The Chilling Effect of Indirect Expropriation Clauses on Host States' Public Policies: a Call for a Legislative Response

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Abstract

While International Investment Agreements (IIAs) can potentially contribute to host states' development, the chilling effect of IIAs on host states' public policies is the flip side of investment treaties. The lack of a clear statutory formulation of indirect expropriation and, hence, the interpretive loopholes in investor-state jurisprudence have caused unfavourable consequences attached to the application of IIAs on the protection and promotion of public welfare. This paper encourages states to revisit the formulation of their indirect expropriation clauses in line with the provided practical solutions, which allow states to have more policy space for their legitimate public policy actions without having their Foreign Direct Investment inflows decreased.

Keywords

competing methods of identifying indirect expropriation – lack of policy space in indirect expropriation clauses – codifying the mitigated police powers doctrine – best practices

1 Introduction

It has been more than half a decade since the adoption of the first International Investment Agreement (IIA),¹ which was negotiated between West Germany and Pakistan.² Initially, investment treaties were concluded with the sole objective of affording maximum protection to foreign investors;³ the expropriation clauses in IIAs and Treaties with Investment Provisions (TIPs) (hereinafter the reference to IIAs will encompass TIPs) grant the right to compensation in case of direct or indirect expropriation. However, the treaties' broadly-worded guarantees to foreign investors have raised tension between host states' international obligation to compensate affected foreign investors for their direct or indirect expropriatory regulations,⁴ and governments' duty to develop public welfare.⁵ The increasing number of foreign investors' allegations against host states' regulatory measures is a testimony to the existence of this tension.⁶

- 1 Jeswald W Salacuze, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries", 24 (23) *International Lawyer* (1990) p. 655.
- 2 Treaty between the Federal Republic of Germany and Pakistan for the Promotion and Protection of Investments (signed 25 November 1959, entered into force 28 April 1962) 457 UNTS 24.
- 3 UNCTAD, "United Nations Conference on Trade and Development: Bilateral Investment Treaties 1959–1999", UNCTAD/ITE/IIA/2 (United Nations, Geneva 2000) p. 1.
- 4 States' obligation to compensate foreign investors for their expropriatory regulations is also a rule of Customary International Law (CIL). Based on CIL, "states have the right to expropriate foreign investors 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". See Peter D Isakof, "Defining the Scope of Indirect Expropriation for International Investments", 3 (2) the *Global Business Law Review* (2013) p. 191; L Yves Fortier and Stephen L Drymer, "Indirect Expropriation in the Law of International Investment: I Know it When I See I, or Caveat Investor", 13 *Asia Pacific Law Review* (2005) p. 81.
- 5 Suzanne A Spears, "The Quest for Policy Space in a New Generation of International Investment Agreements", 13 (4) *Journal of International Economic Law* (2010) p. 1037.
- 6 There have been a number of cases under the North American Free Trade Agreement: Guide to Customs Procedures [hereinafter 'NAFTA'] (signed 8 December 1993, entered into force 1 January 1994), *Methanex Corporation v. United States of America* (*Methanex v. United States*), Final Award (2005), UNCITRAL (measures to protect public water supplies); *Metalclad Corporation v. The United Mexican States* (*Metalclad v. Mexico*), Award (2000), ICSID Case No ARB(AF)/97/1 (refusal to issue a waste disposal permit and an order establishing an ecological park); *S D Myers Inc v. Government of Canada* (*S D Myers v. Canada*), Award (2002), UNCITRAL IIC 252 (ban on hazardous waste exports).

IIAs are well described as “double-edged swords”:⁷ while they can be used as instruments to attract Foreign Direct Investment (FDI),⁸ they constrain host states’ policy space in exercising their legitimate regulatory powers. In most IIAs there are no clear boundaries between non-compensable regulatory measures and measures that lead to an indirect expropriation.⁹ In fact, the desire of contracting states to be perceived as attractive investment destinations or to gain the maximum protection for their national investors investing abroad, meant States failed to foresee the importance of leaving policy space for themselves. The ambiguity surrounding the definition of indirect expropriation in a number of IIAs, has led to the rise of different methods of identifying indirect expropriation in investor-state jurisprudence. In this vein, both the lack of policy space in a number of indirect expropriation clauses combined with the inconsistency and unpredictability regarding the outcome of indirect expropriation claims engender ‘regulatory chill’.¹⁰ Regulatory chill refers to situations where host states settle disputes with aggrieved foreign investors at the cost of enforcing their legitimate measures aimed at protecting and developing public policies.

The present paper investigates the statutory silence of IIAs on the definition of indirect expropriation and investor-state arbitrators’ diverse approaches in interpreting such clauses.¹¹ It is in light of such legislative loopholes that the present paper constructs its core research question: which method for the

7 Wolfgang Alschner and Elizabeth Tuerk, “The Role of International Investment Agreements in Fostering Sustainable Development”, in F. Baetens (ed.), *Investment Law Within International Law: Integrationist Perspectives* (2013) p. 221.

8 Peter Egger and Michael Pefaffermayr, “The Impact of Bilateral Investment Treaties on Foreign Direct Investment”, in K.P. Sauvant and L.E. Sachs (eds.), *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (2009) p. 254; UNCTAD, “The Role of International Investment Agreements in Attracting Foreign Direct Investment in Developing Countries” [hereinafter ‘UNCTAD Series on International Investment Policies for Development, Geneva 2012’] p. 111.

9 See *Saluka Investments BV v. Czech Republic (Saluka v. Czech Republic)*, Partial Award (2006), UNCITRAL IIC 210, para. 263; Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd ed., 2012) p. 102; Isakof, n4, p. 193.

10 Lorenzo Cotula, “Expropriation Clauses and Environmental Regulation: Diffusion of Law in the Era of Investment Treaties”, 24 (3) *RECIEL* (2015) p. 279; Spears, n5, p. 1040; Nathalie Bernasconi-Osterwalder and Rhea Tamara Hoffmann, “The German Nuclear Phase-Out Put to the Test in International Investment Arbitration?: Background to the new dispute Vattenfall v Germany (II)”, (IISD briefing note, June 2012) p. 5.

11 August Reinisch, “Expropriation” in Peter Muchlinski, Federico Ortino, and Christoph Schreuer (eds.), *The Oxford Handbook of International Investment Law* (2008) p. 104; Gebhard Bücheler, *Proportionality in Investor-State Arbitration* (2015), pp. 125–126; Esmé Shirlow, “Deference and Indirect Expropriation Analysis in International Investment

identification of indirect expropriation affords states the greatest policy space, without harming their FDI inflows? Based on a detailed analysis, the paper promotes the application of the mitigated police powers doctrine for identifying indirect expropriation. Furthermore, it argues that in order to direct investor-state tribunals to apply this method, states should codify the nuanced approach of the police powers doctrine in their indirect expropriation clauses. Although only a limited number of states have done so, most states' legislative responses do not solve the uncertainty regarding the identification of indirect expropriation. Therefore, the suggestions presented in the paper attempt to settle the inconsistencies in these legislative responses. Such proposals would prevent the chilling effect of indirect expropriation clauses in a twofold way: firstly, they would leave more policy space for states without negatively affecting their FDI inflows. Secondly, they would mitigate the unpredictability and inconsistency in investor-state indirect expropriation awards.

2 Identifying Indirect Expropriation

2.1 *Identification of Indirect Expropriation in Theory: Competing Doctrines*

The problematic nature of the identification of indirect expropriation was recognised over 60 years ago.¹² The lack of elaboration on the definition of indirect expropriation has opened the door for investor-state tribunals to develop an autonomous formulation of indirect expropriation.¹³ The emergence of three competing principles,¹⁴ namely, (i) the sole effect doctrine; (ii) the police powers or purpose doctrine; and (iii) the principle of proportionality, as possible tools for recognising indirect expropriation has caused disparities in investor-state jurisprudence.¹⁵

Law: Observations on Current Approaches and Frameworks for Future Analysis", 29 (3) *ICSID Review* (2014), p. 625.

12 Ben Mostafa, "The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law", 15 *Australian International Law Journal* (2008) p. 269.

13 Isakof, n4, p. 193.

14 Omar Chehade, "The Evolution of the Law of Indirect Expropriation and its Application to Oil and Gas Investment", 9 *Journal of World Energy Law and Business* (2016) p. 65; Catherine Titi, "Police Powers Doctrine and International Investment Law", in A. Gattini, A. Tanzi and F. Fontanelli (eds.), *General Principles of Law and International Investment Arbitration* (2018) pp. 5–14.

15 Bücheler, n11, p. 142; Dolzer and Schreuer, n9, p. 104; Mostafa, n12, p. 269; Shirlow, n 11, p. 598.

2.1.1 Sole Effect Doctrine

In this doctrine, the determinative element for finding a case of indirect expropriation is the effect of host states' measures.¹⁶ Hence, the purpose and intent of defending states are irrelevant.¹⁷ The proponents of sole effect doctrine argue that the high degree of interference required to find indirect expropriation provides host states with a considerable degree of discretion in adopting their public policies.¹⁸ However, the controversial issue in this doctrine is the exact required degree of interference for finding indirect expropriation.¹⁹ Providing host states with public policy space based on the interpretation of investor-state tribunals on the required degree of interference, constrains the sovereignty of states and exacerbates the inconsistency in the identification of indirect expropriation in investor-state jurisprudence.

2.1.2 Police Powers Doctrine

Contrary to the sole effect doctrine,²⁰ the purpose of host states' measures is central to the police powers doctrine. Under this approach, States are immune from paying compensation for adopting non-discriminatory *bona fide* measures that pursue a public policy objective and meet standards of due process.²¹ A broad range of governmental regulatory interventions, such as taxation, maintenance of public order, health or morality, change in the value of state's currency, may be considered as *bona fide* measures.²² However, as it

16 Titi, m4, p. 6; Suzy H Nikièma, "Best Practices: Indirect Expropriation", (IISD Best Practice Series, March 2012) p. 13.

17 Veijo Heiskanen, "The Doctrine of Indirect Expropriation in Light of the Practice of the Iran-United States Claims Tribunal", 8 *Journal of World Investment and Trade* (2007) p. 218; Titi, m4, p. 6.

18 Mostafa, m2, p. 295. See also, Prabhash Ranjan, "Police Powers, Indirect Expropriation in International Investment Law, and Article 31 (3)(c) of the VCLT: A Critique of Philip Morris v Uruguay", 9 *Asian Journal of International Law* (2019) p. 127.

19 Reinisch, m1, p. 439; Mostafa, m2, p. 280; see also Nikièma, m6, p. 15. The Tribunal in *Pope & Talbot Incorporated v. Canada* (*Pope & Talbot v. Canada*), Award (2002), UNCITRAL IIC 96, para. 100 sets several verification factors for determining the effects of a measure, such as "the ability to have control of the investment and enjoyment of the benefits thereof".

20 *CCL v. Republic of Kazakhstan* (*CCL v. Kazakhstan*), Award (2004), SCC Case No 122/2001, para. 173; Shirlow, m1, p. 598.

21 Howard Mann, "NAFTA Chapter 11 and the Environment: Addressing the Impacts of the Investor State Process on the Environment" (IISD, 1999), p. 47; Prabhash Ranjan and Pushkar Anand, "Determination of Indirect Expropriation and Doctrine of Police Power in International Investment Law: a Critical Appraisal", in L. Choukroune (ed.) *Judging the State in International Trade and Investment Law* (2016) pp. 132, 138.

22 See Louis B Sohn and B.B. Baxter, "Draft Convention on the International Responsibility of States for Injuries to Aliens", 55 *American Journal of International Law* (1961); Ian Brownlie, *Principles of Public International Law* (2008) p. 532.

was noted by the Tribunal in *Saluka v. Czech Republic*, “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.”²³ For instance, while the Tribunal in *Chemtura v. Canada* considered the protection of human health and environment as valid exercise of the states’ police powers,²⁴ the Tribunal in *Santa Elena v. Costa Rica* noted that the state’s environmental measures, “no matter how laudable and beneficial to society as a whole, are in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies.”²⁵ A considerable number of investor-state tribunals have applied the police powers doctrine to identify indirect expropriation.²⁶ In *Sedco Inc v. National Iranian Oil Co*, for instance, the Tribunal noted that it is “an accepted principle of international law that a State is not liable for economic injury which is a consequence of *bona fide* regulation.”²⁷ Furthermore, the Tribunal in *Burlington v. Ecuador* asserted that measures falling under the police power doctrine do not constitute expropriation even if they result in “substantial deprivation” of foreign investment.²⁸ *Methanex v. US* is another prominent example where the Tribunal did not assess the effect of the measure on the foreign investment. The Tribunal stated as follows:²⁹

A non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, *inter alios*, a foreign

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- 23 *Saluka v. Czech Republic*, n9, para. 263; Mostafa, n12, pp. 273–274. Ranjan and Anand, n21, p. 141.
 - 24 *Chemtura Corporation v. Government of Canada* (*Chemtura v. Canada*), Final Award (2010), UNCITRAL IIC 451, para. 266.
 - 25 *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica* (*Santa Elena v. Costa Rica*), Award (2000), ICSID Case No. ARB/96/1, para. 72.
 - 26 See for instance *Burlington v. Ecuador*, Decision on Liability (2012), ICSID Case No ARB/08/5, paras. 472–478. See also *Link-Trading v. Moldova*, Final Award (2002), UNCITRAL IIC 154, para. 64; *Suez, Sociedad General de Aguas de Barcelona, S A and Vivendi Universal, S A v. Argentine Republic* (*Suez v. Argentine*), Award (2015), ICSID Case No ARB/03/19, paras. 134, 145; *Chemtura v. Government of Canada*, n24, para. 266; *El Paso Energy International Company v. Argentine Republic* (*El Paso v. Argentina*), Final Award (2011), ICSID Case No ARB/03/15.
 - 27 *Sedco Inc v. National Iranian Oil Co*, 9 Iran-US CTR (1985) 248, para. 275.
 - 28 *Burlington v. Ecuador*, n26, paras. 472–485; see also Ranjan and Anand, n21, p. 143. *Saluka v. Czech Republic*, n9, para. 278. Later, the Tribunal in *Chemtura v. Canada*, n24, para. 266, which was inspired from *Saluka*, applied the police power doctrine.
 - 29 *Methanex v. US*, n6, part IV, Ch D, para. 6. Jorge E Viñuales, “Foreign Investment and the Environment in International Law: An Ambiguous Relationship”, 80 (1) *British Yearbook of International Law*, p. 327.

investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.

While the police powers doctrine provides states freedom in adopting their regulatory measures, strict application of the doctrine creates a “gaping loop-hole in international protections against expropriation”.³⁰ As Ranjan notes, “it is one thing to state that a host state has the right to adopt nondiscriminatory regulatory measures for a public purpose, and it is another thing to decide how this will be applied in the light of the fact that this very host state has accepted restrictions on its right by entering into a BIT containing the aforementioned expropriation provision”.³¹ In fact, considering that indirect expropriation claims usually arise from the exercise of states’ police powers, the radical application of this doctrine is deemed to be incompatible with the very purpose of the inclusion of the right to compensation in case of indirect expropriation.³² In addition, the application of the (radical) police powers doctrine aggravates the inequality between host states and foreign investors: the latter have to bear the risk of being affected by host states’ regulatory measures without being entitled to any compensation, no matter how serious the effect of the measure is on their investment.³³

In light of the addressed shortcomings in the application of radical police powers doctrine, a number of investor-state tribunals have applied a more nuanced approach when states’ police powers are at stake.³⁴ While the Tribunal in *BG Group v. Argentina* recognised states’ sovereign power in adopting regulatory measures that affect private property for the benefit of the public welfare, it held that “compensation for expropriation is required if the measure adopted by the State is irreversible and permanent and if the assets or rights

30 *Pope & Talbot v. Canada*, n19, para. 99; see also *Azurix Corp v. Argentine Republic (Azurix v. Argentina)*, Award (2006), ICSID Case No ARB/01/12, para. 310. See also Yannick Radi, “Philip Morris v Uruguay: Regulatory Measures in International Investment Law: To Be or Not To Be Compensated?”, *Foreign Investment Law Journal* (2018).

31 Ranjan, n18, p. 123.

32 Kenneth J Vandevelde, *Bilateral Investment Treaties* (2009); Ranjan and Anand, n21, fn. 55. Yannick Radi, “Much Ado About Nothing: An Appraisal of CETA’s Investment Chapter”, (ESIL Reflection, 2017) See also, Yannick Radi, “Realizing Human Rights in Investment Treaty Arbitration: A Perspective from Within the International Investment Law ‘Toolbox’”, 37 (4) *North Carolina Journal of International Law and Commercial Regulation* (2012) p. 1107.

33 Radi, n30, p. 5 criticises this doctrine.

34 *Ibid.*, p. 5.

subject to such measure have been affected in such a way that ‘... any form of exploitation thereof ...’ has disappeared”.³⁵ This approach is thus observed, *inter alia*, in the practice of tribunals that subject the police powers doctrine to an “effect test”. Based on this test, regulatory measures of states that pursue a public policy objective can be considered expropriatory, hence subject to compensation, if they result in a substantial deprivation of foreign investment.³⁶

2.1.3 Proportionality

The aforementioned challenges encountered in the sole effect doctrine and the police powers doctrine have led to the emergence of a more equitable venue for identifying an indirect expropriation, namely a proportionality analysis.³⁷ The core principle in this test is to maintain a balance between the effects of a measure on foreign investors’ interests and the importance of host states’ regulatory measure.³⁸ In addition to considering the objective of the measure at stake and its impacts, the test takes other factors into account, such as the existence of legitimate expectation, and the diligence of the host state in adopting the regulatory measure.³⁹ Although the intermediary approach in a proportionality analysis may seem preferable for recognising an indirect expropriation this test is not without problems.⁴⁰ Section 4 takes a closer look at the proportionality test and its disconnects.

35 *BG Group Plc. v. The Republic of Argentina* (*BG Group v. Argentina*), Final Award (2007), UNCITRAL IIC 327, para. 268. See also *EnCana Corporation v. Republic of Ecuador* (*EnCana Corporation v. Ecuador*), Final Award (2006), LCIA Case No UN3481, paras. 175, 192.

36 Ranjan and Anand, n21, p. 145; Bücheler, n11, p. 126; Titi, n14, p. 2; Radi, n30, p. 6.

37 Mostafa, n12, pp. 267, 280. The first two cases that applied a proportionality analysis are *SD Myers v. Canada*, n6 and *Pope & Talbot v. Canada*, n19. The subsequent cases that implemented the test include: *Técnicas Medioambientales Tecmed, S A v. The United Mexican States* (*Tecmed v. Mexico*), Award (2003), ICSID Case No ARB(AF)00/2; *Talsud S A v. The United Mexican States* (*S A v. Mexico*), Award (2010), ICSID Case No ARB(AF)/04/4; *Azurix v. Argentina*, n30; *Suez v. Argentine*, n 26.

38 *Tecmed v. Mexico*, n37, para. 122; Radi, n30, p. 7; Shirlow, n11, p. 300.

39 In *LG&E Energy Corp, LG&E Capital Corp, and LG&E International, Inc v. Argentine Republic* (*LG&E v. Argentina*), Award (2007), ICSID Case No ARB/02/1, paras. 190–196 the Tribunal listed the following factors: the severity of the economic impact on the investor, the duration of the measure on one hand, and the ‘social or general welfare purpose’ of the measure; Bücheler, n11, p. 130.

40 Caroline Henckels, “Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and the Standard of Review in Investor-State Arbitration”, 15 (1) *Journal of International Economic Law* (2012) pp. 237–238; Jonas Christoffersen, *Fair Balance: Proportionality, Subsidiarity and Primarity in the European Convention on Human Rights* (2009) p. 1.

2.2 What Method Do Investor-State Tribunals Use Predominantly?

As can be seen through the above exploration of approaches to identifying indirect expropriation, there is little consensus on its definition. Therefore, it is necessary to ascertain whether it is possible to trace trends in investor-state jurisprudence when they identify a case of indirect expropriation. Investor-state arbitrators do not follow the same methodology for identifying a case of indirect expropriation, often taking an 'ad hoc approach'.⁴¹ Nevertheless, two common factors have frequently been considered in investor-state jurisprudence.⁴² Firstly, the threshold for finding indirect expropriation is high.⁴³ Secondly, investor-state tribunals consider protection of investors' legitimate expectation with due regard.⁴⁴ Admittedly, every change in host states' regulations would not violate legitimate expectations.⁴⁵ Rather the affected investor has to prove that the state created 'reasonable expectations',⁴⁶ which are disregarded by the state. The statement of the Tribunal in *Thunderbird v. Mexico* sheds light on the general definition of legitimate expectation in the context of investor-state relationship:

Legitimate expectations' relates, within the context of the NAFTA framework, to a situation where a Contracting Party's conduct creates *reasonable and justifiable* expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the NAFTA Party to honour those expectations could cause the investor (or investment) to *suffer damages*.⁴⁷

41 Dolzer and Schreuer, n9, p. 104; Bücheler, n11, pp. 125–126; Isakof, n4, p. 193. See also *Saluka v. Czech Republic*, n9, para. 263.

42 OECD, "Indirect Expropriation' and the 'Right to Regulate' in International Investment Law", OECD Working Papers on International Investment 2004/04 (2004), p. 22.

43 The required threshold is at least a "substantial loss of control or value" or "severe economic impact", see Reinisch, n11, pp. 439–43; UNCTAD, "Expropriation: UNCTAD Series on Issues in International Investment Agreements II", (United Nations Conference on Trade and Development, Geneva 2012) [hereinafter 'UNCTAD Series on Issues in International Investment Agreements II'] p. 140.

44 See for instance *Methanex v. United States*, n6, para. 7.

45 UNCTAD Series on Issues in International Investment Agreements II, n 43, p. 75; Reinisch, n11, p. 448. Cases in which the Tribunals considered legitimate expectations include: *Tecmed v. Mexico*, n37, para. 149; *International Thunderbird Gaming Corporation v. Mexico* (*Thunderbird v. Mexico*), Award (2006), UNCITRAL IIC 136, para. 147.

46 *Generation Ukraine v. Ukraine*, Award (2003), ICSID Case No ARB/00/09, para. 20.

47 *Thunderbird v. Mexico*, n45, para. 147 [emphasis added]; Dolzer and Schreuer, n9, p. n16.

Notwithstanding the existence of inconsistencies in investor-state tribunals' methods of identifying indirect expropriation, a general convergence towards the application of the proportionality principle and the adoption of the nuanced approach of the police powers doctrine can still be observed.⁴⁸ It is noteworthy to mention that while the latter is in line with the proportionality test, by no means should the former be deemed to be synonymous with the latter.⁴⁹ A further explanation and analysis concerning the proportionality test and a more nuanced approach of the police powers doctrine are provided in Section 4.

3 Lack of Consistency in Investor-State Tribunals' Awards: Regulatory Chill

IIAs are enacted based on a quid pro quo: states' promise "to protect investment in return for the prospect of increased investment".⁵⁰ FDI inflows can contribute to the development of host states.⁵¹ This becomes more evident with respect to developing and less-developed countries, where foreign investors from developed countries, brings advanced technologies and capital through their investment.⁵² Nevertheless, foreign investment may have negative impacts on host states' public policy measures. While foreign investors can potentially promote development goals of host states, the fear of capital flight and the financial risk involved in proceedings to arbitrations restrict host states' regulatory space.⁵³ This section explores why and how claims of

48 Bücheler, n11, p. 126; Titi, n14, p. 2; Radi, "Philip Morris v Uruguay: Regulatory Measures in International Investment Law: To Be or Not To Be Compensated?", n30, p. 6.

49 Although the Tribunal in *Philip Morris v. Uruguay*, Award (2016), ICSID Case No ARB/10/7, para. 259 recognised the police powers doctrine as a rule of CIL, it applied a proportionality analysis. See Radi, n30, p. 10; Ranjan and Anand, n21, p. 125. Titi, n14, p. 10.

50 Barnali Choudhury, "International Investment Law as a Global Public Good", 17 (2) *Lewis and Clark Law Review* (2013) p. 495; Jeswald W Salacuse and Nicholas P Sullivan, "Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain", 46 (1) *Harvard International Law Journal* (2005) p. 77.

51 UN, "Developing National Sustainable Development Strategies in Post-Conflict Countries", United Nations Department of Economic and Social Affairs Division for Sustainable Development Draft Paper ROA105, p. 77; UNDP, "Capacity Development: Empowering People and Institutions", (United Nations Development Programme 2008) p. 3.

52 Markus W Gehring and Avidan Kent, "International Investment Agreements and the Emerging Green Economy: Rising to the Challenge", in F. Baetens (ed.), *Investment Law Within International Law: Integrationist Perspectives* (2013) p. 188.

53 Tienhaara, n11, p. 3. Based on the Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral

indirect expropriation may potentially contribute to a regulatory chill on domestic measures.

In investment claims, substantial compensation awards and arbitral proceeding costs are at stake.⁵⁴ Therefore, it is unsurprising to observe elements of cost-effectiveness in a host state's response to such claims. Host states' decision to prioritise non-economic or economic interests may depend on their certainty in winning the dispute and their economic prosperity. When the uncertainty in investor-state tribunals' awards is "combined with the financial risk involved in proceeding to arbitration", the threat of an investment dispute may entice states to "reverse, amend or fail to enforce"⁵⁵ their policy measures.

The idea of regulatory chill is considered as a contentious issue. There exists a wealth of investment awards, such as *Methanex v. US*, *Saluka v. Czech Republic*, *Sedco Inc v. National Iranian Oil Co*, *Sedco Inc v. National Iranian Oil Co* and *El Paso v. Argentina*, which, to investors' disappointment, explicitly recognise states' legitimate right to regulate and exercise its police powers, and are thus not capable of constituting an indirect expropriation. Jr. Coe concentrates on NAFTA related claims, arguing that the chilling effect of indirect expropriation clauses are overdramatised. He refers to decided cases, where the net damage granted to investors were much less than damages sought, in order to support the claim that states do not in fact fear paying high damages.⁵⁶ On the other hand, it is argued that the lack of policy space for states, and the unexpected and inconsistent arbitral awards, have resulted in a regulatory chill in host states because "the mere threat of a claim can lead states to roll back on the intended adoption or implementation of regulatory measures to protect the environment or public health".⁵⁷ Due to the lack of legislative

Investment Treaty: Annexes' (*Centre for Environmental International Law*, 30 January 2004) [hereinafter 'US Sub-Committee Report 2004'] p. 4, even the members who represent companies argued that that foreign investment can potentially "distort or disrupt economic development and thus can be harmful to the public's interest unless appropriately regulated and channeled".

54 Kate Miles, "International Investment Law and Climate Change: Issues in the Transition to a Low Carbon World", Society of International Economic Law Working Paper 27/08 (2008) p. 23.

55 Tienhaara, n11, p. 3.

56 Jack J. Coe, Jr, "Taking Stock of NAFTA Chapter 11 in Its Tenth Year: An Interim Sketch of Selected Themes, Issues, and Methods", 36 *Vanderbilt Journal of Transnational Law* (2003) pp. 1437–1439.

57 Bernasconi-Osterwalder and Hoffmann, n10, p. 5. See, Julia G Brown, "International Investment Agreement: Regulatory Chill in the Face of Litigious Heat?", 3 (1) *Western Journal of Legal Studies* (2013) p. 13; Phuong Tran, "A Review of NAFTA Investor-State Dispute Settlement Claims from 2007 to 2017", 22 (4) *Law and Business Review of America* (2016) p. 446; Jennifer Gerbasi and Mildred E Warner, "Privatization, Public Goods, and

guidance on the definition of indirect expropriation, the indeterminate scope of *bona fide* measures, and absence of a central appellate body in investor state jurisprudence,⁵⁸ there is no guarantee to expect the similar line of approach with respect to future claims in *all* Tribunals. The resulting uncertainty regarding the tribunals' approach in defining an indirect expropriation, especially the fear of states from having their measures to be exclusively subjected to the "sole effect" doctrine, may entice them to refrain from enacting and/or enforcing their public policy objectives.⁵⁹ The settlements in cases such as *Indonesian Forestry Law*,⁶⁰ *Ethyl v. Canada*,⁶¹ *Vattenfall (I)*,⁶² and *Dow Agrosciences LLC v. Canada*⁶³ are illustrate the regulatory chill. However, it is worth noting that "it is difficult, if not impossible, to establish definitively that any particular

the Ironic Challenge of Free Trade Agreements", 39 (2) *Administration & Society* (2007) p. 127.

58 See Jürgen Kurtz, "The Use and Abuse of WTO Law in Investor-State Arbitration: Competition and its Disconnects", 20 (3) *European Journal of International Law* (2009) p. 769; Tienhaara, *nn*, p. 2. Charles H. H. Brower, "Structure, Legitimacy, and NAFTA's Investment Chapter", 36 (37) *Vanderbilt Journal of Transnational Law* (2003) argues in favour of the establishment of an appellate body.

59 See Kevin R. Gray, "Foreign Direct Investment and Environmental Impacts – Is the Debates Over?", 11 (3) *RECIEL* (2002) 307, p. 310.

60 Indonesia, fearing paying US\$31 billion dollars as compensation for the prohibition on opencast mining, enacted a subsequent regulation, which exempted those companies that already held licences from the prohibition. See Miles, *n*54, pp. 24–25; Brown, *n*57, pp. 9–12; Tienhaara, *nn*, pp. 12–20.

61 Canada, being uncertain about how a case of indirect expropriation is defined by the Tribunal and fearing compensation claims from Ethyl Corporation in response to the prohibition on the use of a fuel additive, abolished the ban and paid approximately US\$13 million in compensation. See Miles, *n*54, p. 25.

62 In 2009, Vattenfall, a Swedish energy company investing in Germany, alleged indirect expropriation under the Energy Charter Treaty (signed 17 December 1994, entered into force 16 April 1998) 2080 UNTS 95 [hereinafter 'ECT'] Art. 13. The alleged compensation of €1.4 billion together with arbitration costs enticed Germany to settle the dispute. See Bernasconi-Osterwalder and Hoffmann, *n*10.

63 In *Dow Agrosciences LLC v. Canada*, Settled (2011), UNCITRAL, the claimant alleged violation of Articles 1105 (Minimum Standard of Treatment) and 1110 of NAFTA in response to Quebec's restriction on the use of chemical pesticide 2,4-D; the corporation claimed for \$2 million in damages. Three years later the claimant and Canada entered into a settlement agreement, based on which the government was not required to pay for any compensation but it was obliged to state "products containing 2,4-D do not pose an unacceptable risk to human health or the environment provided that the instructions on the label are followed." See Tran, *n*57, pp. 440–441; Kathleen Cooper and others, "Seeking a Regulatory Chill in Canada: The Dow Agrosciences NAFTA Chapter 11 Challenge to the Quebec Pesticides Management Code", 7(1) *Golden Gate University Environmental Law Journal* (2014) p. 43.

measure was abandoned as a result of a BIT claim”.⁶⁴ The amicable settlement of investment disputes takes place on an *ad hoc* basis, and there are numerous other considerations that may also play a role in the states’ decision to settle the disputes.⁶⁵ As Schneiderman rightly notes, the determination of whether the regulatory chilling effect on states’ public policies exists or not, requires a detailed investigation into the workings and practices of governments.⁶⁶ For instance, in *Indonesian Forestry Law*, sources of revenue and employment were also determinative factors in Indonesia’s settlement decision.⁶⁷ Also, in *Ethyl v. Canada*, if Canada had underpinned the adverse health and environmental impacts of the fuel additive with more scientific justifications, it would have been more confident to defend its regulatory measure before the Tribunal.⁶⁸ Nevertheless, in light of the lack of interpretive guidance on the definition of indirect expropriation, and the unpredictability surrounding investor-state tribunals’ indirect expropriation awards, such claims have the potential to be used as “powerful tools” for foreign investors “to create political influence and financial burdens” on host states’ regulatory measures.⁶⁹

4 The Preferred Method for Identifying Indirect Expropriation

It has been noted that “there is no single satisfactory solution proffered to the thorny issue as to when regulation transforms itself into expropriation”.⁷⁰ Each indirect expropriation claim has some attributes unique to the case at stake that differentiate the claim from other indirect expropriation litigations.⁷¹ Hence, investor-state jurisprudence is inclining towards the application of the proportionality test and the nuanced approach of the police powers doctrine respectively for identifying indirect expropriation, through which the circumstances of each case can be considered.⁷² The current trend in investor-state

64 Gus Van Harten, “Submission to the Productivity Commission: Bilateral and Regional Trade Agreements Study”, (Australian Government Productivity Commission, 2010) p. 5.

65 Brown, n57, pp. 12–18. David Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (2008) p. 70.

66 Schneiderman, *Ibid.*, p. 70.

67 Brown, n57, p. 12.

68 Miles, n54, p. 25.

69 Tran, n57, p. 446.

70 Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (4th ed., 2017) p. 472.

71 *Ibid.* See also Reinisch, n11, p. 426.

72 A limited number of investor-state tribunals’ assessments are still confined to investment protection and they disregard to consider human rights or environmental considerations:

tribunals is, in fact, a positive move towards more consistency and fairness in investor-state tribunals' awards.⁷³ However, the question that arises is: which of the two methods affords more policy space without harming states' FDI inflows? To answer the question, this section explores the nuanced approach of police powers doctrine illustrating its difference from the proportionality test and it prescribes the preferred method for identifying indirect expropriation in investor-state jurisprudence.

4.1 *The Differences between the Proportionality Test and the Nuanced Approach of Police Powers Doctrine*

This paper considers the proportionality test and the nuanced approach of police powers doctrine as distinct methods of identifying an indirect expropriation.

The nuanced approach of police powers doctrine has its root in the radical police powers doctrine.⁷⁴ However, contrary to the radical police powers doctrine, which solely concerns states' public purpose, it 'leaves the door open for the possibility that a non-discriminatory measure enacted under due process and pursuing a public interest objective be characterised as a compensable expropriation and not as a non-compensable regulation'.⁷⁵ The presumption in the nuanced approach of police powers doctrine is that states are not liable for indirect effects of their regulatory measures on investors' investment. Nevertheless, this presumption may be rebutted, albeit 'in rare circumstances'.⁷⁶ In fact, similar to the proportionality test, the nuanced approach of police powers doctrine requires a case to be considered "in light of all the circumstances".⁷⁷ However, the proportionality test does not necessarily entail the strong presumption in favour of states' regulatory measures and states' police powers "figured as *one* among several criteria, (...), that *may* be taken into account in order to determine if there had been an indirect expropriation".⁷⁸

the Tribunal in *Bernhard von Pezold and Others v. Republic of Zimbabwe* (von Pezold v. Zimbabwe), Award (2015), ICSID Case No ARB/10/15 disregarded to take human rights considerations into account; Sornarajah, n70, p. 473.

73 Dolzer and Schreuer, n9, p. 123; Titi, n14, p. 10; Reinisch, n11, p. 449.

74 Bücheler, n11, p. 129.

75 Radi, n30, p. 6.

76 Bücheler, n11, p. 129. Titi, n14, p. 2.

77 *Marvin Roy Feldman Karpa v. United Mexican States* (Feldman v. Mexico), Award (2002), ICSID Case No ARB(AF)/99/1, para. 106; Titi, n14, p. 12.

78 *Fireman's Fund Insurance Company v. The United Mexican States* (Fireman's Fund v. Mexico), para. 176.

4.2 *Proportionality in Investor-State Jurisprudence*

The application of the proportionality test in claims of indirect expropriation is subject of controversy among both commentators and investor-state arbitrators.⁷⁹ Referring to the ECtHR jurisprudence, the Tribunal in *Tecmed v. Mexico* assessed whether Mexico's measures are "proportional to the public interest presumably protected thereby and the protection legally granted to investments".⁸⁰ The Tribunal's reference to the ECtHR jurisprudence may suggest that investor-state tribunals apply the proportionality test in a similar manner as the ECtHR.

However, unlike the ECtHR jurisprudence, in which the proportionality analysis is applied to determine the amount of compensation,⁸¹ IIAs lack such a "gate-keeping element."⁸² When investor-state tribunals conclude that there is an expropriation which is not accompanied by *full* compensation, the host state is accused of violating its treaty obligation. The Tribunals in *S D Myers v. Canada*⁸³ and *Pope & Talbot v. Canada*⁸⁴ applied the proportionality test for the first time to compensate this perceived shortcoming.⁸⁵ Later, in *Tecmed*⁸⁶ the Tribunal cited the ECtHR "as an inspirational source",⁸⁷ and applied an elaborated proportionality test, for which it received considerable applause.⁸⁸ Thereafter, several other investor-state tribunals also followed *Tecmed's* approach.⁸⁹

79 Andreas Kulick, *Global public interest in International Investment Law* (2012); Titi, n14; Bücheler, n11; Shirlow, n11; *Tecmed v. Mexico*, n37; *LG&E v. Argentina*, n39.

80 *Tecmed v. Mexico*, n37, para. 122; OECD, n44, p. 18.

81 For further analysis on this matter see Monica Carss-Frisk, "The Right to Property: A guide to the implementation of Article 1 of Protocol No. 1 to the European Convention on Human Rights" (Human Rights Handbooks No 4, the Council of Europe 2003) para. 99; Bücheler, n11, p. 134; the Court in *James and Others v. the United Kingdom* (*James v. United Kingdom*), ECtHR (1986), Series App no 8793/79, para. 46 examined the existence of an expropriation in advance to weighing the public interest against the applicant's interest.

82 Bücheler, n11, p. 134.

83 *S D Myers v. Canada*, n6, paras. 255, 261, 263.

84 *Pope & Talbot v. Canada*, n19, paras. 123, 125, 128, 155.

85 Bücheler, n11, p. 134; Henckels, n40, p. 230; Steven R Ratner, "Regulatory Takings in Institutional Context: Beyond the Fear of Fragmented International Law", 102 *American Journal of International Law* (2008) p. 527.

86 *Tecmed v. Mexico*, n37, para. 122.

87 Bücheler, n11, p. 145.

88 *Ibid.*, p. 134; Ratner, n 85, p. 527.

89 For instance, see *LG&E v. Argentina*, n39, paras. 177, 189–195; *Total SA v. Argentine Republic* (*Total v. Argentina*), Award (2013), ICSID Case No ARB/04/1, para. 197; *Azurix v. Argentina*, n30, paras. 310–312, *Suez v. Argentina*, n26, paras. 147–148, and *Fireman's Fund v. Mexico*, n79, para. 176 (j).

The Tribunal in *Tecmed* referred to an ECtHR case, *James v. United Kingdom*,⁹⁰ as a persuasive source to introduce a new venue in identifying indirect expropriation in investor-state jurisprudence.⁹¹ However, the Tribunal is criticised for its erroneous understanding on how and when a proportionality analysis is implemented in the ECtHR jurisprudence.⁹² While the ECtHR in *James* applied the test only after establishing that the measure at stake was expropriatory, the Tribunal in *Tecmed* implemented the proportionality test to determine the very existence of indirect expropriation.⁹³

The other disparity between the ECtHR and investor-state jurisprudence lies in the fact that the latter has a different understanding regarding the nature of the proportionality test. The ECtHR applies proportionality test in three steps, which are the requirements of suitability, necessity, and proportionality in the strict sense⁹⁴ However, neither the Tribunal in *Tecmed* nor other investor-state tribunals provided a framework on how to apply the test.⁹⁵ They restricted their assessment to different steps of the proportionality test. For instance, while the Tribunal in *Tecmed* applied the third step of the test (proportionality in the strict sense),⁹⁶ the Tribunals in *S D Myers* and *Pop & Talbot* limited their assessment to the necessity analysis.⁹⁷ This suggests that investor-state tribunals “seem not ready to apply the entire three-factor test”.⁹⁸

Tecmed’s methodology in identifying indirect expropriation is not similar to the ECtHR’s approach. The tribunals’ references to the ECtHR jurisprudence creates the expectation for the parties that investor-state arbitrators apply the proportionality test similar to the European Court’s practice. The Tribunal made a symbolic reference to the ECtHR proportionality test;⁹⁹ the former implements proportionality in a different stage of its assessment.

90 *James v. United Kingdom*, n81.

91 *Tecmed v. Mexico*, n37, para. 122. See Ratner, n85, p. 527; Bücheler, n11, p. 145.

92 Bücheler, n11, p. 131 criticises the tribunals for their failure to adopt a fully-fledged proportionality test. See also Henckels, n40, p. 231 addresses *Tecmed v. Mexico* as an ‘example of a flawed methodology and an overly stringent standard of review’.

93 *Ibid.*, pp. 145–147.

94 Janneke Gerards, “How to improve the necessity test of the European Court of Human Rights”, 11 (2) *International Journal of Constitutional Law* (2013) p. 469; Christoffersen, n40, pp. 1–2.

95 Nevertheless, *Tecmed* remains the most detailed analysis on the proportionality test in the investor-state jurisprudence, see Henckels, n40, p. 230.

96 *Tecmed v. Mexico*, n37, para. 122. For a detailed analysis regarding *Tecmed* case see Henckels, n40, pp. 232–233.

97 *S D Myers v. Canada*, n6, paras. 255, 261, 263; *Pope & Talbot v. Canada*, n19, paras. 123, 125, 128, 155; Henckels, n40, p. 236.

98 Kulick, n79, pp. 266–267.

99 *Tecmed v. Mexico*, n37, para. 122.

In addition, the analyses on investor-state cases, in which a proportionality test was applied, suggest that there is a lack of framework in the application of the test¹⁰⁰ in investor-state jurisprudence. Therefore, considering that the proportionality test is implemented differently in investor-state jurisprudence from the ECtHR, it is proposed that the approach of the Tribunal to proportionality cannot be equated with ECtHR jurisprudence and it is the former the paper will now focus upon.

4.2.1 Disconnects of a Proportionality Analysis

A criticism of investor-state tribunals that follow *Tecmed's* approach is that the use of proportionality analysis in identifying indirect expropriation is “far-reaching”.¹⁰¹ Each of the three steps forming part of the proportionality test affords considerable discretion to investor-state arbitrators, which in turn potentially restricts host states’ policy space. A high degree of awareness about the host state’s political and economic circumstances is required for a correct determination of the legitimate aims, of possible less restrictive means and of the balancing between the public and foreign investors’ interests.¹⁰² By applying a proportionality test, arbitrators may overstep the limits of their mandate. In addition, the principle of proportionality does not have a clear threshold.¹⁰³ Although it is established that tribunals “do not have an open-ended mandate to second-guess government decision-making”,¹⁰⁴ there is no coherent standard of review within investor-state tribunals. For instance, while in *Tecmed* the Tribunal’s approach in applying the proportionality test was in favour of the claimant (investor), in several cases related to the Argentinean crises,¹⁰⁵ the Tribunals “made a deferential approach to proportionality”¹⁰⁶ and set a lower threshold for finding proportionality.¹⁰⁷

The lack of a coherent standard of review within investor-state tribunals transforms the application of a proportionality analysis into a more intrusive

¹⁰⁰ Shirlow, n11, p. 612.

¹⁰¹ Henckels, n40, pp. 237–238; Tor-Inge Harbo, “The Function of the Proportionality Principle in EU Law”, 16 *European Law Journal* (2010) p. 165.

¹⁰² Sornarajah, n70, p. 462; Christoffersen, n40, p. 1.

¹⁰³ Herwig C.H Hofmann, Gerard C Row, Alexander H Turk, *Administrative Law and Policy of the European Union* (2011) p. 130.

¹⁰⁴ *SD Myers v. Canada*, n6, para. 261; Shirlow, n11, p. 601.

¹⁰⁵ *LG&E v. Argentina*, n39, paras. 177, 189–195; *Total v. Argentina*, n89, para. 197; *El Paso Energy v. Argentina*, n26, paras. 241, 243; *Continental Casualty Company v. Argentine Republic* (*Continental Casualty v. Argentina*), Award (2008), ICSID Case No ARB/03/9, paras. 241, 243.

¹⁰⁶ Henckels, n40, p. 234.

¹⁰⁷ *Ibid.*

instrument into host states' autonomy.¹⁰⁸ One of the solutions is that contracting states set standards of review in order to clarify the degree of scrutiny that tribunals can have when they apply a proportionality test. The degree of deference rendered by a tribunal to states may "range from treating authorities' views in relation to a matter as persuasive, to treating them as conclusive".¹⁰⁹ If states impose a deferential standard of review on investor-state tribunals, they can potentially control the extent to which tribunals can infringe on their autonomy.

A possible deferential standard of review is through the margin of appreciation, that only finds states liable when the balance struck by the host state is "blatantly unreasonable and out of proportion".¹¹⁰ The second method is to impose a separate standard of review with respect to each of the three steps involved in proportionality analysis.¹¹¹ For instance, to identify if a state's measure is pursuing a legitimate aim, Henckels suggests a good faith standard of review based on which only state measures that are not "discriminatory, protectionist or otherwise impermissible objective[s]" are deemed legitimate.¹¹² The third proposed standard of review sets a general framework for tribunals.¹¹³ Investor-state arbitrators may refer to the text of the investment treaty to enquire if the state parties have dictated any specific standard of review; they may also assess whether the measure at stake was enforced to react to an emergency situation.¹¹⁴ Furthermore, arbitrators make a more deferential standard of review if the dispute has previously been brought before national courts.¹¹⁵

Imposing pre-established standards of review on investor-state tribunals brings coherence in the application of the proportionality test and the degree of arbitrators' scrutiny over states' regulatory acts becomes clearer. Nevertheless, there are several considerations that reduce the efficiency of this method. Although imposing a deferential standard of review on investor-state tribunals restrains arbitrators' freedom when they apply the test, there

¹⁰⁸ Shirlow, *nn*, p. 239.

¹⁰⁹ Henckels, *n40*, p. 238.

¹¹⁰ Shirlow, *nn*, p. 603; see also William Burke-White and Andreas von Staden, "Private Litigation in a Public Law Sphere: the Standard of Review in Investor-State Arbitration", 35 *Yale Journal of International Law* (2012) p. 343.

¹¹¹ Shirlow, *nn*, pp. 603–604.

¹¹² Caroline Henckels, "Proportionality and the Standard of Review in Fair and Equitable Treatment Claims", (Society of International Economic Law 3rd Biennial Global Conference, Singapore, 12–14 July 2012) p. 23.

¹¹³ Stephan Schill, "Deference in Investment Treaty Arbitration: Reconceptualizing the Standard of Review", 3 (3) *Journal of International Dispute Settlement* (2012) pp. 579–80.

¹¹⁴ Shirlow, *nn*, pp. 604–605.

¹¹⁵ *Ibid.*, p. 605.

is still a lack of coherence in the tribunals' approach. The proportionality test consists of several stages, and the outcome in each stage significantly depends on the arbitrators' reasoning.¹¹⁶ This uncertainty surrounding the possible outcomes of a dispute not only incites states to settle the dispute and compromise on their public policy objectives but also discourages foreign investors to invest abroad. In fact, since the application of the proportionality test subjects claims of indirect expropriation to a diverse degree of elaboration, and hence leads to unpredictable results, investors do not trust in investing their resources abroad.¹¹⁷

In addition to the unpredictability of indirect expropriation awards, the distinct nature of investor-state tribunals from the ECtHR justifies the criticism concerning the application of a proportionality analysis by the former. Considering that a proportionality analysis involves some elements of subjectivity,¹¹⁸ the structure and composition of the ECtHR warrant the adoption of the proportionality test: the ECtHR is a permanent Court, composed of judges who are accustomed to the legal and political systems of all the State parties to the ECHR, whose judgments are subjected to a system of checks and balances.¹¹⁹ However, investor-state tribunals are ad hoc bodies, which are not necessarily accustomed to the legal and political systems of the defending state, and a higher-level body does not scrutinise their reasoning.¹²⁰ Therefore, the use of the proportionality test in the context of regulatory expropriation by investor-state tribunals may lead to an unwarranted improvement of foreign investors position against the host state, unintended by the parties.¹²¹

4.3 *The Nuanced Approach of Police Powers Doctrine or the Proportionality Test?*

Both the proportionality test and the nuanced approach of police powers doctrine enable tribunals to take the circumstances of the case at stake into account. However, the application of the proportionality test by itself is deemed to be a less favourable method compared to the latter. The desirability

116 Ibid., pp. 625–26; Caroline Henckels, “The Role of the Standard of Review and the Importance of Deference in investor-State Arbitration”, in L. Gruszczynski, W.G Werner (eds.), *Deference in International Courts and Tribunals: Standard of Review and Margin of Appreciation* (2014) p. 113.

117 Shirlow, n11, p. 626.

118 Bernhard Schlink, “Proportionality in Constitutional Law: Why Everywhere but here?”, 22 *Duke Journal of Comparative Constitutional Law* (2012) pp. 299–300.

119 Henckels, n124, p. 116.

120 Tienhaara, n11, pp. 2–3.

121 Sornarajah, n70, p. 488.

in adopting a case-by-case analysis should not provide an open-ended mandate to arbitrators when they identify a case of indirect expropriation. The nuanced approach of police powers doctrine pertains to the presumption that host states have the right to protect their public policy objectives even at the cost of foreign investors' interests; however, successful claims under indirect expropriation is not impossible, albeit 'subject to exceptional circumstances'.¹²² Although this approach entails the application of a proportionality analysis, the very nature of the doctrine directs investor-state arbitrators to set a high threshold for a finding of an indirect expropriation.

The effectiveness of the nuanced approach of police powers doctrine is complemented when states codify this doctrine in their IIAs. This approach constrains investor-state tribunals' freedom in identifying indirect expropriation. The codification of this doctrine is attracting the attention of a number of states, which is reflected in their Model Bilateral Investment Treaties (BIT) and IIAs.¹²³

5 Codifying the Nuanced Approach of Police Powers Doctrine: States' Legislative Responses

A number of claims against the United States under Article 1110 of NAFTA,¹²⁴ and investor-state tribunals' inconsistent methods of identifying indirect expropriation triggered the introduction of Annex B in the US Model BIT of 2004 and 2012¹²⁵ (hereinafter the reference to the US Model BIT of 2012 also includes the US Model BIT of 2004),¹²⁶ in which indirect expropriation clauses are drafted with more elaboration.

Annex B of the US Model BIT requires a fact-based inquiry that lists a non-exhaustive list of criterion, called the Penn Central factors, to be considered:

122 This wording is in line with the indirect expropriation provisions enacted in the Model BITs of states such as the US and Canada, which are discussed in detail in the subsequent chapters.

123 Bücheler, 111, pp. 175–177; Titi, 114, p. 19.

124 NAFTA., Art. 1110.

125 Treaty between the Government of United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment [hereinafter 'US Model BIT 2004'] (2004) Annex B, Art. 4 (a); Treaty between the Government of United States of America and the Government of [Country] Concerning the Encouragement and Reciprocal Protection of Investment [hereinafter 'US Model BIT 2012'] (2012) Annex B Sornarajah, 170, p. 300.

126 The wording of Annex B in the US Model BIT 2004, 1125 is remained intact in the US Model BIT 2012, 1125, see also Cotula, 110, p. 282.

- (i) the economic impact of the government action;
- (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
- (iii) the character of the government action¹²⁷

A more or less similar wording also exists in a number of other states' Model BITS and IIAs.¹²⁸ However, a more restrictive approach in favour of host states is reflected in the formulation of the ASEAN Comprehensive Investment Agreement (ACIA) Annex 2.¹²⁹ For instance, the element of "distinct, reasonable, investment-backed expectation"¹³⁰ is limited to the breach of written commitments made by the government to the investor.¹³¹ The states' legislative responses go further and in a separate paragraph, they extend their regulatory space: for instance, Article 4 (b) of the US Annex B and Annex B.13 (1) (c) of the Canadian Model BIT read as follows:

Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives such as, (...), do not constitute indirect expropriations.

The annex formulation of capital exporting countries is diffusing globally. The BITS between Canada and African countries are adopted in light of the

¹²⁷ US Model BIT 2012, n125, Annex B, s 4 (a).

¹²⁸ For examples of Model BITS see Agreement between Canada and (...) for the Promotion and Protection of Investments [hereinafter 'Canadian Model BIT'] (2004); Southern African Development Community, SADC Model Bilateral Investment Agreement Template and Commentary [hereinafter 'SADC Model BIT'] (2012), Art. 6 (7). For examples regarding IIAs, see The United States-Singapore Free Trade Agreement [hereinafter 'United States-Singapore FTA'] (signed 6 May 2003, entered into force 1 January 2004); The Comprehensive Economic and Trade Agreement [hereinafter 'CETA'] (signed 30 October 2016, entered into 21 September 2017); Canada-Mongolia Bilateral Investment Treaty ['Canada-Mongolia BIT'] (signed 8 September 2016, entered into force 24 February 2017); Free trade Agreement between the Kingdom of Morocco and the United States of America (signed 15 June 2004, entered into force 1 January 2006); see ASEA Comprehensive Investment Agreement 2012 [hereinafter 'ACIA'] (signed 26 February 2009, entered into force 29 March 2012).

¹²⁹ ACIA, n128, Annex 2, paras. 2–3.

¹³⁰ See, for instance, US Model BIT 2012, n125, Annex B, Art. 4 (a); Canadian Model BIT, n128, Annex B.13 (1) (c).

¹³¹ The wording is as follows: "Governments' prior binding written commitment to the investor whether by contract, licence or other legal documents". In addition, while the expropriation Annex of the Canadian Model BIT, n128, is in line with the US expropriation Annex, the CETA, n128 is featured with additional criterion to the Penn Central factors, "particularly, a new duration criterion", which concerns about 'the duration of the measure or series of measures', see Cotula, n 10, p. 286.

Canadian Model BIT, hence, unsurprisingly, those agreements include indirect expropriation Annexes with more or less similar wordings to Article 6 of the Canadian Annex B.¹³² The other example is the United States-Singapore Free Trade Agreement (FTA);¹³³ the parties' understanding of indirect expropriation in the 'Exchange of Letters of Expropriation'¹³⁴ is in line with the US Model BIT. There is also a change in the EU's trend of formulating its investment agreements: while the European Commission used to be in favour of the "gold standard of investment protection in treaty practice of Member States, which traditionally does not involve expropriation Annexes",¹³⁵ the investment chapter of the Comprehensive Economic and Trade Agreement (CETA)¹³⁶ features an expropriation Annex which resembles other recent Canadian investment treaties.¹³⁷ Furthermore, the US and the EU have included an expropriation Annex in the Transatlantic Trade and Investment Partnership (TTIP) draft.¹³⁸

A notable departure from the US expropriation Annex can be observed in the ACIA and the investment agreement for the Common Market for Eastern and Southern Africa (COMESA):¹³⁹ in Article 4 of the ACIA Annex 2,¹⁴⁰ the omission of the 'except in rare circumstances' proviso "suggests that non-discriminatory regulatory actions adopted to protect public welfare objectives *never* constitute indirect expropriation".¹⁴¹ In addition, based on the

132 Canadian Model BIT, n128, Annex B, Art. 6; See J Anthony Van Duzer, "Canadian Investment Treaties with African Countries: What Do They Tell Us About Investment Treaty Making in Africa?", 18 *Journal of World Investment & Trade* (2017) p. 556.

133 United States-Singapore FTA, n128. See also Yvette Anthony, "The Evolution of Indirect Expropriation Clauses: Lessons from Singapore's BITs/FTAs", 7 *Asian Journal of International Law* (2017) p. 319.

134 Based on *Ibid.*, Art. 15 (26), the Exchange of Letters of Expropriation is an integral part of the treaty.

135 Cotula, n10, p. 285; see also Commission, "Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions, Towards a Comprehensive European International Investment Policy", COM (2010) 343 final 8–9.

136 CETA, n128, Art. 8(12).

137 Cotula, n10, p. 286.

138 Commission, 'Transatlantic Trade and Investment Partnership: Trade in Services, Investment and E-Commerce' [hereinafter 'Commission Draft Text TTIP-investment'] (TTIP) Annex I.

139 Investment Agreement for the COMESA (Common Market for Eastern and Southern Africa) Common Investment Area [hereinafter 'Investment Agreement for the COMESA'] (signed 23 May 2007, not yet entered into force).

140 ACIA, n128, Annex 2, Art. 4.

141 Titi, n14, p. 284.

Investment Agreement for the COMESA,¹⁴² states' police power is considered as a rule of CIL.¹⁴³

The evolution in a number of states' legislative responses with respect to indirect expropriation clauses reflects the sovereign states' desire and effort "to inject a measure of predictability and consistency in tribunals" judgments.¹⁴⁴ Apart from Article 4 of the ACIA Annex 2 and Article 20 (8) of the Investment Agreement for the COMESA, the mentioned Annexes on expropriation are in line with the nuanced approach of police powers doctrine,¹⁴⁵ based on which the general presumption is in favour of host states' regulatory power, albeit 'except in rare circumstances'. In addition, a noticeable characteristic in all the mentioned Model BITS is that they include a non-exhaustive list of objectives that are deemed as 'legitimate public welfare objectives'.¹⁴⁶

Nevertheless, it is still contentious whether the legislative responses of states can solve their concern surrounding the unpredictability and inconsistency in investor-state tribunals' methodology for finding indirect expropriation.

5.1 *Do States' Legislative Responses Cure the Unpredictability and Inconsistency in Investor-State Jurisprudence?*

One of the shortcomings in expropriation Annexes is the lack of clarity as to what situations fall within the scope of 'rare circumstances.' Most Annexes provide "no guidance on what these 'rare circumstances' might involve".¹⁴⁷ However, some elaboration on this point can be found in the indirect expropriation clauses of the recent Canadian BITS. The BIT between Canada and Mali includes an example to clarify when an exception is acceptable:

142 Based on Investment Agreement for the COMESA, n139, Art. 20 (8), as long there are "bona fide regulatory measures taken by a Member State that are designed and applied to protect or enhance legitimate public welfare" there is no indirect expropriation.

143 As it was noted by Sir. Michael Wood, the existence of a rule of CIL is determined through the examination of the elements of state practice and *opinio Juris*. See ILC, "Second report on Identification of Customary International Law", (sixty sixth session, 2014) UN Doc. A/CN.4/672; Bücheler, n11, pp. 172–177 makes an in-depth analysis on the effects of IIAs on the rules of CIL.

144 Anthony, n133, p. 324.

145 Bücheler, n11, p. 153; Titi, n14, p. 15.

146 Cotula, n10, p. 282; Nikiéma, n16, p. 19.

147 Nikiéma, n16, p. 19; Amokura Kawharu, "The Negotiations for a Trans-Pacific Partnership Agreement", 27 (1) *ICSID Review* (2012) p. 150.

Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith.¹⁴⁸

It may be argued that the adverse effect of states' lack of clarification on what elements constitute 'rare circumstances' unveils when arbitrators interpret this word inconsistently. However, the criticism of states failure to clarify what factors should be taken into account when arbitrators assess 'rare circumstances' is overdramatised. How precisely tribunals interpret 'rare circumstance' is not illuminated yet.¹⁴⁹

Investor-state tribunals "almost invariably"¹⁵⁰ invoke Article 31 VCLT for the purpose of interpretation of IIAS.¹⁵¹ Based on the judicial and arbitral decisions, Articles 31 and 32 VCLT are considered as codification of existing customary international law.¹⁵² The Tribunal, in the consolidated case of *Canfor v. USA, Tembec v. USA and Terminal US Products v. USA* cited the ICJ case on *Kasikili/Sedudu Island (Botswana v. Namibia)*,¹⁵³ and stated as follows:

148 The Agreement between Canada and Mali for the Protection of Investments [hereinafter 'Canada-Mali BIT'] (signed 28 November 2014, not yet entered into force), Annex B.10, s (c).

149 Cotula, mO, p. 287. *Corona Materials LLC v. Dominican Republic (Corona Materials v. Dominican Republic)*, Award (2016), ICSID Case No ARB(AF)/14/3; *Commerce Group Corp and San Sebastian Gold Mines Inc v. Republic of EL Salvador (Commerce Group v. EL Salvador)*, Award (2011), ICSID Case No ARB/09/17; *TCW Group Inc and Dominican Energy Holdings LP v. The Dominican Republic (TCW Group v. Dominican Republic)*, Award (2009), UNCITRAL IIC 407.

150 Christoph Schreuer, "Diversity and Harmonization of Treaty Interpretation in Investment Arbitration", in M. Fitzmaurice, O. Elias, and P. Merkouris (eds.), *Treaty interpretation and the Vienna Convention on the Law of Treaties: 30 years on* (2010), 129–130; Anthony Aust, *Modern Treaty Law and Practice* (2007) p. 36.

151 See, for instance, *Quiborax S.A., Non Metallic Minerals S.A. and Allan Fosk Kaplún v. Plurinational State of Bolivia (Quiborax v. Bolivia)*, Award (2015), ICSID Case No. ARB/06/2. paras. 88–93. *Suez v. Argentina*, n26, para. 54. For further examples see Schreuer, m50, fn., 2.

152 See *Case Concerning the Territorial Dispute (Libyan Arab Jamahiriya v. Chad)*, Judgment, ICJ Rep (1994), para. 41; *LaGrand (Germany v. United States of America)*, Judgment on Merits, ICJ Rep (2001), para. 99; George Abi-Saab, "The Appellate Body and Treaty Interpretation", in M. Fitzmaurice, O. Elias, and P. Merkouris (eds.), *Treaty interpretation and the Vienna Convention on the Law of Treaties: 30 years on* (2010), 129–130.

153 *Kasikili/Sedudu Island (Botswana v. Namibia)* ICJ Rep (1999) p. 1059.

While the 1969 Vienna Convention is not in force among the three NAFTA State Parties (the United States has never ratified it), Articles 31 and 32 are regarded as reflective of established customary international law.¹⁵⁴

Based on Article 31(1) VCLT, a treaty should be interpreted “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”. Given that there is “no legal hierarchy of norms for the interpretation of treaties”,¹⁵⁵ and treaty interpretation is considered as a holistic exercise,¹⁵⁶ there is no single, systemic approach to the interpretation of IIAs.¹⁵⁷ However, the text of Article 31(1) VCLT represents a “logical progression” with a start with the ordinary meaning of the text of the treaty, followed by the context, the object and purpose and then some extrinsic evidence of the intentions of parties as tools to ensure that the ordinary meaning of a treaty term fits in.¹⁵⁸ One of the elements of contextual interpretations is considering “the wording of surrounding provisions”.¹⁵⁹ In *Electrabel v. Hungary*, the Tribunal noted that the first sentence of Art 10(1) ECT sheds light on the meaning of the term “fair and equitable treatment”.¹⁶⁰ Similar to *Electrabel* case, investor-state Tribunals may interpret the term “rare circumstances” in light of the non-exhaustive list of factors (Penn Central Factors) in indirect expropriation provisions. Based on a contextual interpretation, the adverse effect of governments’ measures on the economic value of an investment is predicted to no longer be a determinative factor on its own.¹⁶¹ This conclusion is also consistent with the developments in investor-state jurisprudence, in which arbitrators are diverging from the application of the sole effect doctrine (see section 2). In addition, the second Penn Central Factor,

154 *Canfor v. United States, Tembec v. United States, Terminal Forest Products v. United States*, Decision on Preliminary Question (2006), UNCITRAL, para. 177.

155 ILC, “Draft Articles on the Law of Treaties with commentaries”, in *Yearbooks of the International Law Commission* UN, (1966) pp. 219–220.

156 *United States – Continued Existence and Application of Zeroing Methodology*, Appellate Body (2009), Report, WT/DS350/AB/R, para. 268 *European Communities – Customs Classification of Frozen Boneless Chicken Cuts (EC – Chicken Cuts)*, Appellate Body (2006), WT/DS269/AB/R, WT/DS286/AB/R, para. 176.

157 Aust, n150, p. 234; ILC, “Draft Articles on the Law of Treaties with commentaries”, n155 p. 218.

158 Trinh Hai Yen, *The Interpretation of Investment Treaties* (2014), pp. 44, 46.

159 See Richard Gardiner, *Treaty Interpretation* (2015) p. 210.

160 *Electrabel S.A. v. Republic of Hungary*, Decision on Jurisdiction, Applicable Law and Liability (2012), ICSID Case No. ARB/07/19, para. 7.73.

161 See, for instance, the US Model BIT 2012, n125, Annex B, s 4(a) (i); ACIA, n 128, Annex 2, para. 3 (a).

which is the extent to which the government action interferes with distinct, reasonable investment-backed expectations, may have an impact on investor-state arbitrators' finding. Investor-state tribunals' concern on the protection of investors' legitimate expectation corroborates this prediction.¹⁶² While the nuanced approach of the police powers doctrine does not blame states for protecting the common good, it does punish host states for defying procedural safeguards in the course of enforcing their regulatory measures against foreign investors.¹⁶³ Having said that, it is argued that claims in relation to legitimate expectations are shifting within the scope of the right to fair and equitable treatment: in many awards regarding cancellation of licences "it is not the cancellation that is the focus of attention and the basis for finding to pay compensation but the faulty procedure that preceded the cancellation".¹⁶⁴ This development can also be noticed in a number of IIAs; the expropriation Annex of the EU-Singapore Free Trade Agreement has replaced the legitimate expectation factor with the following requirement:¹⁶⁵ "the extent to which the measure or series of measures interferes with the possibility to use, enjoy or dispose of the property".¹⁶⁶

The other tool that assists tribunals in interpretation, is the object and purpose of the relevant IIA. While all means of interpretation that are referred to under Articles 31 and 32 VCLT can be applied to elucidate the object and purpose of an IIA,¹⁶⁷ a common practice among tribunals is to refer to the preamble of treaties,¹⁶⁸ which are integral parts of treaties.¹⁶⁹ The interpretive discretion of arbitrators in interpreting indirect expropriation "may be channeled into presumptions favouring foreign investors or states in the face of ambiguity in investment treaties".¹⁷⁰ On the one hand, some tribunals such as *SGS v.*

162 See, for instance, *Tecmed v. Mexico*, n37, para. 149; *Thunderbird v. Mexico*, n 45, para. 147.

163 Sornarajah, n70, p. 466.

164 *Ibid.*, pp. 464–465.

165 Cotula, n10, p. 285.

166 Draft EU-Singapore Free Trade Agreement (Version of June 2015).

167 Bücheler, n11, p. 157.

168 See for instance, *Siemens A. G. v. Argentina* (*Siemens v. Argentina*), Decision on Jurisdiction (2004), ICSID Case No ARB/02/8, para. 81; Bücheler, n11, p. 158.

169 VCLT, Art. 31 (2); Frank A Engelen, *Interpretation of Tax Treaties under International Law* (2004) p. 187; Max H Hulme, "Preambles in Treaty Interpretation" 164 *University of Pennsylvania Law Review* (2016) p. 1342.

170 Gus Van Harten, "Leaders in the Expansive and Restrictive Interpretation of Investment Treaties: A Descriptive Study of ISDS Awards to 2010", 29 (2) *European Journal of International Law* (2018) p. 507.

Philippines and *Siemens v. Argentina* took an investor friendly approach;¹⁷¹ the latter, guided by the preamble and title of the treaty, interpreted the intention of the parties as “to create favorable conditions for investments and to stimulate private initiative”.¹⁷² On the other hand, in a number of cases such as *Saluka v. Czech Republic*, the tribunals noted that the protection of foreign investment is not the end goal of the Treaty but rather it is “a necessary element alongside the overall aim of encouraging foreign investment and extending and intensifying the parties’ economic relations”.¹⁷³

A preambular reference to public welfare objectives such as sustainable development or environmental protection goals in an investment treaty,¹⁷⁴ may function as a signal to arbitrators to note the transition of investment treaties’ concern from mere investor protection to modest integrated instruments in which host states’ public welfare objectives are integrated.¹⁷⁵ In *Hamadi Al Tamimi v. Oman* the parties’ desire to strengthen the development and enforcement of environmental laws and policies, which was expressed in the preamble, amounted to “a further clear indication by the State parties that the Treaty is to be interpreted to give effect to the objectives of environmental protection and conservation”.¹⁷⁶ However, while the preambular reference to the treaty’s purpose is encouraged, it may not be deemed as a vital element for restraining arbitrators’ interpretive discretion, since the objective of treaty

171 The Tribunal in *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines* (*SGS v. Philippines*), Final Award (2004), ICSID Case No. ARB/02/6, para. 116 noted that “it is legitimate to resolve uncertainties in its interpretation so as to favour the protection of covered investments”; *Siemens v. Argentina*, n168, para. 81. *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Chile* (*MTD v. Chile*), Award (2004), ICSID Case No. ARB/01/7, para. 104. See also, Tarcisio Gazzini, *Interpretation of International Investment Treaties* (2016) pp. 165–166.

172 *Siemens v. Argentina*, n168, para. 81. See Anne Van Aaken, “Fragmentation of International Law: The Case of International Investment Protection”, xvii *Finnish Yearbook of International Law* (2008) p. 322.

173 *Saluka v. Czech Republic*, n9, para. 300. See also, *El Paso v. Argentina*, n26, para. 70; *Pan American Energy LLC and BP Argentina Exploration Company v. Argentine Republic*, Decision on Preliminary Objections (2006), ICSID Case No. ARB/03/13, para. 99; Bücheler, n11, p. 159; Van Aaken, n172 p. 333.

174 Van Duzer, n132, p. 562; Diepeveen R, Levashova Y and Lambooy T, “Bridging the Gap between International Investment Law and the Environment, 4th and 5th November, The Hague, The Netherlands”, 30 (78) *Utrecht Journal of International and European Law* (2014) p. 149.

175 Gehring and Kent, n52, p. 190; Bücheler, n11, p. 159; cf., Treaty Between the Federal Republic of Germany and [] Concerning the Encouragement and Reciprocal Protection of Investments (2008), Art. 4.

176 *Adel Hamadi Al Tamimi v Sultanate of Oman* (*Hamadi Al Tamimi v. Oman*), Award (2015), ICSID ARB/11/33, 2015, fn., 777. Gazzini, n171, pp. 157–158.

cannot alter the treaty text.¹⁷⁷ Therefore, the inclusion of a more elaborated indirect expropriation provision clauses are a more crucial factor for restricting the arbitrators' interpretative discretion. The Tribunal's statement in *US Federal Reserve Bank v. Iran* illustrates this proposition:

Even when one is dealing with the object and purpose of a treaty, which is the most important part of the treaty's context, the object and purpose does not constitute an element independent of that context. The object and purpose is not to be considered in isolation from the terms of the treaty; it is intrinsic to its text.¹⁷⁸

It is worthwhile mentioning that, based on Article 31(3)(c) VCLT, any rules of international law applicable in the relations between the parties shall be taken into account, together with the context. The ILC's report addresses the function of Article 31(3)(c) VCLT as including the expression of the systematic character of international rules.¹⁷⁹ Systemic integration directs tribunals to broaden their interpretive perspective to the content of international law more generally.¹⁸⁰

The contentious issues that arise in the application of international rules as tools of interpretation, revolve around the extent to which the provision operates:

- 1 whether the international rule has to be comparable to the investment treaty;
- 2 whether the has to be relevant and applicable to all parties in the investment treaty in dispute;

177 *In Société Générale v Dominican Republic*, Award on Preliminary Objection to Jurisdiction (2008), LCIA Case No UN. 7927, para. 32 the Tribunal stated that the preamble "sets out the general purposes and objectives of the Treaty but (...) cannot add substantive requirements to the provisions of the Treaty"; see also, *Total v. Argentina*, n97, para. 116. See also Gazzini, n171, p. 158; Gardiner, n159, p. 219.

178 *USA, Federal Reserve Bank v. Iran, Bank Markazi*, Case A28, 36 Iran-US claims Tribunal Reports 5 (2000–2002) para. 58; see also, Gardiner, n159, p. 219.

179 ILC, "Report of the International Law Commission" (58th Session, 1 May–9 June and 3 July–11 August 2006) UN Doc A/61/10, p. 413, paras. 17–23; ILC, "Report of the Study Group on Fragmentation of International Law: Difficulties Arising from the Diversification and Expansion of International Law" [hereinafter 'Preliminary Report of ILC Study Group'] (29 July 2005) UN Doc A/CN.4/L.676, p. 211, para. 420.

180 See *Saluka v. Czech Republic*, n9, para. 254; *Total v. Argentina*, n89, paras. 126–127; *Ioannis Kardassopoulos v Georgia*, Decision on Jurisdiction (2007), ICSID Case No ARB/05/18, para. 208; *Ambiente Ufficio S.p.A and others v. Argentine Republic*, Decision on Jurisdiction and Admissibility (2013), ICSID Case No ARB 08/9, para. 600. See also Preliminary Report of ILC Study Group, n179, p. 11, para. 27.

- 3 “whether the applicable rules of international law are to be determined as at the date on which the treaty was concluded, or at the date on which the dispute arises”¹⁸¹

The jurisprudential responses regarding the application of Article 31(3)(c) are inconsistent. While the second mentioned point “does not seem to be of great magnitude in the field of foreign investment due to the bilateral nature of most investment treaties”,¹⁸² the first and last issues have been considered more contentious in the context of investment- treaty related claims.¹⁸³

Firstly, Article 31(3)(c) should not be used as a tool for policing states’ compliance with other sources of international law.¹⁸⁴ Secondly, “a treaty is capable of modifying the rules of customary international law that would otherwise be applicable as between the States parties to the treaty”.¹⁸⁵ In addition, it is more convincing to interpret CILs prevailing at the time of interpretation or of the alleged violation of the treaty.¹⁸⁶ Disregarding the evolution of the extraneous international rules, seems to be at odds with the very function of Article 31(3)(c) VCLT as an instrument to serve the systemic integration of international law.¹⁸⁷ Finally, “Article 31(3)(c) assists interpreters to establish the meaning of the treaty at stake in light of extraneous international rules.”¹⁸⁸ *Philip Morris v. Uruguay* demonstrates how the Tribunal’s reasoning in identifying indirect expropriation suffers from lack of internal consistency. Ranjan criticises the Tribunal for ‘laying down two different conceptions of the police powers rule’.¹⁸⁹

181 Campbell McLachlan, “The Principle of Systemic Integration and Article 31 (3)(c) of the Vienna Convention”, 54 *International and Comparative Law Quarterly* (2005) 290, p. 291.

182 Gazzini, 1171, pp. 119–220. See *Glamis Ltd v. United States of America (Glamis v. US)*, Award (2009), UNCITRAL IIC 380, para. 84 and *Hashem Talaat Al Warraq v. the Republic of Indonesia*, Award (2014), UNCITRAL, para. 562.

183 Gazzini, 1171, p. 217.

184 *Ibid.*, p. 218.

185 *Azurix v. Argentina*, n30; *ADC Affiliate Limited and ADC&ADMC Management Limited v. Republic of Hungary (ADC v. Hungary)*, Award (2006), ICSID Case No ARB/03/16, para. 481.

186 Gazzini, 1171, p. 215; ILC, “Reports of the International Law Commission on the second part of its seventeenth session and on its eighteenth session”, in *Yearbooks of the International Law Commission* (1966–11) UN Doc No. A/6309.Rev 1, p. 222, para. 16. Cf. *Siemens v. Argentina*, n168, para. 293. In that case the Tribunal interpreted the text of the treaty in light of the CIL in force at the time of conclusion of the treaty. See also *Mondev International Ltd v. United States of America*, Award (2002), ICSID Case No. ARB(AF) 99/2, para. 125.

187 ILC, “Reports of the International Law Commission on the second part of its seventeenth session and on its eighteenth session”, n186, p. 222, para. 16; Ranjan, n18, p. 104.

188 Gazzini, 1171, p. 214; Ranjan, n18, p. 119.

189 Ranjan, n18, p. 113.

(Rule I: based on the sole effect doctrine) and (Rule II: using Article 31 (3)(c) VCLT as a tool for interpreting the treaty provision in light of the CIL rule of police powers) and the failure to identify the police powers rule precisely". In addition, the author critiques the Tribunal's reliance on Article (3)(c) VCLT as a gateway "to incorporate an extraneous rule into the treaty and apply it directly to the facts at hand, rather than contextualizing it according to the treaty".¹⁹⁰

Although the suggestion to codify the nuanced approach of the police powers doctrine is unable to solve all issues surrounding the unpredictability of investor-state tribunals' awards in identifying indirect expropriation, a legislative response restricts tribunals' broad interpretive discretions and leaves more space for states to enforce their public policies. Nevertheless, as it is discussed in section 6, there is still room for development in states' legislative responses. The subsequent two subsections, take a closer look into the effects of the nuanced approach of the police powers doctrine on the burden of proof and the FDI, respectively.

5.2 *The Effect of the Nuanced Approach of the Police Powers Doctrine on the Burden of Proof*

A wealth of investor-state tribunals' reference to the principle of *onus probandi actori incumbit* illustrates that the party that submits an event took place has the burden to prove its claim.¹⁹¹ As the Tribunal in *AAPL v. Sri Lanka* clarified,¹⁹² the term *actor* in the principle should be interpreted as the real claimant in the view of the issue(s) involved.¹⁹³ Therefore, in the context of investor-state disputes, the burden of proof can be either on the foreign investor or host state, depending on who makes the specific allegation.

There are circumstances where the burden of proof shifts to the other party. The recognition of whether this shift occurs is the matter of dispute among investor-state tribunals. For instance, in *Thunderbird v. Mexico*,¹⁹⁴ the Tribunal's strict adherence to the principle of *onus probandi actori incumbit* placed the burden of proving the breach of the non-discrimination requirement, under Article 1102 NAFTA, *fully* on the investor. In *Pop & Talbot* and *Feldman*,¹⁹⁵ the

¹⁹⁰ Ibid., pp. 119–120.

¹⁹¹ *Apotex Holdings Inc and Apotex Inc v. United States*, Award (2014), ICSID Case No ARB(AF)/12/1, Part VIII, para. 8.8; See also *Feldman v. Mexico*, n77, para. 177.

¹⁹² *AAPL v. Sri Lanka*, Award (1990), ICSID Case No ARB/87/3, para. 56.

¹⁹³ Nathan D O'Malley, *Rules of Evidence in International Arbitration: An Annotated Guide* (2019), para. 7.19.

¹⁹⁴ *Thunderbird v. Mexico*, n45, para. 175.

¹⁹⁵ *Feldman v. Mexico*, n77, para. 184; *Pop & Talbot v. Canada*, n19, para. 78.

investors, by establishing presumption and a *prima facie*¹⁹⁶ case, successfully shifted the burden of proof to the host states, which had to justify the alleged violation of Article 1102 NAFTA on legitimate public policy grounds.¹⁹⁷

The similar issue on the allocation of the burden of proof also emerges with respect to indirect expropriation claims emanating from states' police powers. It is unclear whether the host state's invocation of the doctrine in response to a claim of indirect expropriation shift the burden of proof onto itself. If one considers the police powers doctrine as an "exception", the burden of proving indirect expropriation shifts to the host state, whereas if it is regarded as a "principle" the burden remains for the investor. However, the investor-state tribunals' diverse perceptions on the nature and the extent of states' police powers has led to the lack of clarity.¹⁹⁸

In *Burlington v. Ecuador*,¹⁹⁹ the Tribunal perceived the police powers doctrine as a justification: it noted that to prove there is an indirect expropriation, it has to be shown that there is substantial deprivation of investment, on a permanent basis, and there is no justification under the police powers doctrine. In *Saluka v. Czech Republic*, however, the Tribunal referred to the police powers doctrine both as an exception and principle.²⁰⁰ This ambiguity and inconsistency is also manifest in *Suez v. Argentina*, in which the Tribunal considered states' police powers as an exception to expropriation but, later, the similar composition of arbitrators referred to the doctrine as a principle.²⁰¹ This issue was extensively discussed in *Servier v. Poland*:²⁰² the Claimant contended that the police powers doctrine is an exception, hence, the burden of proof shifts to Poland to justify the alleged expropriation.²⁰³ The Tribunal, however, took the opposite approach and held that since the Respondent had presented

196 *Prima facie* is considered as proof that is sufficient to establish the contention unless contradictory evidence proves otherwise. See D O'Malley, n193, para. 7.31.

197 In *Feldman v. Mexico*, n177, para. 177 the Tribunal noted that "if that party adduces evidence sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption".

198 Jorge E Viñuales, "Sovereignty in Foreign Investment Law", in Z. Douglas, J. Pauwelyn and J.E. Viñuales (eds.), *The Foundations of International Investment Law: Bringing Theory into Practice* (2014) pp. 331–336. See also, ILC, "Draft Articles on Responsibility of States for Internationally Wrongful Acts, with commentaries", Vol. 11 *Yearbook of the International Law Commission* (2001), Part Two, p. 72, para. 8.

199 *Burlington v. Ecuador*, n26, paras. 472–485.

200 *Saluka v. Czech Republic*, n9, paras. 254, 258 and 262; Viñuales, n198, p. 337.

201 *Suez v. Argentina*, n26, paras. 116, 148–51.

202 *Les Laboratoires Servier v. Republic of Poland (Servier v. Poland)*, Award (2012), UNCITRAL.

203 *Ibid.*, paras. 280–281. The Claimants submitted that state must demonstrate that the measure in question was (1) reasonable; (2) non-discriminatory; (3) proportionate to the public interest to be protected; and (4) adopted in good faith."

prima facie justifications for its measures by establishing a reasonable connection between its actions and its public policy objective, “it would not require the Respondent to ‘prove the negative’ in the sense of demonstrating an absence of bad faith and discrimination, or the lack of disproportionateness in the measures”.²⁰⁴ Therefore, “the burden then falls onto the Claimants to show that Poland’s regulatory actions were inconsistent with a legitimate exercise of Poland’s police powers”.²⁰⁵ In a number of cases,²⁰⁶ the claimants proved that the measure in dispute failed to meet domestic law due process guarantees; hence, the Tribunals did not consider the measures at stake within the scope of the respondents’ police powers.²⁰⁷

Although deference to host states should not be interpreted as the freedom of states to take any measure under the shield of exercising police powers, “considering such a power to regulate as an exception would be at odds with the principle that limitations of sovereignty are not to be presumed”.²⁰⁸ The new wave of states’ legislative responses, as discussed in this section, is compatible with this approach since based on the treaty examples mentioned above, those “clauses do not provide an excuse for non-performance of the investment obligation”.²⁰⁹ They rather provide clarifications on the extent of the regulatory powers of states. Hence, the claimant bears the burden of proving the host states’ failure to act within its police power; and if the claimant produces sufficient evidence for such a showing, the burden then shifts to the state.

²⁰⁴ Ibid. para. 583. In *ADC v. Hungary*, n185, para. 359 the Tribunal required the state to establish a genuine link between the measure and public interest.

²⁰⁵ In *Servier v. Poland*, n202, para. 584 the Tribunal further noted that “if the Claimants produce sufficient evidence for such a showing, the burden then shifts to Poland to rebut it”.

²⁰⁶ *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt (Middle East Cement v. Egypt)*, Award (2002), ICSID Case No. ARB/99/6; *Quiborax v. Bolivia*, n181; *Vestey Group Ltd v. Bolivarian Republic of Venezuela (Vestey v. Venezuela)*, Award (2016), ICSID Case No. ARB/06/4.

²⁰⁷ August Reinisch, *Standards of Investment Protection* (2008) p. 193.

²⁰⁸ Viñuales, n198, p. 337. See also *SS Wimbledon (UK v. Japan)*, PCIJ (1923), Series A, No. 1, pp. 24–5; *SS Lotus (France v. Turkey)*, PCIJ (1927), Series A, No. 10, p. 18; *Free Zones of Upper Savoy and the District of Gex (France v. Switzerland)*, PCIJ (1932), Series A/B, No. 46, p. 167.

²⁰⁹ Alessandra Asteriti, “Waiting for the Environmentalists: Environmental Language in Investment Treaties”, in R. Hoffman and C. Tams (eds.), *International Investment Law and Its Others* (2012), pp. 120–121. See also Pellet Alain, “Police Powers or the State’s Right to Regulate: *Chemtura v. Canada*”, in M. Kinnear, G.R. Fischer, J.M. Almeida, L.F. Torres and M.U. Bidegain (eds.), *Building International Law Investment Law* (2016) pp. 461–462; See also Federico Ortino, “Defining Indirect Expropriation: The Transatlantic Trade and Investment Partnership and the (Elusive) Search for ‘Greater Certainty’”, 43 (4) *Legal Issues of Economic Integration* (2016) pp. 361–362.

5.3 *Does Codifying the Nuanced Approach of the Police Powers Affect FDI Inflows?*

Arguably, an investment treaty may lose its attractiveness when the right to compensation is restricted to host states' police powers. However, it is established that "the net impact of a BIT in attracting FDI remains non-significant, or even negative".²¹⁰ In fact, foreign investors are more concerned about the existence of strong institutions in host states where their legitimate expectations are protected with due regard, rather than having an ambiguous right which may be subjected to inconsistent interpretations by tribunals.²¹¹ This conclusion is also supported by the common understanding across the US environmental and industry representatives during the US-Subcommittee negotiation 2004 concerning Annex B of the US Model BIT. On the one hand, the environmental representatives were insisting on affording a more policy space to the government, on the other, the industry representatives were opposing changes, arguing that the 2004 model BIT weakens the position of American investors investing abroad.²¹² Nevertheless, both Sub-Committees believed that "an important factor in facilitating foreign investment is the presence of a regulatory framework that is transparent, stable, predictable and secure".²¹³

6 Best Practice

In order to leave more policy space for host states, albeit with a minimum adverse effect on states' FDI inflows, a more elaborate formulation of indirect expropriation is an imperative starting point. In recent years, states have been more attentive in drafting their IIAs and a more or less similar indirect expropriation Annexes to the US and Canadian model BITs are drafted. While the states' recent efforts are appreciable, a mere codification of the nuanced approach of the police powers is not a sufficient solution.

As stated above, one of the issues is that it is not clear what situations fall under 'except in rare circumstances'; there are two alternative solutions. Firstly, states can enact a list of determinative elements that constitute rare circumstances. The Annex formulations in both the Canada-Mali BIT and

²¹⁰ Mary Hallward-Driemeier, "Do bilateral investment treaties attract foreign direct investment? Only a bit – and they could bite", in K.P. Sauvant and L.E. Sachs (eds.), *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (2009) p. 368.

²¹¹ *Ibid.*, p. 351; Mostafa, *supra* note 112, p. 268.

²¹² US Sub-Committee Report 2004, n53, pp. 2, 6.

²¹³ *Ibid.*, p. 4.

TTIP draft BIT (see section 5.2) are, to some extent, in line with this approach. Alternatively, similar to the ACIA, states can exclude the possibility of any exception to their police powers, which in turn provides greater certainty for both host states and foreign investors. However, in order to make a balance between host states' regulatory space and interests of foreign investors, states can be more precise on the 'nature' of measures that fall under their police power.²¹⁴ Although this solution would narrow states' police powers, both host states and foreign investors would be certain that it is impossible to claim for compensation with respect to non-discriminatory governmental regulations which have the specified nature.

The other reason for the inconsistency in investor-state tribunals' methodology in identifying indirect expropriation lies in the absence of a formal rule of *stare decisis*; investor-state tribunals are "free to choose from a range of competing juridical approaches".²¹⁵ An aspirational suggestion would be to establish a central appellate body. The presence of an appellate body, similar to the World Trade Organization (WTO) system, could lead to more consistency and predictability regarding arbitral awards. However, the establishment of an appellate body in investor-state jurisprudence is unlikely to occur in the near future.²¹⁶ A less far-reaching solution for states is to equip themselves with binding interpretive powers. A familiar example is the NAFTA Free Trade Commission (FTC), which is composed of "cabinet-level representatives"²¹⁷ from each NAFTA country. When there is a dispute regarding interpretation or application of a NAFTA provision, the three parties can resolve the dispute by providing a binding interpretation to the Tribunal.²¹⁸ This solution grants state parties more control over tribunals' treaty interpretation²¹⁹ and due to its

²¹⁴ Nikiéma, n16, p. 21.

²¹⁵ Kurtz, n58, p. 769; Tienhaara, n11, p. 2.

²¹⁶ Lucy Reed and Christine Sim, "Potential Investment Treaty Appellate Bodies: Open Questions Foreign", 32 (3) *Foreign Investment Law Journal* (2017) p. 691; Mark Huber and Greg Tereposky, "The WTO Appellate Body: Viability as a Model for an Investor-State Dispute Settlement Appellate Mechanism", 32 (3) *Foreign Investment Law Journal* (2017) p. 545.

²¹⁷ NAFTA, n6 Art. 2001(1).

²¹⁸ *Ibid.*, Arts. 2001 (2) (c) and 1131 (2). Since investment-related provisions can also be found in Free Trade Agreements (FTAs), the role of the Commissions of the State parties created under FTAs on investment related disputes deserves consideration, see Amokura Kawharu, "Punctuated Equilibrium: The Potential Role of FTA Trade Commissions in the Evolution of International Investment Law", 20 (1) *Journal of International Economic Law* (2017) p. 87. The Author analyses in detail the role of Free Trade Commissions in enhancing states' decision-making power within the international investment regime.

²¹⁹ Bücheler, n11, pp. 156–57.

potential *de facto* precedential value, it generates more consistency and predictability in arbitral awards.²²⁰ Nevertheless, states should bear in mind to not to make an amendment to exportation provisions through their interpretation since their amendment may refute foreign investors' legitimate expectations.²²¹

7 Conclusion

There is no precise definition of indirect expropriation. The absence of attentive drafting regarding indirect expropriation clauses opens the door to a wide range of arbitral interpretations. In fact, the responsibilities placed on investor-state tribunals to identify indirect expropriation are inversely proportional to the clarity of the treaties. Although in investor-state jurisprudence there is a tendency towards the application of a more nuanced approach of the police powers doctrine and proportionality test respectively, there is still no established method in investor-state jurisprudence for identifying indirect expropriation.

The inconsistency and unpredictability in investor-state tribunals' methods for identifying indirect expropriation and the lack of enough policy space for host states is a challenge. On the one hand, sovereign states' insistence on enforcing their legitimate objectives entails the financial risk involved in proceedings to arbitrations. On the other, if states settle a dispute at the cost of not enforcing their public policy, they undermine their measure. The resulting chilling effect of indirect expropriation provisions on states' public policies means that while foreign investors can potentially contribute to host states' development, the absence of an attentive formulation in defining indirect expropriation can transform the investors' presence in host countries into a threat to the common good.

On the basis of the analyses on the proportionality test and the nuanced approach of the police powers doctrine, the present paper calls for a legislative response along the lines of the latter. It argues that states' legislative responses are not without shortcomings; but they can leave more policy space for host states and provide consistency and predictability in investor-state arbitral awards.

220 Gabriel Kaufmann-Kohler, "Interpretative Powers of the Free Trade Commission and the Rule of Law", in E. Gaillard and F. Bachand (eds.), *Fifteen Years of NAFTA Chapter 11* (2011), p. 187.

221 *Ibid.*, p. 188.

This paper provides effective solutions based on states' best practices, which can be adopted by *all* states, including those that have already taken a legislative response. It argues that although a contextual interpretation can potentially alleviate the issue regarding the interpretation of 'except in rare circumstances', the following solutions can rectify the shortcomings that may arise from interpreting the phrase. Firstly, states can introduce a list of determinative elements that constitute rare circumstances. Alternatively, states can be more precise on the 'nature' of measures that fall under their police power. In order to ensure more consistency and predictability with respect to indirect expropriation awards, an aspirational suggestion would be to establish a central appellate body. However, a less far-reaching solution for states would be to equip themselves with binding interpretive powers.

Broadly worded indirect expropriation clauses lie at the root of the chilling effect of indirect expropriation claims on states' public policies, which can be both attributed to states on the one hand, due the formulation of their indirect expropriation clauses, and investor-state arbitrators, on the other, for their failure to stick to a certain method of identifying indirect expropriation. As a result, this paper calls upon states to formulate an effective and unambiguous legislative response.

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