTRALIAN GOVERNMENT DEPARTMENT OF FOREIGN AFFAIRS AND TRADE, GILLARD GOVERNMENT TRADE POLICY STATEMENT: TRADING OUR WAY TO MORE JOBS AND PROSPERITY 14 (2012), *available at* <http://www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.pdf>.

<sup>145</sup> *Id.*

If expropriation provisions in BITs continue to, in practice, “confer greater legal rights on foreign businesses than those available to domestic businesses,”<sup>146</sup> other nations may follow Australia’s lead, resulting in the overall decline of investor-state arbitration. Consequently, arbitral tribunals should apply a clear, narrow standard for determining when indirect expropriation occurs. This article has proposed such a standard by arguing that tribunals should only recognize compensable indirect expropriation when a state action completely defeats the profit-making ability of a foreign investment and an investor could not reasonably predict the state action.

## VI. CONCLUSION

Arbitral tribunals have struggled to differentiate between non-compensable regulation and compensable indirect expropriation. At present, these tribunals apply a wide array of standards to recognize indirect expropriation. Although tribunals generally analyze the effect of the state action on the investor and the purpose of the state action, their specific standards vary greatly from case to case. Given the ambiguity of current standards, some scholars have taken a radical approach by proposing an end to compensation for indirect expropriation. Others have looked to “fair and equitable treatment” as a viable alternative to expropriation analysis. However, these solutions are insufficient because they could fail to recognize legitimate indirect expropriation claims.

This article proposes a uniform standard for identifying indirect expropriation. Arbitral tribunals should only find that indirect expropriation occurs when (i) the state action completely deprives a foreign investor of the profit-making ability of its investment, and (ii) the state action was not reasonably predictable to the investor. This standard would remedy much of the ambiguity of current indirect expropriation standards. Furthermore, it could be easily applied to contemporary expropriation claims such as the *PM Asia* arbitration, and it would promote the overall use of investor-state arbitration as a dispute resolution mechanism.

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<sup>146</sup> *Id.*