

# Externalization of Effective Legal Protection against Indirect Expropriation

## *Can the Legal Order of Developing Countries Live up to the Standards Required by International Investment Agreements? A Disenchanted Comparative Analysis*

Max GUTBROD\* and Steffen HINDELANG\*\*

### INTRODUCTION

In recent years, direct expropriation<sup>1</sup> has rarely been seen. States which wish to import capital do not like to be associated with posing a permanent, non-calculable threat to foreign-owned property but prefer to present themselves as places with very stable, reliable and orderly regulatory environments.<sup>2</sup> Expropriation, however, has by no means vanished; its execution has just become more subtle. Ambiguous or generously worded laws are “interpreted” in the way that suits certain groups in the government or only enforced when it suits a particular interest; administrative discretion is influenced by factors unrelated to the matter at issue, or administrations fail to conduct

---

\* Dr. jur. (Munich), Rechtsanwalt (German lawyer); Partner at Baker & McKenzie, Moscow. The author has advised on many investments being made in emerging markets as well as some international arbitration proceedings.

He may be contacted at [mmax.gutbrod@bakernet.com](mailto:mmax.gutbrod@bakernet.com).

\*\* Ref. jur. (Marburg), LL.M. (Sheffield); Research Fellow, Lecturer and Doctoral Candidate, Eberhard-Karls-University, Tübingen, Germany, Faculty of Law. His research is mainly directed towards the International and EC Legal Framework on Foreign Investment. The author thanks the Working Committee of the Research Assistants in Public Law at the University of Tübingen, Law School for helpful comments on earlier drafts of this article; the participants of the joint seminar on international investment law of the Universities of Kiel and Salzburg in November 2005 in London, organized by Professor Geistlinger and Professor Trunk, for valuable criticism; as well as Ms Bormann and Mr Wahlen for proofreading.

He may be contacted at [st.hi@gmx.de](mailto:st.hi@gmx.de).

<sup>1</sup> In a nutshell, direct expropriation is the compulsory transfer of legal title or the outright seizure of property by the State. In contrast, indirect expropriation refers to the situation in which the investor formally remains legal owner. See, instead of all, Sornarajah, M., *The International Law on Foreign Investment*, 2nd edition, 2004, p. 344, with further references. See generally, Brower, Charles Nelson / Brueschke, Jason D., *The Iran-United States Claims Tribunal*, 1998, p. 379; Christie, George C., *What Constitutes a Taking of Property under International Law?* 38 B.Y.I.L. (1962), pp. 307 *et seq.*, at p. 309; Comeaux, Paul / Kinsella, Stephen, *Protecting Foreign Investment under International Law: Legal Aspects of Political Risk*, 1997, p. 8; Mouri, Allahyar, *The International Law of Expropriation as Reflected in the Work of the Iran-U.S. Claims Tribunal*, 1994, pp. 70 *et seq.*; Schreuer, Christoph, *The Concept of Expropriation under the ECT and other Investment Protection Treaties*, *Transnational Dispute Management*, Vol. 2, Issue 3, June 2005, available at [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) (last visited 7 September 2005); Weston, Burns H., *International Law and the Deprivation of Foreign Wealth: A Framework for Future Inquiry*, in Falk, Richard A. / Black, Cyril (eds.), *The Future of the International Legal Order, Vol. 2: Wealth and Resources*, 1970, pp. 36 *et seq.*, at p. 106; Whiteman, Marjorie M., *Digest of International Law*, U.S. Government Printing Office, Washington, D.C., 1963–1973, Vol. 8, 1976, pp. 1006–1020.

<sup>2</sup> Reisman, Michael W. / Sloane, Robert D., *Indirect Expropriation and its Valuation in the BIT Generation*, 74 B.Y.I.L. (2003), pp. 115 *et seq.*, at p. 118.

their processes in a transparent and comprehensible way. All these measures, turned against a foreign investor, can easily drive him out of business. Virtually all bilateral investment treaties (BITs) and multilateral investment agreements (MITs), therefore, reflect this development and also cover acts of State which may expropriate “indirectly through measures tantamount to expropriation or nationalisation”<sup>3</sup> (indirect expropriation<sup>4</sup>). Moreover, many international investment agreements (IIAs) not only provide rules on (indirect) expropriation but also establish so-called treatment standards “which refer to the legal regime that applies to investments once they have been admitted by the host State”.<sup>5</sup> Administrative malfeasance, misfeasance and nonfeasance may also affect the investment adversely without amounting to “indirect expropriation”, being a rather less intense interference with the property. Indeed, there are arbitral awards which, while not accepting a claim based on “indirect expropriation”, established a compensable violation of “treatment standards”, i.e. in particular the “fair and equitable treatment” embodied in BITs or MITs.<sup>6</sup>

<sup>3</sup> Article III(1) of the Treaty between the United States of America and the Russian Federation concerning the Encouragement and Reciprocal Protection of Investment, signed 17 June 1992, not yet in force; available at: [www.unctad.org/sections/dite/ia/docs/bits/usa\\_russia.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/usa_russia.pdf) (last visited 29 August 2005). See also Article III of the Abs-Shawcross Draft Convention on Investment Abroad of 1959, United Nations Conference on Trade and Development (UNCTAD), *International Investment Instruments: A Compendium*, Vol. v, 2001, p. 396; Article 10(3)(a) of the Harvard Draft Convention of 1961, in Sohn, Louis B. / Baxter, Richard R., *Responsibility of States for Injuries to the Economic Interests of Aliens*, 55 A.J.I.L. (1961), pp. 545 *et seq.*, at p. 553; Protocol No. 1 of the European Convention for the Protection of Human Rights and Fundamental Freedoms of 1952, available at [www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf](http://www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf) (last visited 11 August 2005); Article 3 of the Draft Convention of the Organisation for Economic Co-operation and Development (OECD) on the Protection of Foreign Property of 1967, in UNCTAD, *International Investment Instruments: A Compendium*, Vol. II, 1996, p. 114; Article 21 of the American Convention on Human Rights of 1969, available at [www.oas.org/juridico/english/Treaties/b-32.htm](http://www.oas.org/juridico/english/Treaties/b-32.htm) (last visited 1 September 2005); American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States*, Vol. 2, 1986, §712(1); OECD Negotiating Group on the Multilateral Agreement on Investment (MAI), *The Multilateral Agreement on Investment Draft Consolidated Text*, OECD Doc. DAFFE/MAI(98)7/REV1, 22 April 1998, available at [www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf](http://www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf) (last visited 1 September 2005); Article 13(1) of the Energy Charter Treaty (ECT), available at [www.encharter.org](http://www.encharter.org) (last visited 7 September 2005); Article 1110 of the North American Free Trade Agreement (NAFTA) of 1992, available at [www.nafta-sec-alena.org/DefaultSite/index\\_e.aspx?DetailID=78](http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=78) (last visited 7 September 2005).

<sup>4</sup> From an analytical point of view, one can distinguish between “creeping” and “consequential expropriation”. “Creeping” expropriation is comprised out of a number of elements, none of which can—separately—constitute the international wrong.” Reisman, Michael W. / Sloane, Robert D., *Indirect Expropriation and its Valuation in the BIT Generation*, 74 B.Y.I.L. (2003), at pp. 123, 125–127. Intention to harm the investment or the investor or an intention to expropriate is not necessary but helps to prove a creeping expropriation; Reisman, Michael W. / Sloane, Robert D., *Indirect Expropriation and its Valuation in the BIT Generation*, 74 B.Y.I.L. (2003), pp. 115 *et seq.*, at pp. 124, 128. See also Schachter, Christoph, *The Concept of Expropriation under the ECT and other Investment Protection Treaties*, *Transnational Dispute Management*, Vol. 2, Issue 3, June 2005; available at: [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) (last visited 6 September 2005). “Consequential expropriation” refers to the situation in which the host State fails to properly create, maintain and manage “the legal, administrative, and regulatory normative framework contemplated by the relevant BIT, an indispensable feature of the ‘favourable conditions’ for investment.” Reisman, Michael W. / Sloane, Robert D., *Indirect Expropriation and its Valuation in the BIT Generation*, 74 B.Y.I.L. (2003), pp. 115 *et seq.*, at pp. 129, 130. Here, also, an intention on the part of the host State is not required. Reisman, Michael W. / Sloane, Robert D., *Indirect Expropriation and its Valuation in the BIT Generation*, 74 B.Y.I.L. (2003), pp. 115 *et seq.*, at p. 129.

<sup>5</sup> Dolzer, Rudolf / Stevens, Margrete, *Bilateral Investment Treaties*, 1995, p. 58.

<sup>6</sup> Many BITs provide in rather repetitive wording not only for “fair and equitable treatment” but also for “full protection and security” and prohibit “unreasonable or discriminatory measure in the course of management, maintenance, use, enjoyment or disposal of investments”; Article 2(2) of the Agreement between The Government of the United Kingdom of Great Britain and Northern Ireland and The Union of Soviet Socialist Republics concerning the promotion and reciprocal protection of investments, signed 6 April 1989, entered into force 3 July 1991. In academic writing, much effort has been spent on the question of whether and how the concepts of “fair and equitable treatment”, “full protection and security” and “non-discrimination” are to be delimited from each other.