

**FROM EXPROPRIATION TO NON-EXPROPRIATORY STANDARDS OF  
TREATMENT: TOWARDS A UNIFIED CONCEPT OF AN INVESTMENT TREATY  
BREACH**

**by**

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## **ABSTRACT**

The principal objective of this thesis is to examine the scope of investment treaty protection against the host state's interference with foreign investment, and to identify the frontiers of state responsibility under international investment agreements in light of the decline of expropriation and the rise of non-expropriatory standards of treatment, including the standard of national treatment, fair and equitable treatment and umbrella clauses. In making a foray into the stormy relationship between the protection of foreign investment and the host state's freedom to intervene in the marketplace in the exercise of its regulatory functions, this study is embedded in the wider context of the ongoing debate about the design of the mechanism of investment protection as well as its function in practice. It is argued that the expropriation standard does not provide an adequate framework for determining investor claims against host states. The thesis puts forward a proposal to abandon expropriation and to adopt a unified standard of treatment based on the guarantees of non-discrimination, non-arbitrariness and due process of law.

**To my daughter Shirin, my mother, and in memory of Grandfather**

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## **LIST OF ABBREVIATIONS**

AF - Additional Facility  
ASEAN - Association of Southeast Asian Nations  
BIT - Bilateral Investment Treaty  
CAFTA DR - Central American Dominican Republic Free Trade Agreement  
ECHR - European Court of Human Rights  
ECT - Energy Charter Treaty  
FCN - Friendship, Commerce, and Navigation  
FET - Fair and Equitable Treatment  
FTA - Free Trade Agreement  
FTC - Free Trade Commission  
GA - General Assembly  
GATS - General Agreement on Trade in Services  
GATT - General Agreement on Tariffs and Trade  
ICC - International Chamber of Commerce  
ICJ - International Court of Justice  
ICSID - International Centre for Settlement of Investment Disputes  
ICSID Convention - Convention on the Settlement of Investment Disputes between States and Nationals of Other States (March 1965)  
ILC - International Law Commission  
MAI - Multilateral Agreement on Investment  
MFN - Most-Favoured-Nation  
MIGA - Multilateral Investment Guarantee Agency  
NAFTA - North American Free Trade Agreement  
NGO - Non-Governmental Organisation  
OECD - Organisation for Economic Cooperation and Development  
PCA - Permanent Court of Arbitration  
PCIJ - Permanent Court of International Justice  
UNCITRAL - United Nations Commission on International Trade Law  
UNCTAD - United Nations Conference on Trade and Development  
UNTS - United Nations Treaty Series  
VAT - Value Added Tax  
WTO - World Trade Organisation

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## INTRODUCTION

The prohibition of expropriation of foreign property has long been known as a key international guarantee and an integral part of the international minimum standard.<sup>1</sup> However, notwithstanding its established presence as one of the pillars of state responsibility for treatment of foreigners, the rules governing expropriation have remained among the most contested issues of international law.<sup>2</sup> Beneath both the early debates about compensation for expropriation and the more recent preoccupation with distinguishing between expropriation and a non-compensable regulatory action, one can discern the original disagreement on whether and in what circumstances a host state's interference with a foreigner's property would justify an international claim for monetary redress.<sup>3</sup> Although the expropriation debate

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<sup>1</sup> See G Schwarzenberger and ED Brown, *A Manual of International Law* (6<sup>th</sup> edn Professional Books Ltd 1976) 84 ('In general, it [the minimum standard] demands compliance by any subject of international law in its treatment of foreigners with the rule of law as understood in Western countries. In more specific terms, it means a modicum of respect for the life, liberty, dignity and property of foreign nationals, such as may be expected in a civilised community, freedom of judiciary from direction by the executive, unhindered access to the courts and reasonable means of redress in the case of manifest denial, delay or abuse of justice... In so far as the protection of the property of foreign nationals is concerned, the minimum standard of international law permits expropriation as distinct from confiscation. Expropriation means the transfer of ownership in a property to the state or one of its subordinate organs for reasons of public interest with prompt, effective and full (or adequate) compensation... Failure to comply with any of these conditions makes an otherwise legal expropriation and illegal confiscation and amounts to an international tort'). See also *de Sabla Claim (US v Panama)* (1933) 6 UNRIIA 358, 366 ('acts of a government depriving an alien of his property without compensation impose international responsibility'); Bin Cheng, *General Principles of Law as applied by International Courts and Tribunals* (CUP, Cambridge 1994) 47 ('Both as regards expropriation and requisition, the payment of compensation to the individuals who have been deprived of their property is now considered indispensable'); AP Fachiri, 'Expropriation and International Law' (1925) 6 *British Ybk Intl L* 159; WD Verwey and NJ Schrijver, 'The Taking of Property Under International Law: A New Legal Perspective?' (1984) *Netherlands Ybk Intl L* 3, 16-7.

<sup>2</sup> See, for example, *Barcelona Traction Company (Belgium v Spain)* (1970) ICJ Reps 3, 46-7, (the Court observing that 'no generally accepted rules in the matter have crystallized on the international plane'). More recently, see R Dolzer, 'Indirect Expropriations: New Developments?' (2002) 11 *NYU Envl LJ* 64, 68 (noting that 'the international takings doctrine is in disarray, the jurisprudence is inconsistent, and the results are often unpredictable').

<sup>3</sup> Even beyond the general resistance to the international minimum standard by Latin American and other nations, the existence of an international customary obligation to pay full compensation for an act of expropriation was at various stages doubted in academic writings. See, for example, F Williams, 'International Law and the Property of Aliens' (1928) 9 *British Ybk Intl L* 1 (contesting the validity of the proposition that expropriation should always be compensated and claiming that the right to compensation does not exist outside a treaty). For a further discussion, see BA Wortley, *Expropriation in Public International Law* (University Press, Cambridge 1959) 35-6. See also CF Amerasinghe, *State Responsibility for Injuries to Aliens* (Clarendon Press,

has at different stages focused on various aspects of state responsibility to foreign investors, an underlying question has persisted: is there a duty to compensate for governmental action affecting an investor's property and contractual rights?

It was the obligation to pay full, adequate and effective compensation, regarded by many as a precondition for the exercise by states of their sovereign rights, that triggered an historic opposition to the expropriation standard and the dispute as to its customary international law status.<sup>4</sup> Nevertheless, the prohibition of expropriation has survived notwithstanding an overwhelming resistance to it in the international arena.<sup>5</sup> Following fierce debates in the UN General Assembly which culminated in the adoption of landmark resolutions on the permanent sovereignty over natural resources and on the economic rights and duties of states,<sup>6</sup> the expropriation standard re-emerged in bilateral and multilateral

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Oxford 1967) 124 (discussing other authorities that have disputed the validity of the compensation requirement); also E Jiménez de Aréchaga, 'International law in the past third of a century' (1978) 159 *Recueil des Cours de l'Académie de Droit International* 1, 297-9 (arguing that once the right to expropriate is recognised, a duty to pay compensation would no longer be justified). More recently, see D Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (CUP, Cambridge 2008) 60 (noting that '[d]espite appeals to the "universal standards of civilization," there was no evidence that uniform constitutional standards existed with regard to property').

<sup>4</sup> The standard of prompt, adequate and effective compensation is usually referred as the Hull rule, which originated in a Note from the US Secretary of State, Cordell Hull, to the Mexican Government on 22 August 1938. For a critical discussion of the Hull rule on compensation see B Weston and F Dawson, 'Prompt, adequate, and effective': A Universal Standard of Compensation' (1961-1962) 30 *Fordham L R* 727.

<sup>5</sup> This historic opposition was earmarked as the demise of customary international law. See R Dolzer, 'New Foundations of the Law of Expropriation of Alien Property' (1981) 75 *AJIL* 553 (analysing international law on expropriation and the problem of sources which the opposition to the minimum standard on expropriation had brought about). See also PM Norton, 'A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation' (1991) 85 *AJIL* 474, 499-500 (observing that there were 'no unambiguously authoritative sources to cite or even an accepted rule of recognition by which to distinguish among sources').

<sup>6</sup> See e.g. the UN GA Resolution No 1803 (14 December 1962) and No 3281 (12 December 1984). For the impact of UN resolutions on the international law of expropriation, see HW Baade, 'Permanent Sovereignty over Natural Wealth and Resources', in RS Miller and RJ Stanger (eds) *Essays on Expropriation* (Ohio University Press, Ohio 1967); BH Weston, 'The Charter of Economic Rights and Duties of States and the Deprivation of Foreign-Owned Wealth' (1981) 75 *AJIL* 437; E Penrose, G Joffe, and P Stevens, 'Nationalisation of Foreign-Owned Property for a Public Purpose: An Economic Perspective on Appropriate Compensation' (1992) 55 *MLR* 351; J Arechaga, 'State Responsibility for Nationalization of Foreign-Owned Property' (1978) 11 *NYU J Intl L & P* 179. However, in some sources, the effect of UN Resolutions on the formation of international law was largely dismissed and the full compensation maxim re-asserted as a valid customary norm. See, for example, D Johnson, 'The Effect of the Resolutions of the General Assembly of the UN' (1955) 32 *British Ybk Intl L* 97; R Higgins, 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 *Recueil des Cours* 259; WD Verwey and NJ Schrijver, 'The Taking of Property Under International Law: A New Legal

investment treaties that outlawed an uncompensated deprivation of a foreign investment.<sup>7</sup> It has continued to hold sway decades later as states have increasingly assumed a greater interventionist role, and the focus of academic enquiry has shifted to expansionist trends in interpreting the standard.<sup>8</sup> Since the guarantee against expropriation was being expressly stipulated in international investment instruments, the question was no longer about the foundation of the right to compensation for expropriation, but rather concerned the scope of investment protection. The concept of an indirect or regulatory expropriation came to dominate legal discourse, prompting enquiry into the relationship between the protection against a host state's interference with foreign investment and a host state's freedom to regulate in such areas as environmental protection, public health, competition and human rights.<sup>9</sup>

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Perspective?' (1984) *Netherlands Ybk Intl L* 3; and Arbitrator Dupuy in *Texas Overseas Petroleum Co & California Asiatic Oil Co v Libyan Arab Republic* (1978) 17 ILM 1, 24.

<sup>7</sup> Although expropriation seems to be the most commonly used term in treaties, there are examples of different terminology, such as deprivation and dispossession. See UNCTAD, *Bilateral Investment Treaties 1995-2006: Trends in Investment Rule-Making* (United Nations, New York 2007) 45-6. See also BH Weston, "'Constructive Takings" under International Law: A Modest Foray into the Problem of "Creeping Expropriation"' (1975-1976) 16 *Va J Intl L* 103, 110 (criticising international law in this area for imprecise and ambiguous formulations).

<sup>8</sup> See, for example, S Subedi, 'The Challenge of Reconciling the Competing Principles within the Law of Foreign Investment with Special Reference to the Recent Trend in the Interpretation of the term "Expropriation"' (2006) 40 *Intl Law* 121; V Lowe, 'Regulation or Expropriation?' (2002) 55 *CLP* 447; V Been and J Beauvais, 'The Global Fifth Amendment? The NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine' (2003) 78 *NYU L Rev* 30; M Poirier, 'The NAFTA Chapter 11 Expropriation Debate Through the Eyes of a Property Theorist' (2003) 33 *Envtl L* 851. Prior to a first wave of critical opinion triggered by early NAFTA awards, the failure of the Draft Multilateral Agreement on Investment had shown that opposition by developing states was ceasing to be a major impediment. The creation of a multilateral investment protection regime came under attack from NGOs and civil society due to concerns about the effect of the proposed regime on the states' ability to regulate in a wider public interest. See P Muchlinski, 'The Rise and Fall of the Multilateral Agreement on Investment: Where Now?' (2000) 34 *Intl L* 1033.

<sup>9</sup> The recent award in *Glamis Gold Ltd v United States*, 14 May 2009 (Ad Hoc – UNCITRAL Arbitration Rules) provides an example of an investment dispute involving a clash between human rights (including the rights of indigenous people), environmental protection, and investment arbitration. The conflict between expropriation and the protection of the environment and public health has been at issue in a number of arbitral cases, including *Chemtura Corporation v Canada*, Award, 2 August 2010 (Ad hoc—UNCITRAL Arbitration Rules); *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345; *Técnicas Medioambientales Tecmed SA v Mexico*, Award, 29 May 2003 (ARB(AF)/00/2) 10 ICSID Rep 130; *Metalclad Corporation v Mexico*, Award, 25 August 2000 (ICSID Case No ARB (AF)/97/1) (2001) 40 ILM 36; *SD Myers Incorporated v Canada*, First Partial Award and Separate Opinion, 13 November 2000 (Ad hoc—UNCITRAL Arbitration Rules) (2001) 40 ILM 1408; *Ethyl Corporation v Canada*, Decision on Jurisdiction, 24 June 1998, 7 ICSID Reps 12. For discussion, see T Weiler, 'Balancing

Ironically, international investment agreements that had paved the way for the return of expropriation (albeit through the backdoor) into the international arena, have also led to the subsequent demise of the standard. Amidst the mounting awareness of the matter of reconciling investment protection with competing societal interests, the debate over the interpretation of expropriation has been overtaken by the growing attention to the emerging non-expropriatory standards of treatment, such as the fair and equitable treatment standard (hereinafter FET), the prohibition of arbitrary and discriminatory measures, national and most-favoured nation treatment and umbrella clauses. In a fast rising number of arbitral awards, claims of expropriation have been dismissed as lacking merit, with the claimant investors nevertheless being awarded large amounts in damages for breaches of non-expropriatory standards of treatment. Although states have continued to regulate and interfere with foreign investment, the number of successful expropriation claims have sharply fallen, giving way to alternative causes of action.

The principal objective of this study is to examine the scope of investment protection against the host state's interference with foreign investment, and to identify the frontiers of state responsibility under international investment agreements in light of the rise of non-expropriatory standards of treatment and the corresponding decline of expropriation. In particular, this thesis aims to analyse the existing approaches to determining a host state's

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Human Rights and Investor Protection: A New Approach for a Different Legal Order' (2004) 27 Boston College Intl & Comp L Rev 429; P Dupuy and F Francioni (eds), *Human Rights in International Investment Law and Arbitration* (OUP, Oxford 2009); A Al Faruque, 'Mapping the Relationship between Investment Protection and Human Rights' (2010) 11 J World Investment & Trade 539; A Kolo and T Waelde, 'Environmental Regulation, Investment Protection and "Regulatory Takings" in International Law' (2001) 50 ICLQ 811; A Cosbey, H Mann, L Peterson, and K Moltke, *Investment and Sustainable Development: A Guide to the Use and Potential of International Investment Agreements* (International Institute for Sustainable Development, 2004); P Kundra, 'Looking Beyond the Dabhol Debacle: Examining Its Causes and Understanding Its Lessons' (2008) 41 Vand J Transntl L 907; JC Kahn, 'A Golden Opportunity for NAFTA' (2008) 16 NYU Env L J 380; S Baughen, 'Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven (2006) 18 J Env L 207; H Hasic, 'Article 1110 of NAFTA: Investment Barriers to "Upward Harmonization" of Environmental Standards' (2005) 12 Southwestern J L & Trade Am 137; M Hirsch, 'Interactions between Investment and Non-investment Obligations' in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 155.

liability for interference with a foreign investment. When does a governmental action give rise to a host state's obligation to compensate the investor? In making a foray into the stormy relationship between the protection of foreign investment and the host state's freedom to intervene in the marketplace in the exercise of its regulatory functions, this study will be embedded in the wider context of the ongoing debate about the design of the instruments of investment protection as well as their function in practice. The inexorable rise of regulatory states, the institutionalisation of investor-state arbitration, and the spread of international investment treaties provide the backdrop against which the present contours of state responsibility in international law need to be examined. Some of the landmark developments that international investment law has undergone in the past two decades include the adoption of the North American Free Trade Agreement (hereinafter NAFTA), the Energy Charter Treaty (ECT) and regional free trade agreements, the rise in the number of investment treaties concluded among the former capital-importing countries, and the emergence of sovereign wealth funds as a new class of investors.<sup>10</sup> After investors started to mount claims against developed states such as Canada and the United States, the international community began to witness a retreat from rigorous investment protection policies. This has marked the end of the North-South divide and the return of the Calvo doctrine.<sup>11</sup> The global economic crisis has further accelerated the process of change by making protectionism a reality and prompting a revision of both neo-liberal economic policies and also of the role of the state in the regulation

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<sup>10</sup> See M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 68-9.

<sup>11</sup> For the return of the Calvo doctrine and the national treatment principle, see C Dugan, D Wallace Jr, N Rubins and B Sabahi, *Investor-State Arbitration* (OUP, Oxford 2008) 488 ('It is indeed ironic that the United States – long the leading opponent of the Calvo Doctrine – may now be considered its proponent, at least in regard to national treatment and indirect expropriation'); W Shan, 'From "North-South Divide" to "Private-Public Debate": Revival of the Calvo Doctrine and the Changing Landscape in International Investment Law' (2006-2007) 27 *NWJILB* 631; G Sampliner, 'Arbitration of Expropriation Cases Under U.S. Investment Treaties- A Threat to Democracy or the Dog that Didn't Bark?' (2003) 18 *ICSID Rev FILJ* 1; J McIlroy, 'Canada's New Foreign Investment Protection and Promotion Agreement: Two Steps Forward, One Step Back?' (2004) 5 *J World Investment & Trade* 621.



of national economies.<sup>12</sup> These developments have altered the landscape of international investment law and have influenced emerging approaches to delineating the scope of state responsibility towards foreign investors.

Despite the claim that international investment law is evolving into a coherent and homogenous system of norms,<sup>13</sup> a realistic assessment of investment arbitration and treaty practice points to the opposite conclusion. The interpretation and application of investment treaty standards by arbitral tribunals has been widely criticised for imbalance,<sup>14</sup> inconsistency,<sup>15</sup> lack of legitimacy<sup>16</sup> and ensuing uncertainty.<sup>17</sup> It is paradoxical that while

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<sup>12</sup> See generally M Sornarajah, 'The Neo-Liberal Agenda in Investment Arbitration: Its Rise, Retreat and Impact on State Sovereignty' in W Shan, P Simons and D Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart Publishing, Oxford 2008) 199.

<sup>13</sup> See S Schill, *The Multilateralization of International Investment Law* (CUP, Cambridge 2009).

<sup>14</sup> JE Stiglitz, 'Regulating Multinational Corporations: Towards Principles of Cross-Border Legal Frameworks in a Globalized World Balancing Rights with Responsibilities' (2008) 23 Am U Intl L Rev 45, 468 ('One problem of BITs is that they are one-sided and unbalanced: they give corporations rights without responsibilities, compensation for adverse treatment, but not recovery of capital gains from positive treatment. They also provide firms protections not afforded to domestic firms, thereby creating an unlevel playing field, with perverse incentives'); B Choudhury, 'Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to the Democratic Deficit?' (2008) 41 Vand J Transnatl L 775, 807 (noting that 'in an attempt to protect investors from states that hide behind public interest regulations as a disguise for protectionism, investment arbitration has moved too far away from the core rights that state sovereignty entails'); A Kaushal, 'Revisiting History: How the Past Matters For The Present Backlash Against The Foreign Investment Regime' (2009) 50 Harv Intl L J 491, 513 (noting that BITs fall short of providing domestic investors and host states with rights equivalent to those enjoyed by foreign investors, and pointing to the fact that BITs extend protection to contracts made with corrupt governments); J W Yackee, 'Do We Really Need BITs? Toward a Return to Contract in International Investment Law' (2008) 3 Asian Journal WTO & Intl Health Law & Policy 121; JW Yackee, 'Toward a Minimalist System of International Investment Law?' (2009) 32 Suffolk Transnatl L Rev 303 (criticising BITs for their asymmetric focus on investors' rights and intrinsic inflexibility); Gus van Haarten, *Investment Treaty Arbitration and Public Law* (OUP, Oxford 2007) 9-10 (criticising the selectivity of the system which grants extensive rights to investors whilst victims of human rights violations, indigenous people and migrant workers have no comparable guarantees of access to international protection mechanisms); S Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, Oxford 2008) (pointing to the growing perception that 'the institution of a BIT or foreign investment law itself is serving neither the interests of developing countries nor the higher policy objectives of the international community').

<sup>15</sup> See J Karl, 'International Investment Arbitration: A Threat to State Sovereignty' in W Shan, P Simons and D Singh (eds), *Redefining Sovereignty in International Economic Law* (Hart Publishing, Oxford 2008) 236, 237 (noting that 'a lack of consistency could make the outcome of arbitration proceedings unpredictable and thereby ultimately undermine the legitimacy of investor-state dispute settlement procedures'); see further S Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatising Public International Law Through Inconsistent Decisions' (2005) 73 Fordham L Rev 1521.

<sup>16</sup> See, for example, S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 141-59 (analysing different sources of legitimacy of the existing system: consent legitimacy, output legitimacy, exit legitimacy, the rule of law, and

host states have been held responsible for the lack of stability and predictability of national regulatory regimes, treaty drafters and arbitral tribunals for their part have not succeeded in making the growing body of international rules and practices on the protection of foreign investment less fragmented, volatile or unpredictable.

So far as the scope of expropriation and its relationship with non-expropriatory standards of treatment are concerned, this thesis argues that beneath the existing disarray and conceptual incoherence lays the excessive reliance on the notion of property and on the traditional expropriation maxim with its outdated emphasis on the mandatory compensation rule. Based on this premise, the thesis develops three principal arguments. First, it is argued that a distinctive feature of investment treaties—which form the bedrock of contemporary international investment law—is that protection of foreign investment is no longer confined to property but extends to a range of rights stemming from the investor’s undertaking, including contractual claims, quasi-contractual entitlements and investment returns. Second, expropriation, as a concept developed mostly in the context of a direct state intervention in the form of a seizure, nationalisation or a unilateral abrogation of concession rights, is no longer a single standard of treatment that investors can invoke against host states. The losses caused to an investor by a governmental action can be recovered through a successful claim under the standards of national treatment and fair and equitable treatment, the prohibition of arbitrary and discriminatory measures, the observance of undertakings clause and other substantive protections. The contemporary investment protection regime is not about expropriated property; rather, it safeguards a variety of interests having an economic value against a host

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institution-building legitimacy); A Afilalo, ‘Towards a Common Law of International Investment: How NAFTA Chapter 11 Panels Should Solve Their Legitimacy Crisis’ (2004) 17 *Geo Intl Env’tl L Rev* 51.

<sup>17</sup>See D Schneiderman, ‘Investment Rules and the New Constitutionalism’ (2000) 25 *L & Soc Inquiry* 757, 775; also Schneiderman (n 3) 75 (observing that ‘the takings rule... is a notoriously opaque discipline. One can search far and wide in vain for a clear and workable distinction between regulations exempt from and expropriations caught by the rule’).

state's interference in violation of its treaty obligations. Third, this thesis argues that the expropriation standard does not provide an adequate framework for determining investor claims against host states because the rule that expropriation must always be compensated reflects the context in which such rule was developed, namely the physicality and permanence of state interference. The rule therefore does not accommodate the reality of a modern regulatory state where the governmental decisions may cause varying degrees of loss in the value of an investment. In the modern regulatory environment, the diminution of an investment's value may be caused by legitimate governmental measures. Compensating investors for every change in value caused by such measures would transform investment treaties into instruments of insurance against regulatory change. Not only is the enforcement of the mandatory compensation requirement undesirable from a policy perspective as it imposes an unrealistic burden on host states, but it is also inconsistent with the principles governing state liability under non-expropriatory standards of treatment. The latter command the payment of compensation only for loss that is inflicted through governmental action in violation of the standards of non-discrimination, non-arbitrariness, and due process of law; the mere fact of deprivation does not suffice to establish a breach of a non-expropriatory standard.

The thesis begins with Chapter I focusing on the definition of investment under the ICSID Convention and international investment instruments. It aims to highlight the shift from the protection of property to the protection of a much broader category of economic rights hidden behind the rubric of 'investment.' A critical examination of the ongoing debate about the definition of investment for jurisdictional purposes is followed by the outline of possible ways in which investment can be defined in order to prevent the further exposure of a host state to liability in claims brought against it in the ICSID and other international forums.

Chapter II analyses the sole effect doctrine and its yardstick of 'substantial

deprivation’ which has been widely endorsed in arbitral practice in dealing with expropriation claims under international investment agreements. Since contemporary investment treaties do not limit their scope to the protection of property but instead adopt a broader framework centred on the notion of investment, the chapter examines whether the prevailing approaches to determining expropriation claims are both feasible and consistent with the existing structure and underpinnings of the investment protection regime. It highlights the critical shortcomings in the test of substantial deprivation and questions the extent to which an expropriation, defined in terms of ‘substantial deprivation’, retains its role as a distinct investment protection standard. This theme is further explored in Chapter III, which draws attention to an emerging shift from the sole effect and substantial deprivation tests to the character-focused approaches to state responsibility for interference with foreign investment. The chapter traces recent developments in investment treaty practice and arbitration whereby the existence of expropriation (as a ground of state responsibility for regulatory action) is determined through an analysis of the character or the manner of a disputed action. Since establishing the existence of non-expropriatory treaty breaches hinges on the manner in which a host state treated a foreign investment, measured against the guarantees of non-discrimination, non-arbitrariness and procedural fairness, the chapter puts forward a proposal to abandon expropriation in favour of an alternative framework.

In the following chapters, the thesis focuses on the key elements of the proposed framework. It furthers the idea that a governmental action should lead to a host state’s responsibility only if the action violates the non-discrimination, non-arbitrariness and due process standards. Chapter IV shows that as far as investment treaty law is concerned, the principle of non-discrimination has evolved from being a mere condition of the legality of an expropriation into a standalone guarantee, a violation of which may lead to a host state’s

responsibility to an investor. At the same time, the chapter stresses that the shift from expropriation to non-expropriatory standards of treatment cannot cure the existing imbalance and inconsistency unless approaches to drafting and interpretation of the non-discrimination provisions, including the national treatment and the arbitrary and discriminatory measures clauses, are revised. Attention is drawn to the existing practice on the application of the ‘like circumstances requirement’, arbitral approaches to a host state’s justifications for differential treatment, and the problem of multiple and overlapping investment treaty standards.

The standard of due process forms the subject of Chapter V. It begins by tracing the evolution of the due process requirement from a legality criterion in the expropriation analysis to an important component of the guarantee of FET. The chapter also examines the scope of the international protection against denial of justice and its operation in the practice of investment arbitration. In particular, attention is drawn to the local remedies rule and its impact on the development of a coherent theory of state responsibility in investment treaty law. The chapter further develops the argument for a unified concept of an investment treaty breach, and analyses both the recent practice of presenting a denial of justice claim under the guise of a judicial expropriation and the failure to provide effective means of asserting claims. It highlights the fact that the multiple and overlapping causes of action enable investors to circumvent important procedural barriers agreed between the state parties in the applicable investment treaty instrument.

The focus of Chapter VI is on umbrella clauses. After briefly outlining the history of protection of investment contracts in international law, the chapter examines umbrella clauses and dispute resolution clauses (DRCs) as two principal grounds on which an investment contract can be internationalised, giving rise to a state’s international responsibility for what would otherwise be treated as a pure contract claim. While umbrella clauses were designed as

a contractual analogue of the protection against an expropriation of foreign property, recent investment arbitration and treaty practice both show that umbrella clauses have outgrown the intentions of their drafters, as they entitle investors to a level of protection which neither expropriation nor other non-expropriatory standards offer. Along with exploring the scope of umbrella clauses and their relationship with other standards of treatment, the chapter discusses the scope of state consent to arbitration, the problem of competing jurisdictions to which umbrella clauses give rise, and the role of contractual commitments in protecting an investor against a host state's interference.

The questions of balancing the protection of investment with the host state's freedom to regulate and of the need to create a credible and sustainable mechanism of investment protection are further addressed in Chapter VII, the principal focus of which is on the FET standard. Can FET serve as the basis for a unified concept of investment treaty breach? Although FET has grown into a fully fledged substitute for the expropriation standard, it can only restrain the otherwise expanding scope of state responsibility in investment treaty law if construed in accordance with the ordinary meaning of the treaty terms as well as pursuant to the context and any relevant rules of international law applicable in the relationship between the parties. This method of interpretation militates against transforming FET into a standard of super-protection. The chapter will critically examine arbitral practice, including cases where FET was interpreted to require the transparency, stability and predictability of an investment regime. It will argue that the reasoning behind the relevant tribunal awards lacks support in treaty text and customary international law as well as in general principles of law.

In analysing existing investment arbitration practice and treaties and in developing the relevant critiques and arguments, this thesis rests on a view that an accurate assessment of the scope of international investment instruments is the key to developing a coherent theory of

state responsibility for interference with foreign investment. Instead of advocating a narrow reading of investment treaty provisions and arbitral awards, it argues that adequate responses can be developed only through a realistic portrayal of the law and of its potential. Without endorsing any particular theory of investment and economic development, the thesis supports the idea that the protection of investment against the deleterious effects of the regulatory conduct of a state should be balanced to ensure the long-term sustainability and credibility of international investment law. Investment treaty standards perform an important signalling function<sup>18</sup> and their good faith interpretation helps to draw the boundaries of conduct which is permissible under international law, thus facilitating an informed decision-making process both by investors and by host states. As shown in recent practice, an imbalance in the interpretation and application of investment treaty standards may result in withdrawals by states from their international investment agreements and other forms of backlash.<sup>19</sup>

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<sup>18</sup> 'It is imperative that states be in a position to make rational and informed decisions in the public interest concerning measures that might have an impact on foreign investment activity and their ability to do so would be severely undermined if the circumstances giving rise to expropriation defied any generalization.' (Z Douglas and J Paulsson, 'Indirect Expropriation in Investment Treaty Arbitrations' in N Horn and S Kröll, *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The Hague 2000) 146).

<sup>19</sup> Ecuador, Bolivia and Russia have set a precedent by expressing their intention to withdraw from international investment treaties. On 2 May 2007 Bolivia submitted a written notice of its denunciation of the ICSID Convention. A similar step was later taken by Ecuador on 6 July 2009. On 20 August 2009 the Russian Federation officially informed the Depository of the Energy Charter Treaty (ECT) that it did not intend to become a contracting party to the ECT or the Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA). In accordance with Article 45(3(a)) of the ECT, such notification resulted in Russia's termination of its provisional application of the ECT and the PEEREA upon expiration of 60 calendar days from the date on which the notification was received by the Depository. See also O Chung, 'The Lop-Sided International Investment Law Regime and Its Effect on the Future of Investor-State Arbitration' (2006-2007) 47 Va J Intl L 953 (pointing to unequal BIT negotiations, inequitable awards, and states escaping the BIT regime by defying arbitration); A van Aaken, 'Perils of Success? The Case of International Investment Protection' (2008) 9 European Business Organization L Rev 1 (discussing the consequences of overprotection, such as withdrawals from international investment instruments, refusals to honour awards, revising BITs, and abandoning investor-state arbitration). For a growing reluctance to endorse contentious investment treatment standards, see A van Aaken, 'International Investment Law between Commitment and Flexibility: A Contract Theory Analysis' (2009) 12 Journal of Intl Economic Law 507, 535 (noting that the 2005 Economic Cooperation Agreement between India and Singapore excludes FET and MFN); CM Ryan, 'Meeting Expectations: Assessing the Long-Term Legitimacy and Stability of International Investment Law' (2008) 29 U Pa J Intl L 725, 754 (noting that the 2006 Japan-Philippines Economic Partnership Agreement provides no right to investor-state arbitration).

## **CHAPTER I: THE DEFINITION OF ‘INVESTMENT’**

What constitutes an investment? The importance of this question goes beyond the need to identify an investment that has been subjected to an expropriation or another form of interference by the host state. The existence of an investment is a prerequisite for bringing a dispute before an ICSID tribunal. According to Article 25(1) of the Washington Convention, the jurisdiction of the ICSID extends to any legal dispute arising directly out of an investment.<sup>1</sup> It is the notion of investment that forms the cornerstone of the system of investment treaty protection: a claimant is entitled to substantive and procedural guarantees under bilateral and multilateral arrangements only if its enterprise qualifies as an investment.

This chapter intends to examine critically the notion of investment as a key condition of the host state responsibility under investment treaty instruments. It will begin with outlining a debate over the scope and meaning of investment under Article 25 ICSID and BITs. The second section of this chapter will demonstrate the flaws of an objective theory of investment. As both the ICSID Convention and BITs fail to define investment in comprehensive terms, it will be argued that the ordinary interpretation of the term allows any commitment of resources in the expectation of profit to be characterised as an investment. After analysing the existing definitions of investment, as developed in arbitral practice and scholarship, this chapter will conclude with proposals as to how the existing controversy about the proper meaning and scope of investment could be resolved. It will highlight the shift in the role of investment treaty law, which has expanded beyond protecting against expropriation of foreign property, and now also embraces general international guarantees against conduct that detrimentally affects the foreign investor's rights.

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<sup>1</sup> Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (signed 18 March 1965, opened for signature 14 October 1966) 575 UNTS 159 ('ICSID Convention').



## 1. General

Until recently, foreign property was the principal object of international protection against expropriation.<sup>2</sup> With the massive spread of bilateral and multilateral international investment treaties, however, the focus has shifted from the protection of foreign property to the protection of foreign investment. This shift is evident in the formulation of investment treaty provisions. A typical BIT includes a clause on investment, which is customarily defined by reference to assets falling within its protective scope. Such assets are by no means confined to property. For instance, in accordance with the UK-Lebanon BIT, ‘investment’ means every kind of asset including:

- (a) movable and immovable property as well as any other property rights in rem, such as mortgages, liens, and pledges;
- (b) shares in and stock and debentures of a company and any other form of participation in a company;
- (c) claims to money or to any performance under contract having a financial value;
- (d) intellectual property rights, such as copyrights, patents, industrial designs or models, trade or service marks, trade names, technical processes, know-how and goodwill, as well as other similar rights recognized by the laws of the Contracting Parties; and
- (e) business concessions under public law, including concessions to search, extract or exploit natural resources as well as all other rights given by law, by contract or by decision of the authority in accordance with the law.<sup>3</sup>

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<sup>2</sup> J Hertz, ‘Expropriation of Foreign Property’ (1941) 35 AJI L 243; FA Mann, ‘Outlines of a History of Expropriation’ (1959) 75 LQR 188; GS Christie, ‘What Constitutes A Taking of Property Under International law’ (1962) 38 British Ybk Intl L 307; S Friedman, *Expropriation in International Law* (Steven & Sons, London 1953); R Higgins, ‘The Taking of Property by the State: Recent Developments in International Law’ (1982) 176 Recueil des Cours 259; M Sornarajah, *The pursuit of nationalized property* (M. Nijhoff, Dordrecht, Lancaster 1986); WD Verwey, NJ Schrijver, ‘The Taking of Property Under International Law: A New Legal Perspective?’ (1984) Netherlands Ybk Intl L 3; BA Wortley, *Expropriation in Public International Law* (University Press, Cambridge 1959); BA Wortley, ‘Some Early Theories of Expropriation’ (1977) German Ybk Intl L 236; SD Metzger, ‘Property in International Law’ (1964) 50 Va L Rev 594.

<sup>3</sup> Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Lebanese Republic for the Promotion and Reciprocal Protection of Investments (2002)

Prominent in the list of assets comprising investment are references to ‘claims to money or to any performance under contract having a financial value’ and ‘other rights given by law, by contract or by decision of the authority in accordance with the law’. It is clear that the protective scope of the BIT is no longer limited to property rights, however broadly defined, but instead extends to a variety of other economic interests embodied in contractual and other rights. By covering a range of diverse assets and rights, BITs protect foreign business interests against not only expropriation of property but also against a host state interference affecting contractual and other rights, such as the right to arbitrate disputes.<sup>4</sup> Furthermore, the inclusion of claims to money and cognate rights in the treaty definition of investment opens the door to claims arising from state contracts that are different from traditional concession contracts in the transport and natural resources sectors, which prevailed in the earlier expropriation cases.<sup>5</sup> As the recent arbitral practice has shown, foreign businesses have resorted to investment treaty instruments in disputes arising from contracts for the provision of pre-shipment inspection, salvage, road construction, and legal services.

As one would expect, the breadth of the definition of ‘investment’ and its potential to increase the exposure of host states to liability has given rise to controversy. Particularly in the context of the ICSID Convention, it has been argued that investor-state arbitration should

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<sup>4</sup> In a very controversial decision, the tribunal in *ATA Construction, Industrial and Trading Company v Jordan*, Award, 12 May 2010 (ICSID Case No ARB/08/2) paras 117-120, found that a right to arbitrate was a distinct investment in the meaning of the BIT. One cannot disagree with the respondent’s objection that ‘it stretches language and legal reasoning beyond the breaking point’ to argue that the claimant’s interest constituted an investment (ibid para 63). Compared with this approach, the early treaty formulations providing for the protection of broadly defined property interests seem to be very moderate. See, e.g. the Peace Treaty with Italy of 1947 which extended the definition of property to all rights and interests of *any kind* in property (BA Wortley, *Expropriation in Public International Law* (n 2) 8 (emphasis original)). See also *Norwegian Shipowners (Norway v USA)* (1922) 1 RIAA 307, 362, 386.

<sup>5</sup> See, e.g. *Anglo-Iranian Oil Company Case* [1952] ICJ Rep 93; *Lena Goldfields v USSR* (1950-1951) 31 Cornell L Q 42; *Texas Overseas Petroleum Co & California Asiatic Oil Co v. Libyan Arab Republic* (1978) 17 ILM 1; *Revere Copper and Brass Inc v Overseas Private Investment Corporation* (1978) 56 ILR 258; C Greenwood, ‘State Contracts in International Law – The Libyan Oil Arbitrations’ (1982) 33 British Ybk Intl L 27.

be limited to disputes arising from investment and the latter should be construed strictly according to its objective meaning. Under this objectivist theory of investment, Article 25(1) ICSID implicitly restricts the jurisdiction of arbitral tribunals by imposing outer limits on the notion of investment. In other words, a certain asset qualifying as an investment under the applicable BIT should also meet the objective criteria of investment in order to satisfy the jurisdictional conditions of Article 25. For instance, a claim arising from a contract with a host state organ typically falls under the treaty definition of investment. Proponents of the objectivist view have argued that in order for such a claim to be entitled to the benefits of arbitration before an ICSID tribunal, it would be necessary to establish whether it constitutes an investment under the provisions of Article 25 ICSID.

The award in *Salini v Morocco* set the precedent by distinguishing between a treaty clause on investment and investment as a condition for the jurisdiction of an ICSID tribunal.<sup>6</sup> In considering whether a contract for the construction of a highway constituted an investment, the *Salini* tribunal observed that the contract was covered by the Italy-Morocco BIT, the investment clause of which encompassed ‘a contractual benefit having an economic value’ and ‘a right of an economic nature conferred by contract.’<sup>7</sup> Nonetheless, in the tribunal’s view, the consent of the state parties to the BIT outlining the forms of activities that the parties designated as investment was insufficient for satisfying the requirement of investment

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<sup>6</sup> *Salini Construttori S.p.A. and Italstrade S.p.A. v Kingdom of Morocco*, Decision on Jurisdiction, 23 July 2001 (ICSID Case No. ARB/00/4) (2003) 42 ILM 609. Before *Salini*, various tribunals indirectly dealt with the notion of investment as part of examining the jurisdiction *ratione materiae* under Article 25(1) ICSID. See, eg, *Kaiser Bauxite Company v Jamaica*, Decision on Jurisdiction and Competence 6 July 1975 (ICSID Case No ARB/74/3) (1999) 114 ILR 144 (involving a bauxite mining operation); *Société Ouest Africaine des Bétons Industriels v Sénégal*, Award 25 February 1988 (ICSID Case No ARB/82/1) (1991) 6 ICSID Rev 15 (involving a construction of low-income housing units). *Fedax* was the first case involving an objection to jurisdiction of an ICSID tribunal on the ground that the underlying transaction did not qualify as investment (*Fedax N.V. v Republic of Venezuela*, Decision on Jurisdiction, 11 July 1997 (ICSID Case No. ARB/96/3) (1998) 47 ILM 1378).

<sup>7</sup> *Salini*, *ibid* paras 44-45.

under Article 25 as an objective condition of the ICSID jurisdiction.<sup>8</sup> Relying on academic writings and arbitral cases which had earlier addressed the scope of investment, the tribunal concluded that in accordance with an objective test implicit in Article 25, an investment required a commitment of resources, a certain duration, an element of risk, and ‘a contribution to the economic development of the host state.’<sup>9</sup> Subsequently, the objective theory of investment was further articulated by the tribunal in *Joy Mining*, which stressed that the absence of a definition in the ICSID Convention ought not to be construed that ‘anything consented to by the parties might qualify as an investment.’<sup>10</sup> It held that the state parties to a BIT were not free to define an investment in order to engage the jurisdiction of ICSID tribunals.<sup>11</sup>

A decade later, the *Salini* test continues to prevail in arbitral practice. Furthermore, it seems to have influenced the interpretation of investment in non-ICSID disputes. By way of example, in *Romak v Uzbekistan*<sup>12</sup> a dispute arose from a contract for the delivery of wheat. Romak contended that the respondent’s failure to perform payment obligations under a quadripartite agreement and a subsequent refusal to abide by the award rendered in a

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<sup>8</sup> Ibid para 52.

<sup>9</sup> Ibid. The tribunal referred to a decision in *Alcoa Minerals of Jamaica, Inc. v. Jamaica*, Decision on Jurisdiction and Competence, 6 July 1975 (ICSID Case No. ARB/74/2) (1979) 4 Ybk Commercial Arbitration 206.

<sup>10</sup> *Joy Mining Machinery Ltd v Egypt*, Award on Jurisdiction, 30 July 2004 (ICSID Case No ARB/03/11) (2004) 19 ICSID Rev 486, para 49. The tribunal further emphasised the controlling role of the investment requirement in ICSID Article 25(1): ‘The parties to a dispute cannot by contract or treaty define as investment, for the purpose of ICSID jurisdiction, something which does not satisfy the objective requirements of Article 25 of the Convention. Otherwise Article 25 and its reliance on the concept of investment, even if not specifically defined, would be turned into a meaningless provision’ (ibid para 50). A similar emphasis on the “outer limits” of investment was made by a dissenting member of an *ad hoc* committee in *Malaysian Historical Salvors v Malaysia*, Decision on the application for annulment, 28 February 2009 (ICSID Case No ARB/05/10) para 9.

<sup>11</sup> *Joy Mining* (n 10) para 50. This position was recently endorsed by the tribunal in *Fakes v Turkey*, Award, 12 July 2010 (ICSID Case No ARB/07/20) paras 107-109. Some commentators are similarly opposed to the ‘subjectivist’ emphasis on the parties’ agreement. See F Yala, ‘The Notion of “Investment” in ICSID Case Law: A Drifting Jurisdictional Requirement? Some “Un-Conventional Thoughts on *Salini*, *SGS* and *Mihaly*”’ (2005) 22 J Intl Arbitration 105, 117 (arguing that ‘there are serious problems with admitting an operation within the ambit of ICSID jurisdiction simply because it falls under a category of investments protected by a BIT containing an ICSID clause. In certain respects, one could submit that this amounts to a violation of the ICSID Convention’).

<sup>12</sup> *Romak S.A (Switzerland) v Republic of Uzbekistan*, Decision 26 November 2009 (PCA Case No. AA280).

contractual arbitration violated the Uzbekistan-Switzerland BIT. In its decision on jurisdiction, the Permanent Court of Arbitration declined to accept as an investment ‘whatever the contracting States have decided to label as such in the treaty they have concluded.’<sup>13</sup> The tribunal denied jurisdiction over the dispute on the ground that the disputed contractual rights did not constitute an investment under the BIT.<sup>14</sup> It endorsed the *Salini* test even despite the fact that the applicable UNCITRAL Arbitration Rules did not contain a jurisdictional requirement equivalent to Article 25(1) ICSID.<sup>15</sup>

## 2. Is there an objective test of investment under the ICSID Convention?

Despite its strong influence on the interpretation of investment, the *Salini* test of investment has not been uniformly endorsed in arbitral practice. The major point of disagreement has been the role of BITs in defining investment. As international investment agreements frequently provide for an asset-based definition of investment, the question arises as to how the objective notion of investment is to be reconciled with what the state parties to a BIT have designated as an investment. While some tribunals have addressed the tension between Article 25(1) ICSID and BIT clauses on investment through the application of the so-called dual test of investment,<sup>16</sup> other panels have questioned the need for an objective test. For instance, an *ad hoc* committee in *Malaysian Salvors* held the parties’ agreement on what constitutes an investment, including the reference to claims to money in the BIT’s definition of investment, to be decisive.<sup>17</sup> The tribunal in *Biwater v Tanzania* also refused to downplay the significance

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<sup>13</sup> Ibid para 205.

<sup>14</sup> Ibid para 242.

<sup>15</sup> Ibid para 207.

<sup>16</sup> See, e.g., *Ceskoslovenska Obchodni Banka v Slovakia*, Decision on Jurisdiction, 1 December 2000 (ICSID Case No ARB/97/4) (2000) 15 ICSID Rev 544.

<sup>17</sup> *Malaysian Historical Salvors* (Annulment) (n 10) para 72.

of the definition of investment agreed by the state parties to the BIT.<sup>18</sup>

It is submitted that the objective test of investment lacks a sufficient normative foundation. It is true that a BIT definition of investment should not be controlling, especially if state parties to a bilateral instrument define investment in broad terms and go beyond the scope of a multilateral instrument such as the ICSID Convention.<sup>19</sup> Nonetheless, it bears emphasis that the ICSID Convention contains no *apriori* definition of investment that would set limits to its subject matter jurisdiction. As will be shown below, without an express definition of investment limiting it to certain forms of economic activity, arbitral tribunals should not fill the lacuna by introducing tests that have no basis in the text of the Convention. It is also doubtful that the requirement of investment in the ICSID Convention can differ from that contained in BITs. Finally, the rules of treaty interpretation militate against the imposition of outer limits on the meaning of investment: the negotiation history of the Convention shows that parties never intended to define investment by reference to its objective meaning.<sup>20</sup>

## 2.1. The functional perspective

By construing Article 25(1) as implying an objective test of investment different from that agreed between state parties to a BIT, the *Salini* test assumes that a BIT and the ICSID Convention pursue distinct and even opposing objectives. It is submitted that the correct approach would be to interpret both the ICSID Convention and BITs in light of their

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<sup>18</sup> See *Biwater Gauff (Tanzania) Ltd v United Republic of Tanzania*, Award and Dissenting Opinion, 24 July 2008 (ICSID Case No ARB/25/22) para 314: 'If very substantial numbers of BITs across the world express the definition of "investment" more broadly than the *Salini* test, and if this constitutes any type of international consensus, it is difficult to see why the ICSID Convention ought to be read more narrowly.'

<sup>19</sup> Z Douglas, *The International Law of Investment Claims* (CUP, Cambridge 2009) 165. See also RN Hornick, 'Pre-investment Expenditure as a Basis for ICSID Jurisdiction' (2003) 20 J Intl Arbitration 189, 193-4 (arguing that states are not free to adopt a bilateral definition that goes beyond the objective meaning of the term of Article 25).

<sup>20</sup> See below nn 29-32 and accompanying text.

concurring function of protecting foreign business abroad. So far as dispute resolution is concerned, investment treaties and the ICSID Convention pursue equally the objective of providing foreign business initiatives abroad with an effective means of protection. The fact that a BIT or a regional investment agreement such as the NAFTA (North American Free Trade Agreement) are entered into between only a group of states does not transform their investment protection objective into something qualitatively different from objectives pursued by the ICSID Convention. Similarly, the fact that the ICSID Convention establishes a procedural framework – in contrast to BITs which contain substantive standards of investment protection – does not justify concluding that the former pursues a completely different purpose. The correct approach is to acknowledge that the Convention *and* other investment treaty instruments overlap in their function of establishing the legal framework for the protection of foreign investment abroad.

The annulment decision in *Malaysian Salvors* highlights the concurring function of BITs and the ICSID Convention.<sup>21</sup> In this case, a request for annulment was brought after the tribunal had denied jurisdiction on the basis that a salvage contract did not constitute an investment. The *ad hoc* committee found that the salvage contract might be treated as a business concession granted under contract, and the dispute between the parties as a claim to money arising thereof, thus falling within the scope of the BIT definition of investment.<sup>22</sup> The committee proceeded to emphasise that the United Kingdom—Malaysia BIT did not provide any dispute settlement options other than ICSID. Hence, in the tribunal's view it was implausible to argue that two states would expressly include contracts and claims arising

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<sup>21</sup> The *ad hoc* committee stressed that: '[i]t is those bilateral and multilateral treaties which today are the engine of ICSID's effective jurisdiction. To ignore or depreciate the importance of the jurisdiction they bestow upon ICSID, and rather embroider upon questionable interpretations of the term "investment" as found in Article 25(1) of the Convention, risks crippling the institution.' (*Malaysian Salvors* (n 10) para 73).

<sup>22</sup> *Ibid* para 59-60.

thereof in the BIT definition of covered investment, knowing that such assets fall outside the remit of ICSID arbitration, which the BIT designated as an exclusive means of dispute resolution:

the Governments of Malaysia and the United Kingdom concluded a treaty providing for arbitration of disputes arising under it in respect of investments so comprehensively described, with the intention that the only arbitral recourse provided between a Contracting State and a national of another Contracting State, that of ICSID, could be rendered nugatory by a restrictive definition of a deliberately undefined term of the ICSID Convention...<sup>23</sup>

The decision of an *ad hoc* committee stresses the role of BITs as the effective source of the jurisdiction of an ICSID tribunal. In the absence of expressly formulated limitations, Article 25(1) cannot be read as imposing a different, more stringent or more liberal investment protection regime than that endorsed in BITs.

## 2.2. Historical perspective

The argument for an objective definition of investment under the Washington Convention presupposes the existence of an autonomous, strict meaning of investment, which sets the boundaries to the jurisdiction of the ICSID independently of any bilateral or multilateral treaties. One would therefore search for such an autonomous, objective meaning of investment in the text of the Convention. Since the Convention fails to articulate the meaning of investment, the term needs to be construed 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.’<sup>24</sup> But the ordinary meaning of investment is broad enough to encompass any commitment of

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<sup>23</sup> Ibid para 62. However, see critical comments in M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 312-3.

<sup>24</sup> The Vienna Convention on the Law of Treaties (entered into force on 27 January 1980) (1969) 1155 UNTS 331.



resources in the expectation of commercial return.<sup>25</sup> The Oxford Dictionary, for instance, defines investment as an act of investing money and also as the money that is invested, and investing is in turn defined as buying something in the hope to make profit.<sup>26</sup> An economic definition of investment is based on the concept of foreign direct investment (FDI), but it is equally broad due to the inclusion of portfolio and other investments in the form of various ‘assets and liabilities.’<sup>27</sup> Attempts to invoke the Convention’s object and purpose in order to narrow the interpretation of an otherwise broad ordinary meaning of ‘investment’ prove futile due to the vagueness and circularity of references to the promotion of international cooperation and economic development.<sup>28</sup>

The text of the Convention and the ordinary meaning of the term ‘investment’ failing to offer a sufficiently exacting definition, one is compelled to look at the negotiation history. The findings are illuminating. The first draft of the Convention defined the subject-matter jurisdiction by reference to ‘any disputes between Contracting States and the nationals of other Contracting States.’<sup>29</sup> The negotiation history also reveals that in discussing the subsequent drafts the delegates purported to specify the subject-matter jurisdiction by reference to the form of arrangement (such as the existence of a direct contract with a host state) and the nature of the dispute (which excluded purely political and commercial matters).<sup>30</sup>

It is remarkable that the delegates were barely concerned with an objective definition

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<sup>25</sup> See *Oxford Advanced Learner’s Dictionary* (7<sup>th</sup> edn OUP, Oxford 2005) 818-9).

<sup>26</sup> *Ibid.* An economic definition of investment is based on the concept of foreign direct investment (FDI), but equally includes portfolio and other investments (the latter being defined as “assets and liabilities”)

<sup>27</sup> See IMF Communication to WTO Working Group on the Relationship between Trade and Investment, WTO Doc. WT/WGTI/W/61 (November 3, 1998), cited in D Krishan, ‘A Notion of ICSID Investment’ (2009) 6 (1) *Transnational Dispute Management* 1, 20. See also JD Mortenson, ‘The Meaning of “Investment”: ICSID’s Travaux and the Domain of International Investment Law’ (2010) 51 *Harv Intl L J* 257309-10 (noting that investment can plausibly be extended to any economic activity).

<sup>28</sup> ICSID Preamble (n 1)

<sup>29</sup> Mortenson (n 27) 281-2.

<sup>30</sup> *Ibid* 282-5.

of investment. Instead of defining investment by reference to its objective economic characteristics, the proposals reflect a desire to delineate the types of disputes a certain signatory state would wish to submit to arbitration.<sup>31</sup> As the final version of the Convention abandoned any definition of investment,<sup>32</sup> it is safe to conclude that an objective meaning of investment is that derived from its ordinary and effective interpretation. As mentioned earlier, if construed in accordance with Article 31 of the Vienna Convention, investment would denote any commitment of resources in the expectation of profit.<sup>33</sup> Hence, if the outer limits of the ICSID jurisdiction were to be determined according to an objective notion of investment, a legal dispute arising from *any* commitment of resources in the expectation of a profit would qualify as an investment dispute.

### 3. The broad scope of ‘investment’ under BITs

#### 3.1. Relying on the BIT definition of investment

Once we recognise that an objective notion of investment is very broad, it can be argued that BITs supply a definition of investment with more exacting parameters. Unlike Article 25(1)

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<sup>31</sup> Ibid. See also 290 (analysing the history of negotiations and observing that the solution was based on the United Kingdom proposal which deleted the definition of investment and instead added a subsection for a procedure whereby states would notify other signatories of the categories of dispute they would not consider submitting to arbitration).

<sup>32</sup> See A Broches, ‘The Convention on The Settlement of Investment Disputes: Some Observations on Jurisdiction’ (1966) Col J Transnatl L 261, 268. The history of the ICSID negotiation reveals that Mr Broches was personally opposed to a definition and insisted that the precise delimitation of the Centre’s jurisdiction ought to be left to the parties. (C Schreuer and others, *The ICSID Convention: A Commentary* (2nd edn CUP, Cambridge 2009) 113-5). Following Mr. Broches’s proposal, the Executive Director’s Report stated that ‘[n]o attempt was made to define the term “investment” given the essential requirement of consent by the parties.’ (The Report of the Executive Directors on the ICSID Convention (1993) 1 ICSID Rep 28). Although the Report does not fully reflect the reality of negotiations where attempts to define investment were actually made but all of them failed, it has nevertheless been referred to in some arbitral decisions (for criticism see Schreuer, *Commentary*, 116; Yala (n 11) 105-6).

<sup>33</sup> See (n 25).

ICSID, BITs typically elaborate on what constitutes a covered investment. However, the formulation of BIT provisions on investment and the variations in the treaty coverage with respect to types of investment testify to the fact that bilateral definitions of investment do not pursue the task of ascertaining what investment is generally. That is, a BIT definition of investment does not provide a set of criteria that needs to be met in order for an investment to be established. Instead, a typical asset-based formulation in investment treaty texts identifies broad categories of rights and interests falling within the protective scope of that treaty. For instance, some BITs exclude portfolio investment and debt securities, whereas others limit the scope of the investment clause to approved investments or investments made in accordance with the host state law.<sup>34</sup> Simply because a certain BIT excludes it from the scope of protection, portfolio investment does not cease to be an investment in the general meaning of the term. The fact that a BIT excludes portfolio investments signifies that such investments are not protected. Reference to investments ‘made in accordance with the law’ is also instructive. In both cases, treaties purport to outline their *individual* coverage, without setting out an objective and generally acceptable definition of investment.<sup>35</sup>

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<sup>34</sup> For instance, Article 2 ASEAN expressly excludes portfolio investment. (See the Agreement among the Governments of Brunei Darussalam, the Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand for the Promotion and Protection of Investments (1988) 27 ILM 612). For its part, NAFTA includes portfolio investment, but excludes debts securities and claims to money that arise solely from commercial contracts. For discussion, see EC Schlemmer, ‘Investment, Investor, Nationality, and Shareholders’ in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 56 and N Rubins, ‘The Notion of ‘Investment in International Investment Arbitration’ in N Horn (ed) *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The Hague 2004) 283, 320 (noting ‘the historical reluctance of Host States to extend investment protection to foreign-owned passive assets’). Also, Sornarajah (n 23) 196-7 (arguing against the inclusion of portfolio investments due to their potential negative impact on the host state economy in the case of withdrawal, and suggesting that references to shares and stock do not include shares purchased by a non-resident outside the host state). In arbitral practice, the investment treaty protection was extended to portfolio investment in *Saluka v Czech Republic*, even without a reference to portfolio securities in Article 1 of the Netherlands-Czech BIT. (*Saluka Investments BV v Czech Republic*, Partial Award, 17 March 2006 (PCA—UNCITRAL Arbitration Rules) para 209).

<sup>35</sup> See *Yaung Chi Oo Trading Pte Ltd v Myanmar*, Award, 31 March 2003 (ASEAN Case No ARB/01/1) para 53 (discussing Article II(1) of the 1987 ASEAN Agreement providing the investment must be ‘specifically approved in writing and registered by the host country and upon such conditions as it deems fit for the purposes

Interestingly, an historical examination of BITs reveals that a question of what will qualify as investment for jurisdictional purposes was not on the agenda of investment treaty negotiators. It also shows that the BITs have been designed to protect a wide range of foreign economic interests abroad. The BIT definition of an investment mirrors the early preoccupation with the security of foreign interests, the latter being defined as broadly as possible.<sup>36</sup> Before the rise of BITs, the remit of customary international law was not limited to the protection of foreign property, but included standards of treatment of aliens as regards their life, security, and property more generally.<sup>37</sup> It formed part of the law on state responsibility for injuries to aliens and overlapped, to a certain extent, with the protection of human rights.<sup>38</sup> Early Friendship, Commerce and Navigation Treaties similarly envisaged the protection of *property* and *persons* of foreign nationals.<sup>39</sup> Subsequently, the wave of nationalisations in the first half of the twentieth century, which included repudiations of concession contracts, led to the adoption of international agreements containing a broader definition of property and the extension of international protection to contractual

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of this Agreement.’); on the requirement that investment be approved see *Gruslin v Malaysia*, Award, 27 November 2000 (ICSID Case No ARB/99/3) para 25.5. See also Sornarajah (n 23) 10 (pointing out that the notion of investment can be wider than that adopted in BITs, in spite of the fact that treaty drafters intend to cover a complete range of interests).

<sup>36</sup> As noted earlier, some international treaties defined property in very broad terms including ‘all rights and interests of any kind in property’. See Wortley (n 3) 8.

<sup>37</sup> The fact that the customary international minimum standard draws principal support from an international decision unrelated to investment or property is illustrative. The *Neer* case, which serves as an authority for the standard of minimum protection, was an international criminal law case (*LFH Neer & Pauline v United Mexican States* (1926) AJIL 555). For more detail, see AH Roth, *The Minimum Standard of International Law Applied to Aliens* (A. W. Sijthoff, Leiden 1949).

<sup>38</sup> Cf Amerasinghe, *State Responsibility for Injuries to Aliens* (Clarendon Press, Oxford 1967); also G Schwarzenberger, ‘The Protection of Human Rights in British State Practice’ (1948) 10 *The Review of Politics*. The 1929 Draft Convention on the Treatment of Foreigners, prepared by the League of Nations and the International Chamber of Commerce, extended protection not only to economic rights but also to civil and legal rights. See AK Kuhn, ‘The International Conference on the Treatment of Foreigners’ (1930) 24 AJIL 570, 571; G Van Harten, *Investment Treaty Arbitration and Public Law* (OUP, Oxford 2007) 19.

<sup>39</sup> RR Wilson, *Property-Protection Provisions in United States Commercial Treaties* (1951) 45 AJIL 83, 98, 102 (referring to the 1949 Treaty of Friendship, Commerce and Economic Development with Uruguay containing the provision guaranteeing the protection for the “persons, rights and property”).

undertakings.<sup>40</sup> For instance, while the Havana Charter referred to foreign investors' interests,<sup>41</sup> the Abs-Shawcross draft extended the protection to undertakings with aliens, in addition to the traditional reference to *all property, rights, and interests*.<sup>42</sup>

It was the emergence of BITs and the creation of the ICSID as special vehicles of investment protection that changed the semantics of international law on the protection of foreigners abroad. Foreign property, rights and interests – including those arising from contract – have been lumped together under the rubric of investment.<sup>43</sup> The potential breadth of the BIT definition of investment reflects the ambitious objective of casting an all-encompassing net over the international protection of foreign businesses abroad.<sup>44</sup> A typical investment clause in BITs can therefore be regarded as a list of substantive investor rights.<sup>45</sup> The inclusion of 'claims to money and to performance having an economic value'<sup>46</sup> and 'investment returns'<sup>47</sup> in the definition of investment clearly indicates that BITs are designed

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<sup>40</sup> NR Doman, 'Postwar Nationalization of Foreign Property in Europe' (1948) 48 Columbia Law Review 1125, see also M Domke, 'American Protection Against Foreign Expropriation in the Light of the Suez Canal Crisis' (1956-57) 105 U Penn L Rev 1033, 1038 (noting that a revision of the existing instruments was proposed to the effect that the definition of property should cover all types of property).

<sup>41</sup> Art 11 (1) (b), commented in AA Fatouros, 'An International Code to Protect Private Investment – Proposals and Perspectives' (1961) 14 U Toronto L J 77, 80.

<sup>42</sup> See G Schwarzenberger, 'The Abs-Shawcross Draft Convention: On Investments Abroad: A Critical Commentary' (1960) 9 J Pub L 147, 152.

<sup>43</sup> It is noteworthy that negotiators of early US BITs faced the choice of not defining 'investment' at all. The concern was that new forms of investment might be excluded from the definition if the drafters failed to anticipate them. See K J Vandeveld, *U.S. International Investment Agreements* (OUP, Oxford 2009) 114.

<sup>44</sup> See MR Poirier, 'The NAFTA Chapter 11 Expropriation Debate Through the Eyes of the Property Theorist' (2003) 33 Envtl L 851, 876 (observing that 'like medieval merchants who developed the law merchant and the law of insurance to facilitate commercial relations..., foreign investors have an interest in developing a property rule around regulatory takings that is 1) clear, 2) portable to different cultures worldwide, 3) protective of their investments to the maximum extent possible').

<sup>45</sup> A substantive function of the BIT investment clause does not mean that the BIT creates entitlements in the form of property and contracts referred to in its list of investments. It is substantive in the sense that the definition of investment in BITs is not intended to answer the jurisdictional question of what kind of forms of economic activity fall within the jurisdiction of a treaty-based tribunal. See S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 252 (arguing that the substantive dimension of property is limited to its patterning function, i.e. identifying interests that are protected under international law).

<sup>46</sup> See, e.g. Article 1 (a) (iii) of the Netherlands Model BIT (1997), re-printed in Douglas (n 19) 547.

<sup>47</sup> See, e.g. Article 1 (6) (e) of the Energy Charter Treaty (1995) 2080 UNTS 100. See further Article 1(2) of the Japan-Korea BIT, whereby investments include "the amounts yielded by an investment, in particular, profit, interest, capital gains, dividends, royalties and fees" (Agreement between the Government of Japan and the

to ensure that international protection is available to the widest range of foreign business interests, and not just as a jurisdictional test. Indeed, how can ‘investment returns’ be viewed as a form of investment which involves commitment of capital, a degree of risk and a potential to contribute to the host state economy? It is clear that BITs do not purport to define investment in comprehensive terms but rather intend to capture the mix of diverse assets, rights and interests which fall within their protective ambit.<sup>48</sup>

### 3.2. Investment as a process: distinguishing between an investment and rights arising from an investment

It has been suggested that an investment should be defined in each case depending on the definition of investment in the applicable BIT.<sup>49</sup> However, it is important to bear in mind that the definition of investment in BITs includes both investments *per se* and rights relating to investments. For instance, a concession for the exploration and development of oil reserves represents an investment, whereas a right to a tax refund under that concession does not constitute an investment but rather is a claim to money or investment returns. This distinction

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Government of the Republic of Korea for the Liberalisation, Promotion and Protection of Investment (adopted 22 May 2002, entered into force 1 January 2003)).

<sup>48</sup> The notable exception is a type of a treaty that limits its scope to foreign direct investment. For instance, according to Article 45 of the Mexico-EFTA FTA (the text available at <<http://www.sice.oas.org/Trade/mexefta/mexefta.asp>>),

investment made in accordance with the laws and regulations of the Parties means direct investment, which is defined as investment for the purpose of establishing lasting economic relations with an undertaking such as, in particular, investments which give the possibility of exercising an effective influence on the management thereof.

See R Dolzer, ‘The Notion of Investment in Recent Practice’ in S Charnovitz, DP Steger and P Van Den Bossche (eds) *Law in the Service of Human Dignity: Essays in Honour of Florentino Feliciano* (CUP, Cambridge 2005) 265. The definition of this kind is indeed exceptional as it not only defines investment (something the majority of BITs fail to do) but also does so in sufficiently precise terms by indicating the form of investment, and its legal and temporal characteristics. The fact that only a minority of BITs contain more narrowly defined investment provisions only accentuates the breadth of investment under the ICSID Convention and a great many BITs.

<sup>49</sup> See Mortenson (n 27) 302, Krishan (n 27) 12.

is very important for both conceptual and practical reasons. The inclusion of ‘claims to money’ in the BIT definition of investment does not exempt a putative claimant-investor from establishing that a contract or an operation, which forms the basis of its claim, constitutes an investment.<sup>50</sup>

It can be argued that, the ICSID Convention failing to confine investment to certain forms of business activity, a distinction between investment and claims to money is not significant. This distinction is, however, crucial. Broad though it may be, the ordinary meaning of investment presupposes the existence of a commitment of money or resources in the expectation of profit.<sup>51</sup> Thus, a claim arising from a confidentiality agreement or an employment contract will not qualify as an investment because neither arrangement involves a commitment of resources in the expectation of commercial return. Claims to money are entitled to the BIT protection only if they arise from a contract or other undertaking that constitutes an investment in its ordinary sense.

Another important aspect which should inform the analysis of the BIT definition of investment is that investment cannot always be examined in terms of an asset. It remains open to question whether ‘investment’ is a thing or an activity.<sup>52</sup> The variety of forms that business activity may take explains the corresponding variety of approaches to defining investment as a phenomenon, a process, an action,<sup>53</sup> or the ‘use of resources intended to increase future production output or income’.<sup>54</sup> It is submitted that investment is better regarded as a process or activity, rather than an asset.<sup>55</sup> The process-orientated view of investment is preferable

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<sup>50</sup> This matter was discussed in *Romak v Uzbekistan* (see n 12 above).

<sup>51</sup> See above nn 29-32 and accompanying text.

<sup>52</sup> See Rubins (n 34) 283.

<sup>53</sup> Sornarajah (n 23) 4.

<sup>54</sup> S Ripinsky and K Williams, *Damages in International Investment Law* (British Institute of International and Comparative Law, London 2008) 5.

<sup>55</sup> While the US Model BIT (2004) defines the investment as every asset that an investor owns or controls, the

because it encompasses various elements of the putative investment activity without losing sight of a core transaction and its economic nature. For instance, it is the acquisition of an asset for the purpose of its commercial exploitation that should be viewed as an investment, but not the asset itself. Similarly, it is not a right to provide water services that forms an investment. Rather, an investment comprises the whole operation including the acquisition of the necessary rights and the deployment of capital, technology and personnel in exercising those rights. Considering an investment as a process also facilitates drawing a line between the investment itself and the rights arising from it.

Arbitral tribunals have acknowledged the need to regard investment as an entire operation.<sup>56</sup> For example, the tribunal in *Saipem v Bangladesh*<sup>57</sup> correctly highlighted the difference between an overall investment operation and its individual components, including claims arising from a relevant contract. The case concerned a payment under a contract for the construction of a pipeline. Following the Bangladeshi court's refusal to enforce the award rendered by an ICC tribunal in a contractual arbitration, Saipem claimed an expropriation in violation of the Italy-Bangladesh BIT. In addressing the respondent's objection to jurisdiction, the tribunal agreed with Bangladesh that the right accruing to the claimant under the ICC award arose only indirectly from the investment. The tribunal was not prepared to consider the ICC award itself as constituting an investment.<sup>58</sup> Having correctly emphasised

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reference to the forms that an investment can take (including an enterprise, participation in an enterprise, a turnkey contract) indicates that in most cases investment is a process and not an asset. See also the treaty's definition of an investment agreement by reference to exploration, transportation, infrastructure projects. See also JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 18-9 (noting the difference between process-based and asset-based approaches to 'investment').

<sup>56</sup> This is what other commentators have described as "the general unity of an investment operation." See ICSID Commentary (n 32) 108-12.

<sup>57</sup> *Saipem S.p.A. v People's Republic of Bangladesh*, Decision on jurisdiction, 21 March 2007 (ICSID Case No ARB/05/7) (2007) 22 ICSID Rev 100.

<sup>58</sup> *Ibid* para 113.



that the notion of investment must be understood as covering all elements of the operation<sup>59</sup>, the tribunal held that both the contract and the construction project itself were the elements of the investment operation, and considered the ICC award as a crystallisation of the rights and obligations under the contract.<sup>60</sup> The decision illustrates the importance of distinguishing between an investment operation, and distinct rights and interests which arise thereof.

A failure to distinguish between an investment and investor rights arising by virtue of such an investment may be fatal for the outcome of a dispute. In *Joy Mining*, an investor's claim concerned a contract for the provision of 'Longwall Mining Systems and Supporting Equipment for the Abu Tartur Phosphate Mining Project.'<sup>61</sup> As the parties disagreed about technical aspects of the commissioning and performance tests of the equipment, the claimant contended that it was entitled to the release of bank guarantees that had been provided for each stage of the contract. In its claim brought before an ICSID tribunal, the claimant submitted that the participation in the project constituted an investment under Article 1 of the United Kingdom—Egypt BIT because the letters of guarantee were pledges, the entitlement to payment was a claim to money, and the equipment and personnel involved in the project were

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<sup>59</sup> Ibid para 114.

<sup>60</sup> Ibid para 127. See also *Ceskoslovenska Obchodni Banka v Slovakia*, Decision on Jurisdiction, 1 December 2000 (ICSID Case No ARB/97/4) (2000) 15 ICSID Rev 544. In this case, a dispute arose from the alleged breach by Slovakia of its obligations under the Consolidation Agreement. The Consolidation Agreement was concluded to ensure privatisation and operation of the Ceskoslovenska Obchodni Banka (CSOB) in the Czech and Slovak Republics after their separation. The agreement provided for a complex system that included the assignment of certain non-performing portfolios to the so-called collection companies. The CSOB and Slovak Collection Company concluded a loan agreement on the refinancing of assigned receivables, pursuant to which the repayment of the loan was secured by an obligation of the Ministry of Finance of the Slovak Republic. The respondent objected on the basis that CSOB's loan was not an investment. The tribunal observed that 'an investment is frequently a rather complex operation, composed of various interrelated transactions, each element of which might not qualify as an investment' (ibid para 72). It concluded that a dispute must be deemed to have arisen from an investment even if it is based on a transaction which per se would not qualify as an investment under the Convention, provided that the particular transaction forms an integral part of an overall operation that qualifies as an investment (ibid para 72). Thus, even if an obligation to cover the losses of the Slovak Collection Company was not an investment, it was closely linked to the loan provided by CSOB pursuant to Article 3 of the Consolidation Agreement and the provisions of the Loan Agreement. Although loans were not mentioned in Article 1(1) of the BIT, the tribunal found that 'assets and monetary receivables or claims clearly encompassed loans extended to a Slovak entity by a national of the other Contracting Party' (ibid paras 75-77).

<sup>61</sup> *Joy Mining v Egypt* (n 10).

assets.<sup>62</sup> The tribunal began with noting that one element of the complex transaction should not be examined in isolation from the operation as a whole. However, the tribunal concluded that in order to determine the existence of investment as part of establishing its jurisdiction, it had to examine only the status and implications of the bank guarantees.<sup>63</sup> The same inconsistency is also evident in the tribunal's application of the *Salini* test. While addressing the requirements of a commitment, duration, and a risk, the tribunal discussed the entire project. Yet in its analysis of whether the state benefited from a putative investment (the requirement of a contribution to the economic development of the host state), it preferred to focus on the bank guarantees and not the contract itself.<sup>64</sup> The tribunal failed to maintain consistency in distinguishing between the contract as an alleged investment and a claim to payment under the letters of guarantee as a right arising from the alleged investment.<sup>65</sup>

Similarly, the *ad hoc* committee in *Malaysian Salvors* did not draw a clear line between a contract, which allegedly constituted an investment, and a claim to money. Instead, in its analysis of whether a dispute arose from an investment it examined both a salvage contract and a claim for moneys unpaid under the contract. In the committee's view,

...the contract between the Government of Malaysia and Malaysian Historical Salvors

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<sup>62</sup> Ibid para 39.

<sup>63</sup> Ibid para 45.

<sup>64</sup> Ibid para 61. In analysing the positive impact criterion, the tribunal compared the case before it to *Fedax v Venezuela* and decided that the Egyptian government had not benefited from the drawdown of the bank guarantee.

<sup>65</sup> For critical comment, see Schreuer (n 32) 111-2. See also C Schreuer and U Kriebaum, 'The Concept of Property in Human Rights Law and International Investment Law' in S Breitenmoser and others (eds) *Human Rights, Democracy and the Rule of Law: Liber Amicorum Luzius Wildhaber* (Nomos, Dike 2007) 760-1 (criticising the awards in *Joy Mining v Egypt* and *Eureko v Poland* for a failure to recognise the general unity of the investment operation. In *Eureko*, for instance, the tribunal failed to distinguish between an investment in shares of a privatised enterprise and corporate governance rights arising from the possession of those shares. It held that corporate governance rights constituted an investment. See *Eureko BV v Poland*, Partial Award and Dissenting Opinion, 19 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) para 144. Similarly, a recent award in *ATA v Jordan*, although acknowledging the need to view an investment as an entire operation, culminated in a controversial finding that a right to arbitrate constituted an investment (see n 4 above, paras 96, 117-120). The correct approach would be to consider whether an underlying contract providing for arbitration qualified as an investment.

is one of a kind of asset; what is precisely at issue between the Government and the Salvor is a claim to money and to performance under a contract having financial value; the contract involves intellectual property rights; and the right granted to salvage may be treated as a business concession conferred under contract.<sup>66</sup>

The annulment decision is open to criticism for its conflation of a contract and a contractual claim to money. The correct approach would be to examine whether the salvage contract constituted an investment, and to consider a claim to money as a right arising from an investment. Presently, a cause of confusion is that a typical BIT contains an asset-based definition covering both investments and claims arising from investments.

#### 4. Defining investment

##### 4.1. General

The foregoing discussion reveals a pervasive lack of consensus on the meaning of investment. While an objective notion of investment is so broad as to encompass any economic disputes arising from the commitment of resources, BITs provide only limited guidance due to the piecemeal character of their asset-based approach to defining investment. In order to address the resulting uncertainty, state parties to investment treaties may wish to delineate the scope of investment treaty protection in more specific terms. Investors should be able to know beforehand whether a certain transaction would constitute an investment and entitle the investor to the benefits of investor-state arbitration.<sup>67</sup> Host states, for their part, would equally benefit from knowing what kind of investments they undertake to protect and promote.

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<sup>66</sup> (n 10) para 60.

<sup>67</sup> See Douglas (n 19) 190 (highlighting the importance of certainty and quoting *Bayview Irrigation District No 11 and ors v Mexico*, Award, 19 June 2007 (Case No ARB(AF)/05/1) para 99 ('When the investment is made in a different country which has concluded an investment protection treaty covering that investment, the investor is entitled to rely upon the fact the States Parties to the treaty have decided to commit themselves to give a minimum level of legal protection to such foreign investments').

The following sections will analyse some of the major approaches to defining investment. The first section will address the shortcomings of the typical characteristics approach as proposed by the *Salini* tribunal. After critiquing the normative and practical inadequacy of individual elements of the test, this section will show that despite being designed to address an open-ended definition of investment under BITs, the *Salini* test is prone to a broad interpretation covering a whole host of business operations. This is in stark contrast to a proprietary approach to defining investment recently advanced by Douglas. As argued in the second section, Douglas' test based on the distinction between rights *in rem* and rights *in personam* reflects a restrictive treaty interpretation and lacks support in treaty texts. A proprietary view of investment is also problematic due to the fading distinction between property and contract. The third section will examine whether investment can be defined by reference to the economic nature of a putative operation and its classification as a capital movement, sale or service. After outlining a proposal to limit investment to enterprises involving a sustained engagement of the foreign investor from the delivery through to the exploitation phase, the chapter will conclude by highlighting the need for a revision of the notion of investment as a subject matter of BITs and a cornerstone of ICSID arbitration. It will also emphasise that until a more precise definition of investment is formally agreed between states, investment treaties will continue to open the doors to arbitration and litigation of disputes that go beyond the classic claim of expropriation and include grievances caused by host state interference with investor rights and interests generally.

#### 4.2. A 'Typical characteristics' approach

The *Salini* tribunal attempted to define investment against a set of what it regarded to be

‘typical characteristics’, including the commitment of resources, duration, risk, and the contribution to the economic development of the host state. The test was endorsed in a number of cases,<sup>68</sup> although with certain variations and the inclusion of additional elements. For instance, some tribunals have considered a regularity of profit and returns to be a typical characteristic of investment.<sup>69</sup> In considering whether a certain economic activity would qualify as an investment, the public law character of a transaction was also regarded as a relevant factor.<sup>70</sup> It has also been suggested that the *bona fide* character of the purported investment should also be examined in establishing whether such investment can enjoy the treaty protection.<sup>71</sup>

The *Salini* test has been criticised for its tendency to bring under the umbrella of investment a broad range of economic rights,<sup>72</sup> and for its inherent subjectivity which stems

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<sup>68</sup> For instance, the *Salini* test was fully endorsed in *Joy Mining* (n 10) paras 55-57; *Bayindir Insaat Turizm Ticaretve Sanayi A Ş v Pakistan*, Decision on Jurisdiction, 14 November 2005 (ICSID Case No ARB/03/29) paras 130-137; *Jan de Nul NV and Dredging International NV v Egypt*, Decision on Jurisdiction, 16 June 2006 (ICSID Case No ARB/04/13) paras 90-96; *Saipem* (n 57) para 99-114; *Malaysian Historical Salvors Sdn Bhd v Malaysia*, Award on jurisdiction, 10 May 2007 (ICSID Case No ARB/05/10) paras 43-46.

<sup>69</sup> See *Fedax NV v Republic of Venezuela*, Decision on Jurisdiction, 11 July 1997 (Case No ARB/96/3) (1998) 37 ILM 1378, para 43; *Joy Mining* (n 10) para 53; *Helnan International Hotels A/S v Egypt*, Decision of the Tribunal on Objection to Jurisdiction, 17 October 2006 (ICSID Case No ARB/05/19) para 77; and *Malaysian Historical Salvors* (n 61) paras 108-45.

<sup>70</sup> See *SGS Société Générale de Surveillance SA v Pakistan*, Decision on Objections to Jurisdiction, 6 August 2003 (Case No ARB/01/13) (2003) 42 ILM 1290, paras 139-140; *Joy Mining* (n 10) para 60; *Fedax* (n 58) para 42.

<sup>71</sup> *Phoenix Action Limited v Czech Republic*, Award, 9 April 2009 (Case No ARB/06/5) para 114. The claimant was an Israeli company established with the sole aim of creating a diversity of nationality so as to take advantage of a right to claim directly against the Czech Republic. The tribunal held that in the absence of a genuine economic activity, the operation would not qualify as a protected investment even if such an operation meets the requirements of a contribution, a duration and risk (*ibid* para 86). The tribunal explained: ‘[t]he ICSID Convention/BIT system is not deemed to protect economic transactions undertaken and performed with the sole purpose of taking advantage of the rights contained in such instruments, without any significant economic activity which is the fundamental prerequisite of any investor’s protection’ (*ibid* para 93). Other tribunals have also found that a commitment of resources made in violation of the host state laws was not entitled to the protection (see *Fraport AG Frankfurt Airport Services Worldwide v Philippines*, Award, 16 August 2007 (ICSID Case No ARB/03/25) para 401; *Inceysa Vallisoletane, SL v El Salvador*, Award, 2 August 2006 (ICSID Case No ARB/03/26, paras 192-207). However, minor failures to comply with the host state law will not preclude the finding of a qualifying investment. See *Tokios Tokelès v Ukraine*, Decision on Jurisdiction and Dissenting Opinion, 29 April 2004 (ICSID Case No ARB/02/18) (2005) 20 ICSID Rev-FILJ 205, para 86. In contrast to the emerging tendency, the *Fakes v Turkey* tribunal held that principles of good faith and legality could not be read into Article 25 ICSID (above n 11, para 112).

<sup>72</sup> Yala (n 11) 110-1. However, cf. *Mortenson* (n 27) and *Krishan* (n 27).

from a wide margin of discretion that the test grants to tribunals.<sup>73</sup> It has also been argued that the “typical characteristics” of investment should be treated as mere examples instead of being elevated to legal requirements.<sup>74</sup> Indeed, the *Salini* test of investment lacks a normative foundation. As examined earlier, neither the text of the ICSID Convention nor the ordinary meaning of investment justify limiting the notion of investment by the *Salini* criteria.<sup>75</sup> Furthermore, an overview of arbitral practice reveals problems arising from the stringent application of all of the *Salini* criteria and differences in construing individual elements of the test. The interpretation of the requirement of the contribution to the economic development of the host state is illustrative. Recently, the issue was addressed in *Malaysian Salvors*. A dispute was brought before an ICSID tribunal in connection with the contract under which the investor undertook to carry out the location and salvage of *Diana*, a British vessel that sank off the coast of Malacca in 1817. While the tribunal emphasised the need for a ‘holistic assessment’ of the classical *Salini* hallmarks,<sup>76</sup> its decision denying jurisdiction over the dispute primarily turned on the lack of the investment’s impact on the host state’s development. The tribunal found it necessary to reject ‘any perceived political or cultural benefits’ arising from the contract, unless such benefits had ‘a significant impact on the Respondent’s economic development.’<sup>77</sup> Similarly, in *Patrick Mitchell v Congo*, where a dispute arose from the seizure of the claimant’s legal services firm, an *ad hoc* committee

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<sup>73</sup> Douglas (n 19) 191.

<sup>74</sup> See *MCI Power Group LC and New Turbine Inc v Ecuador*, Award, 26 July 2007 (ICSID Case No ARB/03/6) para 165; *CSOB v Slovakia* (n 11) para 90 (noting that ‘these elements of the suggested definition, while they tend as a rule to be present in most investments, are not a formal prerequisite for the finding that a transaction constitutes an investment as that concept is understood under the Convention’). See also *Biwater* (n 18) paras 312-3. Also, P Vargiu, ‘Beyond Hallmarks and Formal Requirements: A “Jurisprudence Constante” on the Notion of Investment in the ICSID Convention’ (2009) 10 (5) *J World Investment & Trade* 753, 765 (arguing that elevating certain characteristics of investment to the level of formal requirements is contrary to the intention of the ICSID drafters which dispensed with a set of criteria for establishing investment).

<sup>75</sup> See above sections 2.1. and 2.2.

<sup>76</sup> *Malaysian Historical Salvors*, Decision on Jurisdiction (n 68) paras 71-72.

<sup>77</sup> *Ibid* para 138.

annulled the tribunal award on the ground that ‘a legal consulting firm is a somewhat uncommon operation from the standpoint of the concept of investment.’<sup>78</sup> The committee held that it was necessary for the contribution to the economic development or at least the interests of the State to be ‘somehow present in the operation.’<sup>79</sup>

The application of the economic development criterion in both *Malaysian Salvors* and the annulment decision in *Patrick Mitchell* exposes the complications involved in defining investment by reference to the capacity of a disputed transaction or activity to contribute to the host state development. While noting that the reliance on the concept of economic development may be outdated, it has been correctly observed that cultural and political benefits should equally be taken into consideration in establishing the existence of an investment.<sup>80</sup> Furthermore, the very assessment of whether a certain activity contributes to the development of the host state is problematic as it implies the need for quantitative and qualitative criteria, especially if tribunals insist on a *significant* contribution to the development of the host state.<sup>81</sup> Small and medium size investors may not be able to

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<sup>78</sup> *Mitchell v the Democratic Republic of the Congo*, Decision on the Application for Annulment of the Award, 27 October 2006 (ICSID Case No ARB/99/7) para 39.

<sup>79</sup> *Ibid.* While endorsing the development criterion as part of establishing the existence of investment, some tribunals found the criterion to be subsumed in other elements of the *Salini* test, such as duration and the commitment of resources. See *Consortium Groupement L.E.S.I.- DIPENTA v. Algeria*, Award, 10 January 2005 (ICSID Case No. ARB/03/08) para 72; *Victor Pey Casado and President Allende Foundation v. Republic of Chile*, Award, 26 April 2008 (ICSID Case No. ARB/98/2) para 232.

<sup>80</sup> S Manciaux, ‘The Notion of Investment: New Controversies’ (2008) 9 J World Investment & Trade 443, 458. See also ME Hiscock, ‘The Emerging Legal Concept of Investment’ (2009) 27 Penn State Intl L Rev 765, 778-9, citing M Jezewski, ‘There is No Freedom Without Solidarity: Towards New Definition of Investment in International Economic Law’, Society of International Economic Law (SIEL) Inaugural Conference 2008 Paper, (arguing that the criterion of benefiting the host state should not be limited to economic benefit alone; it should include contribution to areas of social policy and human rights). Also, VS Vadi, ‘Investing in Culture: Underwater Cultural Heritage and International Investment Law’ (2009) 42 Vand J Transnatl L 853.

<sup>81</sup> Manciaux, *ibid* (criticising the tribunal decision in *Malaysian Salvors* for setting a quantitative threshold and failing to specify it). See also the annulment decision in *Malaysian Salvors* (n 10) para 36 (the applicant argued that, even if a contribution to the economic development of the host state were a condition, the tribunal erred in finding that while the contract contributed to Malaysia’s economic development, this benefit is not of the same quality or quantity envisaged in previous ICSID jurisprudence). Also, W Ben Hamida, ‘Two Nebulous ICSID Features: The Notion of Investment and the Scope of Annulment Control’ (2007) 24 J Intl Arbitration 287, 294 (criticising the annulment decision in *Patrick Mitchell* for the failure to give precise meaning to the economic development criterion). The contribution to the economic development criterion has been tersely rejected in a

demonstrate a significant impact on the development of the host country, but this consideration provides only a highly doubtful basis upon which to deny them the benefits of investment treaty protection. Further, the question arises: by which yardstick is the significance of an investment's contribution to the host state's development to be assessed? Should the positive impact be measured by reference to the rise in the country's GDP, the creation of jobs or the promotion of certain social and cultural values? Finally, should the criterion of development be applied equally to investments that are made in capital-exporting countries and capital-importing countries?

Similar difficulties arise in connection with the criteria of duration, risk and the regularity of profit or returns. Absent any reference to a minimum duration of investment under the ICSID Convention, defining the existence of a qualifying investment according to the duration of a project would first of all necessitate setting a minimum time limit. Establishing a minimum duration is problematic because it risks denying protection to a range of projects and transactions that involve a substantial commitment of resources by purported investors but fall short of the minimum time limit.<sup>82</sup> Finally, there is an important question of what the duration of an investment should include. For instance, in *Jan de Nul v Egypt* the respondent argued that less than two years had passed between the beginning of the dredging operations and the issuance of the final certificate.<sup>83</sup> The tribunal upheld the investor's argument that an investment commences with the participation in the tender and lasts until the full repatriation of the equipment. In *Saipem v Bangladesh*, the duration of an investment encompassed the period of delay caused by the local opposition to the construction pipeline.<sup>84</sup> The determination of the duration of an investment may vary not only according to the

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recent case of *Fakes v Turkey* (n 11) para 111.

<sup>82</sup> Ibid 453.

<sup>83</sup> *Jan de Nul* (n 68) paras 94-95.

<sup>84</sup> *Saipem* (n 57) para 102.



circumstances of a case but may also depend on a tribunal's readiness to view a certain economic activity as a form of investment.

In relation to the risk criterion, it has been observed, rightly, that a certain degree of risk is implicit in *any* transaction undertaken by an investor abroad and therefore the presence of risk cannot be considered to be a fundamental requirement of establishing the existence of investment.<sup>85</sup> While referring to risk as a prerequisite of investment, tribunals have differed in their assessment of the kind of risk that needs to be present. Some tribunals have held that there must be a “qualified” risk, as opposed to merely economic risk,<sup>86</sup> whereas others have simply deduced the presence of risk from the duration of a project which extended over a substantial period of time.<sup>87</sup> A disagreement over the extent of the risk criterion raises doubts about its capacity to filter an investment from non-qualifying forms of business activities. Since a certain degree of risk is generally present not only in investment activities, but also in any commercial transactions, both domestic and foreign, such a criterion cannot be relied upon for the purposes of establishing the jurisdiction of an investment tribunal.

It appears that the impact, duration, and risk criteria cannot form the basis of a sound and reliable definition of investment. The *Salini* test attempts to define investment by reference to a set of characteristics which the tribunal believed to be typical in investment transactions. However, these characteristics, if construed literally, would allow any

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<sup>85</sup> Manciaux (n 80) 456, see also M Waibel ‘Opening Pandora’s Box: Sovereign Bonds in International Arbitration’ (2007) 101 AJIL 711, 726 (noting that mere default risk cannot be a meaningful standard for qualifying transactions as investments).

<sup>86</sup> *Salini* (n 6) para 52; *Joy Mining* (n 10) para 57. See also Vargiu (n 74) 757-8 (noting that the decisions in *Salini* and *Joy Mining* do not contain any discussion as to what would qualify as a risk under the ICSID Convention). Similarly, for a criticism of the approach to the risk criterion, in particular lack of definition and guidance, see Yala (n 11) 112.

<sup>87</sup> *Toto Costruzioni Generali SpA v Lebanon*, Decision on Jurisdiction, 8 September 2009 (ICSID Case No ARB/07/12) para 78 (‘A construction contract in which the execution of the works extends over a substantial period of time involves by definition an element of risk. The duration of the contract is a determining factor with regards to the magnitude of the risk since the exposure to changes and unexpected occurrences increases in proportion to the duration of the contract’).

commercial transaction to fall into the realm of investment. A long-term contract for the delivery of tailor-made machinery to a state infamous for its political instability and corruption may well pass the threshold requirements of duration, risk, and even that of a contribution to the economy.<sup>88</sup> Yet many would doubt that a sale of goods contract should qualify as investment and be eligible for investment treaty protection.<sup>89</sup> While the principal disadvantage of the *Salini* test is its lack of a normative basis and the absence of benchmarks (which renders it open to an interpretation that is driven by personal preferences rather than principled analysis<sup>90</sup>), the test ultimately fails due to its capacity to extend the treaty protection to *any* forms of commitment.

#### 4.3. Investment as rights *in rem*

##### A. Distinguishing between rights *in rem* and rights *in personam*

Of all of the components of the *Salini* test, the contribution or the commitment of resources requirement would appear to be uncontroversial.<sup>91</sup> However, on a closer examination the commitment of resources criterion is no less ambiguous than that of the need to have a positive impact on the host state economy. The *ad hoc* committee in *Malaysian Salvors* held that ‘the “ordinary meaning” of the term ‘investment’ is the commitment of money and other assets for the purpose of providing a return.’<sup>92</sup> While the transfer of resources in complex construction and turn-key projects is more readily recognised as a form of investment into the

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<sup>88</sup> See e.g. *Pantechniki SA Contractors and Engineers v Albania*, Award, 28 July 2009 (ICSID Case No ARB/07/21).

<sup>89</sup> See *Joy Mining* (n 10).

<sup>90</sup> See Krishan (n 27) 16.

<sup>91</sup> Manciaux (n 80) 450.

<sup>92</sup> (n 10) para 57.

host state economy,<sup>93</sup> there is a large grey area comprised of forms of economic activity which can be undertaken on the basis of a contract and which do not easily yield to analysis. This issue has recently been the subject of an acrimonious debate in a number of arbitral cases, which triggered similarly divided academic comments. It is not surprising that proposals vary from those arguing for an objective notion of investment and the extension of the investment treaty mechanisms to any economic disputes,<sup>94</sup> to those who propose limiting the notion of investment to rights *in rem*.<sup>95</sup>

Douglas argues that where a contract is relied upon to establish the existence of an investment the tribunal should differentiate between rights *in personam* and rights *in rem*. The rights *in personam*, it has been argued, do not qualify as an investment independently of the rights *in rem*.<sup>96</sup> Hence, an investment agreement does not constitute an investment *per se*; rather, Douglas argues that an agreement ‘memorialises’ a covered investment. The importance of the distinction is illustrated by reference to the core characteristics of each legal institution: a right *in rem* is a right in respect of a thing and binds the whole world, whereas a right *in personam* is a right over the person as an individual and therefore binds only specific individuals or legal entities.<sup>97</sup> The rationale for the exclusion of rights *in personam* from the scope of investment treaty protection lies in the desirability, from a policy perspective, of limiting state responsibility toward individuals.<sup>98</sup> As a justification for the exclusion of a

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<sup>93</sup> See e.g. *PSEG Global Inc and ors v Turkey*, Decision on Jurisdiction, 4 June 2004 (ICSID Case No ARB/02/5) which involved a project to build a coal-fired electric energy production facility, and *Kaiser Bauxite Company v Jamaica* (n 6) which involved a bauxite mining operation. As Yala explains, the existence of complex arrangements contributes to qualifying the binomial “investor-host state” as a partnership rather than as an ephemeral “vendor-client” relationship. (Yala (n 11 ) 107).

<sup>94</sup> Mortenson (n 27).

<sup>95</sup> Douglas (n 19) 191, 202.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid 203.

<sup>98</sup> ‘A State, like all individuals or entities within its jurisdiction, has actual or constructive notice of rights over property because such rights bind everyone in the jurisdiction. By virtue of this actual or constructive notice, it is fair and just to impose international obligations upon the state with respect to the protection of property rights.

range of contractual rights from the scope of ‘investment’, it has been argued that international law (including investment treaties) provides for protection against state interference with property rights, but has no system of contract law.<sup>99</sup> Hence, rights *in personam* cannot be the subject of expropriation and the very notion of contractual expropriation is a misnomer.<sup>100</sup>

Douglas’ test of investment based on excluding rights *in personam* from the scope of treaty protection is not entirely convincing. Limiting the notion of investment to property rights, along with insisting on the primacy of domestic law in the adjudication of contractual matters, clearly aims to curb the internationalisation of contracts.<sup>101</sup> The argument also exhibits an academic disquiet about inconsistency in arbitral treatment of the choice of law matters.<sup>102</sup> It is true that an investor’s contractual rights should be subject to adjudication in accordance with the proper law of contract.<sup>103</sup> That the proper law of contract should

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The value of the rights and obligations under a contract is directly linked to the ‘personality’ or ‘individuality’ of the specified persons or legal entities who are bound by the contract, rather than the ability of the right holder to exclude all others from use of the thing over which the right is asserted. Insofar as value for contractual rights and obligations is inexorably tied to the identity of free agents (individuals or legal entities), it is neither fair nor just to superimpose a form of international responsibility upon states for the disappointment of expectations within private contractual relationships’ (Ibid 205).

<sup>99</sup> Ibid 207. For a similar argument, see WM Reisman, ‘The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of Its Threshold (2000) 15 ICSID Rev 362, 370 (observing that in the absence of special agreements investment contracts are founded in the national law of the host state and not in an undefined international legal order).

<sup>100</sup> Ibid 214. According to Douglas, international decisions, which are commonly invoked as authority in contractual expropriation cases, have involved either granting some sort of remedy for a breach of contract or granting remedies for the expropriation of rights *in rem* (Ibid 214-224). By way of example, Douglas revisits *SPP v Egypt*, which is commonly regarded as a case of contractual expropriation and where the claimant received expectation damages and out-of-pocket expenses. (See *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, Award on the Merits, 20 May 1992 (ICSID Case No ARB/84/3) 3 ICSID Rep 189). *Shufeldt Claim (USA v Guatemala)* (1930) 28 RIAA 1080, involved a concession to exploit natural resource, yet instead of characterising the case in terms of contractual expropriation, Douglas argues that it was an expropriation of a right *in rem* (a right to extract chicle) memorialised in the contract. By the same token, *Chorzow Factory (Germany v Poland)* 1926 PCIJ (Ser. A) No 7 (Merits) has been characterised as a case of expropriation of a right *in rem* (the right to the exploitation of the factory) as evidenced or ‘memorialised’ by the contract.

<sup>101</sup> For discussion of the internationalisation theory, see Chapter VI.

<sup>102</sup> Douglas (n 19) 207 (criticising decisions ‘applying wrong law or no law at all with varying layers of specious reasoning’).

<sup>103</sup> This is what Douglas reinstates as one of the major principles of international investment law: ‘The law applicable to an issue relating to a claim founded upon a contractual obligation is the law governing the contract

determine contractual relationships does not, however, necessitate excluding contracts from the scope of investment, nor does it justify that only property rights are entitled to international protection. While international law does not contain a sub-system of contract law, the same holds true in relation to property rights.<sup>104</sup> It is also evident that nothing prevents tribunals from applying the proper law of contract in accordance with principles of private international law. The fact that international tribunals have erred in choosing the proper law applicable to a dispute involving contractual rights does not justify an outright denial of the ability of contracts to constitute an investment. Problems relating to the identification of the proper law of contract and other repercussions of the internationalisation of contract would be better addressed through defining, in the text of a treaty, the applicable law and the scope of the state consent to arbitration.<sup>105</sup> Limiting an investment to rights *in rem* is not only conceptually troublesome but may also lead to inequitable results. Consider, for instance, a scenario where a contractual dispute has been adjudicated in accordance with the applicable law of contract by the municipal court. The claimant subsequently alleges that the court has committed a manifest denial of justice giving rise to a cause of action in international law. The *apriori* exclusion of a contract from the ambit of investment would rule out the claimant's right of recourse to investment treaty protection in the situation where the circumstances of the case would call for the intervention by an international court or a tribunal.

It is clear that the reluctance to recognise contractual rights as form of investment

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in accordance with generally accepted principles of private international law' (Douglas (n 19) 90). For a further discussion of problems arising from deciding contract-related investment claims in accordance with international law as opposed to applying the proper law of contract, see Z Douglas, 'Nothing if Not Critical for Investment Treaty Arbitration: *Occidental, Eureka, and Methanex*' (2006) 22 *Arbitration Intl* 27.

<sup>104</sup> International law does not contain a sub-system on the law of property: the prohibition of expropriation and rules on compensation are not only contested but are also largely parasitic on national legal norms – just as the international rules on contracts.

<sup>105</sup> See Chapter VI.

stems from a restrictive interpretation of the investment protection mandate. By excluding a wide range of contracts from the scope of investment, Douglas confines the investment treaty mechanism to the protection of property rights.<sup>106</sup> For instance, in his analysis of ‘claims to money’ as a form of investment, he draws support from the ECtHR decision in *Beshiri v Albania* holding that ‘[w]here the proprietary interest is in the nature of a claim it may be regarded as an ‘asset’ only where it has a sufficient basis in national law, for example where there is settled caselaw of the domestic courts confirming it or whether it takes the form of a final enforceable judgment in an applicant’s favour.’<sup>107</sup> The *Beshiri* decision, however, cannot be read as an authority for denying investment treaty protection to contract claims. The decision in question does not address the issue of what constitutes an investment; rather, in the quoted passage, it rightly stresses the importance of establishing whether a certain claim has a basis in national law in order to qualify as a property right for the purpose of the ECHR. The European Convention on Human Rights deals with the protection of property and not the protection of investment. The mandate of an investment treaty is arguably different.<sup>108</sup> Investment treaty preambles commonly refer to the objective of promoting the flow of capital and private business initiative, without limiting the notion of investment to property. By way of example, a preamble of the Germany Model BIT expressly refers to the encouragement and

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<sup>106</sup> Interestingly, it was Douglas who had earlier argued that tribunals ‘should give the widest possible scope to the notion of proprietary interests.’ (Z Douglas and J Paulsson, ‘Indirect Expropriation in Investment Treaty Arbitrations’ in N Horn and S Kröll, *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The Hague 2000) 152. The argument for the widest possible notion of property is difficult to reconcile with the restrictive view of the investment protection underlying his theory of limiting investment to rights *in rem*.)

<sup>107</sup> *Beshiri v Albania* (App 7352 /03) 22 August 2006, para 79.

<sup>108</sup> See, e.g. SR Ratner, ‘Regulatory Takings in Institutional Context: Beyond the Fear of Fragmented International Law’ (2008) 102 AJIL 475, 501 (arguing that the relevance of the protection of property under the ECHR for decision-making in other regimes is circumscribed due to the distinct purpose and institutional features of the Convention and the Court). See also R Dolzer, ‘Indirect Expropriation: New Developments?’ (2002) 11 NYU Env L J 64, 74 (suggesting that human rights and foreign investment regimes may be subject to different maxims of interpretation due to their different objectives).

*contractual* protection of investments among its objectives.<sup>109</sup> Furthermore, as claims to money and to performance, as well as contractual rights, are almost invariably included in existing investment treaties, the law as it stands today goes beyond the narrow mandate of the protection of property and does not preclude treating contractual rights as a form of investment.

## B. The blurring boundaries between contract and property

Even if analysed exclusively as *lex ferenda*, the theory of investment as rights *in rem* does not seem to provide a viable analytical framework for deciding which form of economic activity deserves the benefits of investment treaty protection. As property is an increasingly fluid concept, it may be difficult to draw a line between contracts and property or between rights *in rem* and rights *in personam*. Consider, for example, shares. Most lawyers would easily recognise shares as a form of investment and an object of a right *in rem*. Yet, a share in a company can also be seen as ‘a contingent right in the property of the company on winding up’ and as ‘an expression of a hope that a dividend will be declared.’<sup>110</sup> It is thus a mere expression of commercial value and not a thing in itself.<sup>111</sup> As Hudson observes, ‘property in this new world order is identifiable primarily by its ability to generate cash flow.’<sup>112</sup> Investment tribunals have been willing to embrace the understanding of property in terms of wealth generation. For instance, the *Methanex* tribunal acknowledged that

Certainly, the restrictive notion of property as a material “thing” is obsolete and has ceded its place to a contemporary conception which includes managerial control over

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<sup>109</sup> See the preamble of the Germany Model BIT (2005).

<sup>110</sup> A Hudson, ‘The unbearable lightness of property’ in A Hudson (ed) *New Perspectives on Property Law, Obligations and Restitution* (Cavendish Publishing, London 2004) 4.

<sup>111</sup> *Ibid.*

<sup>112</sup> *Ibid.* 5. For a similar view, see CA Reich, ‘The New Property’ (1964) 73 Yale LJ 734, 735.

components of a process that is wealth producing.<sup>113</sup>

The constantly evolving notion of property presents a serious challenge to the distinction between rights *in rem* and rights *in personam*. While the traditional characteristics of rights *in rem* can be present in some forms of contractual transactions, their absence has not precluded courts from admitting certain contractual rights into the realm of property. Consider, for instance, assignability as one of defining characteristics of rights *in rem*. It has been argued that service contracts do not involve assignable rights *in rem* and hence, cannot qualify as investment.<sup>114</sup> In a similar vein, a lawyer's know-how is not an investment because it is non-assignable, except for where its value has been assessed and its existence registered prior to the dispute.<sup>115</sup> However, assignability or transferability is an increasingly fading feature of property. For instance, in English law a non-transferable right does not constitute property, but any future entitlement which might flow from that non-transferable right can itself be considered a property.<sup>116</sup> A right to future benefits flowing from a non-assignable contract, such as a promotion contract, has been recognised as property.<sup>117</sup>

Goodwill is a further example of a non-assignable intangible interest.<sup>118</sup> Goodwill is best understood as referring to people's perceptions and judgements about a company's past performance and future prospects:<sup>119</sup>

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<sup>113</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345, Part IV, Chapter D, para 17.

<sup>114</sup> Douglas (n 19) 185.

<sup>115</sup> Ibid 197-8 (commenting on the annulment decision in *Mitchell v the Democratic Republic of the Congo*, Decision on the Application for Annulment of the Award, 27 October 2006 (ICSID Case No ARB/99/7)).

<sup>116</sup> Hudson (n 110) 12 (referring to *Don King v Warren* [2000] Ch 291).

<sup>117</sup> Ibid. It is also worth noting the US court decision in *Webb's Fabulous Pharmacies v Beckwith* [1980] 449 U.S. 155 (the court recognising the right to earn interest on the principal sum as an intangible property interest protected by the Fifth Amendment from expropriation). See also GM Starner, 'Taking a Constitutional Look: NAFTA Chapter 11 as an Extension of Member States' Constitutional Protection of Property' (2002) 33 Law & Policy Intl Bus 405.

<sup>118</sup> See, e.g., Article 1 of the Netherlands Model BIT and Article 1 of the Germany Model BIT.

<sup>119</sup> D Saidov, 'Damage to Business Reputation and Goodwill under the Vienna Sales Convention' in D Saidov, R Cunnington, *Contract Damages: Domestic and International Perspectives* (Hart Publishing, Oxford 2008) 390.



There is a substantial body of evidence, both in law and outside it, demonstrating that it is often the case that reputation and goodwill are viewed by business persons as important commercial assets. Although the reasons are many, they revolve around benefits flowing from having a good reputation or goodwill. These benefits include a company's ability to charge premium prices for their products/services, pay lower prices to its suppliers, incur lower marketing costs, attract top recruits, experience greater loyalty from customers and employees, have more stable profits, face fewer risks in times of crisis, obtain credit more easily and, more generally, have greater freedom of decision-making.<sup>120</sup>

Goodwill is clearly an asset possessing an economic value. Loss of goodwill can form the basis for an investor's claim of an investment treaty breach, such as the claim of expropriation.<sup>121</sup> In any event, the fact remains that while goodwill is a form of intangible property due to its ability to generate cash flows, it nevertheless is non-assignable. Should it be protected as an investment? It is submitted that the answer should be in the affirmative, given that investment treaties commonly cover goodwill as a protected investment.<sup>122</sup> Despite the non-assignable nature of goodwill and the problems related with classifying it as a right *in rem*, the express provision in a BIT supports the inclusion of goodwill into the list of protected assets. At the same time, it would seem that in most circumstances goodwill is better regarded as a right or benefit accruing to the investor by virtue of the latter's

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<sup>120</sup> Ibid 393, referring to C Fombrun, *Reputation: Realizing Value from the Corporate Image* (Harvard Business School Press, Boston MA 1996) 11, 73-5.

<sup>121</sup> In arbitral practice, goodwill has been addressed as an object of expropriation. See *Methanex v United States* (n 132) (the tribunal holding that items such as goodwill and market share may constitute an element of the value of an enterprise). For early views on goodwill as an object of expropriation, see F Williams, 'International Law and the Property of Aliens' (1928) 9 British Ybk Intl L 1, 25 (arguing that a distinction should not be drawn between the taking of intangibles, including goodwill, and tangibles); Christie (n 2) 319-21 (examining an expropriation through the granting of monopoly and the loss of goodwill). Recently, following the Canadian health authorities' initiative to issue a new regulation on cigarette labelling, a US tobacco company threatened to use NAFTA Chapter 11. The company insisted that the restriction on the use of the terms "light, mild and low" that were incorporated into cigarette names would destroy valuable trademarks and the goodwill thus amounting to expropriation. The case provides an example of goodwill as a possible object of expropriation. See VS Vadi, 'Trade Mark Protection, Public Health and International Investment Law: Strain and Paradoxes' (2009) 20 EJIL 773, 786.

<sup>122</sup> See, for example, Article 1(1)(d) of the Treaty between the Federal Republic of Germany and the Islamic Republic of Afghanistan concerning the Encouragement and Reciprocal Protection of Investments (signed 20 April 2005, entered into force 12 October 2007). The model BITs of the UK, Germany and the Netherlands include goodwill in the list of assets qualifying as an investment.

commitment of resources.<sup>123</sup>

Another key characteristic of rights *in rem* is excludability: a right *in rem* is a right enforceable against the world.<sup>124</sup> Municipal legal systems, however, do provide examples of cases where the existence of the contract was seen as something ‘in the nature of a property interest in the plaintiff.’<sup>125</sup> Excludability, as a defining feature of rights *in rem*, is also problematic in light of the changing notion of property. It is the right to exclude others that lies at the heart of the claim that ‘...there must be a zone of privacy for each individual beyond which neither government nor private power can push – a hiding place from the all-pervasive system of regulation and control.’<sup>126</sup> Yet a growing tendency to regard property as having a public function makes it difficult to draw a line between a form of wealth which is sacrosanct and for which an individual possesses a right enforceable against the whole world, and other forms of wealth in respect of which the individual’s right to exclude is somewhat relative.<sup>127</sup> The ability of a right-holder to exclude others is particularly challenging in the context of economic activity, which is subject to complex regulatory control even in states that have

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<sup>123</sup> In *Chemtura Corporation v Canada*, Award, 2 August 2010 (Ad hoc—UNCITRAL Arbitration Rules) para 243, the tribunal held that ‘goodwill or market position may indeed be seen as accessories’. Other non-assignable assets protected by BITs are ‘business secrets’. See Protocol I of the Algeria-Germany BIT (signed 11 March 1996, entered into force 30 May 2002). Both goodwill and business secrets are best classified not as investments *per se* but rather as rights arising from investment or components of an overall investment operation.

<sup>124</sup> According to Blackstone’s Commentaries, property is ‘[t]hat sole and despotic dominion which one man claims and exercises over the external things in the world, in total exclusion of the right of any other in the universe.’ (Sir William Blackstone, *Commentaries on the Laws of England* (11<sup>th</sup> edn London 1791) Vol II, 2.

<sup>125</sup> R Cunningham, ‘Contract Rights as Property Rights’ in A Robertson (ed), *The Law of Obligations: Connections and Boundaries* (UCL, London 2004) 184, discussing the English court decision in *Lumley v Guy* [1853] 2 E & B 216. *Lumley v Guy* appears to have influenced the characterisation of a contract as a form of property in the US courts. See, e.g. *Munchak Corp v Riko Enterprises*, 368 F Supp 1366 (it was held that a contract between a North Carolina corporation and a basketball player was a property right); *Raymond v Yarrington*, 96 Tex 443; 72 SW 580; 73 SW 800 (‘to knowingly induce the other party to violate [the contract] is as distinct a wrong as it is to injure or destroy his property’).

<sup>126</sup> Reich (n 112) 785.

<sup>127</sup> See R Barnes, *Property Rights and Natural Resources* (Hart Publishing, Oxford 2009) 119 (arguing that ‘despite property’s characteristic association with private interests and the notion of excludability, it cannot be understood apart from its public functions’). For a discussion of a public function of property, see M Roberston, ‘Liberal, Democratic, and Socialist Approaches to the Public Dimension of Private Property’ in J McLean (ed), *Property and the Constitution* (Oxford, Hart Publishing 1999) 248; see also M Cohen, ‘Property and Sovereignty’ (1927) 13 Cornell Law Quarterly 8, 26 (arguing that property should be subject to positive duties in the public interest).

traditionally championed liberalist views on the protection of property rights.<sup>128</sup>

The NAFTA award in *Bayview Irrigation District v Mexico* provides an interesting example of the new perception of property and its problematic excludability.<sup>129</sup> In *Bayview*, the claimants were a group of farmers, agricultural corporations and irrigation districts. At the heart of the dispute was a claim that Mexico violated its obligations under NAFTA Chapter 11 by a ‘purposeful and systematic capture, seizure, and diversion of water belonging to Bayview while it was located in Mexican territory for use by farmers located in Mexico.’<sup>130</sup> The alleged violation was also contrary to the Treaty relating to the Utilization of the Waters of the Colorado and Tijuana Rivers and of the Rio Grande. In confronting the question of whether water could constitute an investment, the tribunal observed that both Mexican law and the law of Texas provided for the grant of legal rights to extract water from rivers in Mexico for defined periods, in defined amounts, and for defined purposes. The tribunal acknowledged that water rights acquired for agricultural purposes were acquired in the expectation of and the use for the purpose of deriving economic benefits, thus falling within the definition of property in NAFTA Article 1139(g).<sup>131</sup> However, the tribunal rejected the claimants’ assertion that they owned water in Mexico, by way of ownership of personal property rights in the physical waters of rivers flowing in Mexican territory.<sup>132</sup> In the tribunal’s view, it was conceptually problematic to claim the existence of property in water because the entitlement of each claimant depended on the apportionment of a certain volume of water, measured over a five-year period and only by reference to the volume of water,

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<sup>128</sup> See also MJ Radin, *Reinterpreting Property* (University of Chicago Press, Chicago, London 1993). However, compare R Epstein, *Takings: Private Property and the Power of Eminent Domain* (Harvard University Press, Cambridge MA 1985).

<sup>129</sup> *Bayview Irrigation District No 11 and ors v Mexico*, Award, 19 June 2007 (Case No ARB(AF)/05/1). For discussion, see P Stanton Kibel, ‘Grasp on Water: A Natural Resource that Eludes NAFTA’s Notion of Investment’ (2007) 34 Ecology LQ 655.

<sup>130</sup> *Bayview* (n 129) para 40.

<sup>131</sup> *Ibid* para 111.

<sup>132</sup> *Ibid* para 114.

which had actually reached the main channel of Rio Bravo/Rio Grande.<sup>133</sup> The tribunal concluded that the holder of a right to take a certain amount of water from the Rio Bravo/Rio Grande did not possess property rights in a particular volume of water as it descended through Mexican streams and rivers towards the Rio Bravo/Rio Grande and found its way into the right-holders' irrigation pipes. The tribunal held that 'while the water is in Mexico, it belongs to Mexico, even though Mexico may be obliged to deliver a certain amount of it into the Rio Bravo/Rio Grande for taking by US nationals.'<sup>134</sup> The tribunal's analysis of water, as a form of property and investment, puts to the test the notion of excludability. While a right to water has been recognised as a property right, the exclusion of others by the holder of such a right was subject to physical and legal constraints. Underlying this new form of property is not a relationship between the holder and the thing, but a relationship between 'a host of competing resource users.'<sup>135</sup>

#### 4.4. Defining investment by reference to the economic nature of an activity

##### A. Sale as investment

Both the *Salini* typical characteristics test and Douglas' right *in rem* theory of investment concur in recognising traditional property rights as investment. They also concur in their attempt to restrict the notion of investment by postulating the existence of outer limits and by distinguishing between *in rem* and *in personam* rights. However, as discussed above, the normative, conceptual and practical validity of these approaches is doubtful. 'Investment' remains open to a broad and potentially far-reaching interpretation. Notwithstanding the fact

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<sup>133</sup> Ibid para 115.

<sup>134</sup> Ibid para 116.

<sup>135</sup> BA Ackerman, *Private Property and the Constitution* (Yale University Press, New Haven and London 1977) 26.

that a liberal interpretation of the *Salini* test has allowed various service contracts into the realm of investment, arbitral practice reveals that some types of services may give rise to controversy. The jurisdictional award and the subsequent annulment decision in *Malaysian Salvors* are particularly illustrative. While the tribunal refused to characterise the salvage contract as a form of investment, the annulment committee reached the opposite conclusion.<sup>136</sup> It held that the outer limits of investment were defined by ‘the fundamental assumption that the investment does not mean sale.’<sup>137</sup>

In practice, however, a negative reference to sale raises some difficult questions. A blanket exclusion of sale from the scope of investment treaty protection is not commonly endorsed. It has been suggested that certain forms of sale may qualify as an investment. For instance, in *Pope & Talbot*, Canada contended that the ability to sell lumber in the US market was not an investment within the meaning of NAFTA.<sup>138</sup> The tribunal, however, found that the investor’s right to sell its product was critical to the investor’s business and therefore measures affecting the investor’s right to sell softwood lumber affected its investment.<sup>139</sup> Although the tribunal did not expressly hold that a right to sell one’s product in a certain market should qualify as investment, it correctly approached the issue by analysing the disputed right as an important element of the investor’s enterprise.<sup>140</sup> The tribunal’s discussion of the right to sell softwood lumber alludes to how investment should be correctly understood: an investment is frequently not limited to the acquisition of assets but also comprises of rights and interests that are essential to and obtained for the purpose of the

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<sup>136</sup> *Malaysian Salvors* (n 10) para 72.

<sup>137</sup> *Ibid.*

<sup>138</sup> *Pope & Talbot Inc v Canada*, Interim Award, 26 June 2000 (Ad hoc—UNCITRAL Arbitration Rules) para 97.

<sup>139</sup> *Ibid* para 98.

<sup>140</sup> See, however, critical comments by S Baughen, ‘Expropriation and Environmental Regulation: The Lessons of NAFTA Chapter Eleven (2006) 18 J Envtl L 207, 228 (suggesting that ‘once market access is treated as a distinct category of property..., it becomes far easier to categorise regulatory interference as amounting to an expropriation’).

activity which the investor intends to pursue in the host state.

*Pantechniki v Albania* is yet another decision illustrating the relationship between sales and investment.<sup>141</sup> In this case, the sole arbitrator held that while the sale of a single tractor could not be labelled ‘investment’, investment treaty protection ought not to be denied to a transaction involving the delivery of a large number of machines and envisaging a deferral of payments for a substantial period.<sup>142</sup> The arbitrator found that the claimant committed resources and equipment to carry out the bridge and road works under the contract.<sup>143</sup> In his finding of the claimant’s commitment under the contract as a form of investment, the arbitrator highlighted the shortage of material and skilled personnel in Albania at the time of the contract and the fact that the claimant had to import everything from cement to guardrails.<sup>144</sup>

It is submitted that the *Pantechniki* approach to defining investment is somewhat problematic. The arbitrator seems to have conflated the question of the commitment of resources with the issue of contribution to the host state development without, however, articulating the latter as a necessary component of investment. Furthermore, while admitting that a commitment of resources is required, the arbitrator did not elaborate on what kind of commitment would satisfy the test of investment.<sup>145</sup> Even if the decision is analysed without regard being paid to the arbitrator’s emphasis on the deplorable socio-economic situation in Albania at the time of the contract performance, one may infer that the commitment of resources requirement should be deemed satisfied where a contract involves the importation of materials and the deployment of skilled personnel. Such an approach to interpreting the

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<sup>141</sup> *Pantechniki v Albania* (n 88).

<sup>142</sup> Ibid para 44.

<sup>143</sup> Ibid para 48.

<sup>144</sup> Ibid para 49.

<sup>145</sup> See ibid para 36: having referred in its reasoning to Douglas’ theory of investment, the arbitrator omitted any reference to the latter’s suggestion on the exclusion of service contracts from the ambit of investment.

commitment of resources element can be characterised as very liberal. It echoes proposals for extending the benefits of investment treaty protection to any economic asset or activity.<sup>146</sup>

At the same time, *Pantechniki* and *Pope & Talbot* seem to support the view that, in principle, sale may form an investment. Yet, other tribunals expressly rejected the possibility of sale being recognised as investment.<sup>147</sup> In refusing to characterise a contract for the delivery and installation of mining equipment as a form of investment, the *Joy Mining* tribunal pointed to the United Nations Convention on Contracts for the International Sale of Goods as an instrument governing sale contracts.<sup>148</sup> This rationale is, however, problematic. If the existence of international instruments dealing with sale contracts implies that investment excludes sale of goods, a question arises as to whether services, too, should be denied the status of investment and thus be excluded from the scope of investment treaty protection. It can be argued that once services fall within the scope of the General Agreement on Trade in Services or, in the EU context, within the scope of EC Treaty provisions on the free movement of services and the freedom of establishment, the relevant transactions should not be regarded as investment.<sup>149</sup>

## B. BITs as instruments of market access and liberalisation

It is submitted that due to their broad compass investment treaty instruments could potentially be extended to protect sale as well as service contracts as a form of investment, unless an

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<sup>146</sup> See Mortenson (n 27); also Vargiu (n 74).

<sup>147</sup> See for example *Joy Mining* (n 10) paras 55-58; *Malaysian Salvors* (Annulment) (n 10) para 72.

<sup>148</sup> *Joy Mining* (n 10) para 58.

<sup>149</sup> General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, Legal Instruments--Results of the Uruguay Round vol. 1, 1869 UNTS 183, (1994) 33 ILM 1125, 1168; and Consolidated Version of the Treaty on the Functioning of the European Union art26 (ex Article 14 TEC). See also Van Harten (n 38) 78-9 (pointing to the existing overlap between international investment agreements and international trade instruments).

express provision to the contrary is made – as is the case with a number of BITs and FTAs.<sup>150</sup>

While appreciating that such a proposition has ramifications, it is important to take a realistic view of the potential for the broad interpretation that the notion of investment creates. Only then would it be possible to identify the pitfalls of the existing system and to make proposals for its improvement. A brief examination of the history of BITs helps to explain the troublesome ambiguity of the notion of investment and to ascertain possible solutions. Early international instruments on the protection of foreign interests abroad did not differentiate between goods, services and FDI. The first model BITs were negotiated and drafted before the dawn of economic liberalisation and large-scale privatisations, and at that time foreign investment was limited primarily to concessions in natural resources and long-term utilities.<sup>151</sup> Access to concessions, protection against expropriation and restrictions on the repatriation of returns were among the predominant concerns in the drafting of model clauses.<sup>152</sup> These concerns are mirrored in a typical BIT definition of investment, which invariably refers to investor rights, investor property, and investment returns, without, however, defining the types of transactions or forms of activities entitled to protection. Treaty drafters intentionally left the definition open to allow its flexible interpretation, fearing that precision in the wording of the relevant provisions might prevent future investors from committing resources in new areas not covered by a treaty.<sup>153</sup>

It is also interesting that as predecessors of modern BITs, FCNs were originally

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<sup>150</sup> See, for example, Article I (xi) (i) of the 2005 Australia–Mexico BIT providing that investment does not include claims to money that arise solely from commercial contracts for the sale of goods or services by a national or enterprise in the territory of a contracting party to a national or enterprise in the territory of another contracting party. A similar provision is contained in the 2002 Mexico–Czech Republic BIT. See also JW Salacuse, *The Law of Investment Treaties* (n 55) 162 (concluding that ‘by extending the treaty’s application to ‘any kind of assets’ the definitions are designed to protect as wide a range of investment forms as possible’).

<sup>151</sup> WS Culbertson, ‘Foreign Interests in Mexico’ (1938) 17 *International Affairs* 769.

<sup>152</sup> See Vandevelde (n 39) 21, S Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, Oxford 2008) 114-5.

<sup>153</sup> Vandevelde *ibid.*



intended to promote international commerce,<sup>154</sup> and only following the emergence of bilateral trade agreements and the GATT were they ‘retooled to fit the newly crystallized investment need.’<sup>155</sup> The range of activities covered by FCNs cut across commerce and industry generally.<sup>156</sup> The subsequent spread of liberalisation and privatisation processes opened up foreign markets to a large group of foreigners who could benefit from the existing protection standards. A new generation of investment treaty instruments, including the failed Multilateral Agreement on Investment, pursued the aim of not only the protection of foreign investment but also that of liberalisation and improving access to markets.<sup>157</sup> This blend of the investment protection and market liberalisation objectives is evident in some investment instruments, which include clauses providing for investor rights of entry and establishment.<sup>158</sup> Such clauses can be viewed as an embryonic form of a freedom of establishment and free movement of goods and services. This shows a partial overlap in the material scope of BITs, trade agreements, and regional economic integration instruments.<sup>159</sup> Consequently, the notion of investment emerges as a poorly defined conglomerate of rights relating to the protection of foreign property abroad and the promotion of the unrestricted movement of capital, services

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<sup>154</sup> The primary purpose of FCNs was to establish closer commercial and political relations between the contracting parties. See H Walker Jr, ‘Treaties for Encouragement and Protection of Foreign Investment: Present United States Practice (1956) 5 A J Comp L 229, 231; K Vandeveld, ‘A Brief History of International Investment Agreements’ (2005) 12 U C Davis J Intl L & Policy 157, 158.

<sup>155</sup> Walker *ibid* 231.

<sup>156</sup> *Ibid* 232.

<sup>157</sup> G Sacerdoti, ‘Bilateral Treaties and Multilateral Instruments on Investment Protection’ (1998) 269 *Recueil des Cours de l’Académie de Droit International* 251 (n 74) 265; PT Muchlinski, ‘The Rise and Fall of the Multilateral Agreement on Investment: Where Now?’ (2000) 34 *Intl Law* 1033, 1038; R Echandi, ‘Bilateral Investment Treaties and Investment Provisions in Regional Trade Agreements: Recent Developments in Investment Rulemaking’ in K Yannaca-Small (ed), *Arbitration under International Investment Agreements: A Guide to the Key Issues* (OUP, Oxford 2010) 8 (noting that ‘greater market access through market presence, and not just protection for private property, is gradually becoming part of the main interest of international investors when seeking the application of an IIA’). The fact that investment protection chapters are increasingly included in FTAs is also illustrative.

<sup>158</sup> I Gomez-Palacio and P Muchlinski, ‘Admission and Establishment’ in PT Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook on International Investment Law* (OUP, Oxford 2008) 228. See also Subedi (n 152) (noting that a BIT is in effect an individual market tool designed to open a domestic market to foreign investors). Also Salacuse (n 55) 112-3; 89-90.

<sup>159</sup> Muchlinski *ibid* 232 (noting that a right of admission ensures access to cross-border provision of goods and/or services and this represents the case of not so much investment but trade).

and goods.<sup>160</sup> The growing tendency to extend the benefits of investment protection instruments to service contracts and, in certain industry sectors, to sale contracts,<sup>161</sup> demonstrates the problem with the original drafting, which reflected a preoccupation with the protection of foreign interests that were engaged in a wide range of economic activity. The history of investment treaty protection tends to support a very broad notion of investment, which includes capital movements as well as sale and services. While the international regulation of trade in goods and services has developed into a separate area of international economic law, due to the open-ended definition of investment BITs continue to ‘regulate the exercise of sovereign authority over *international business* in general.’<sup>162</sup>

#### 4.5. Defining investment: the nature and extent of the investor’s engagement

An alternative approach to defining investment would be to rely on the nature and extent of a putative investor’s involvement in a particular business. It has been suggested that investment necessitates a partnership between the foreign business and the host state, as opposed to a

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<sup>160</sup> The fact that the notion of investment is parasitic on various forms of business activities is evidenced in Sacerdoti’s work on Bilateral Treaties and Multilateral Instruments (above n 74). When dealing with different aspects of foreign investment, the author has considered BITs as well as EC treaty provisions on establishment and free movement of capital. From this perspective, one can argue that investment, as the subject matter of BITs, is rather ill-suited as it presents a rather poorly defined conglomerate of rights relating to access to markets, establishment, and movement of foreign capital and services. See also, K Yannaca-Small, ‘Definition of “Investment”: An Open-Ended Search for a Balanced Solution’ in K Yannaca-Small (ed), *Arbitration under International Investment Agreements: A Guide to the Key Issues* (OUP, Oxford 2010) 244 (noting that a definition of investment depends on the objective pursued by a certain investment treaty instrument, and indicating that liberalisation of capital movements has been one of the reasons for the replacement of the static notion of property by the dynamic notion of investment). See further S Hindelang, *The Free Movement of Capital and Foreign Direct Investment: The Scope of Protection in EU Law* (OUP, Oxford 2009) (analysing the protection of foreign investment under the EU regime of free movement of capital).

<sup>161</sup> For instance, Article 1 of the Energy Charter Treaty (1994) where an investment is defined by reference to Economic Activity in the energy sector, including ‘trade, marketing, or sale of Energy Products and Materials.’ See E Gaillard, ‘Investment and Investors Covered by the Energy Charter Treaty’ in C Ribeiro (ed), *Investment Arbitration and the Energy Charter Treaty* (JurisNet, 2006) 64-5.

<sup>162</sup> Van Harten (n 38) 80 (emphasis added).

‘vendor-client’ relationship.<sup>163</sup> For instance,

..if the principal reason for the foreign company to participate is to sell some resources in connection with the project (for example, equipment, technology, etc.) and not to obtain for itself a part of the profits generated by the exploitation of the project... then, from the company perspective, the operation is a sale, and not an investment.<sup>164</sup>

Thus, if remuneration is obtained from the construction of a plant, and not from the profits generated by the commercial exploitation of the plant, the operation should not be characterised as an investment. The key requirement is the investor’s participation in a project after its completion, that is, after it has realised its immediate interest in selling goods or delivering services. This approach is focused not on the type of economic activity or its typical characteristics, but on the nature of the investor’s engagement in an enterprise. In contrast with the right *in rem* theory of investment, this proposed framework admits certain forms of contractual undertakings as investment. Production-sharing and joint venture agreements are the prime examples: in both categories of contract, a putative investor becomes entitled to its share of profit after the project has moved to the exploitation phase. From the pool of existing arbitral awards only few would satisfy the strictly defined commitment of resources requirement.<sup>165</sup> Road construction, pre-shipment inspection, and salvage contracts would not pass the test due to the lack of investor engagement in the post-delivery phase. The stringency of the test enables the accommodation of the investment treaty objectives of promoting capital flows and business initiative because foreign companies are enabled to take part in a variety of business activities without being limited to projects that necessitate the acquisition of property. The test is equally capable of promoting the host

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<sup>163</sup> Yala (n 11) 107.

<sup>164</sup> C Oman, ‘Les Nouvelles Formes d’Investissement Dans les Industries des Pays en Voie de Developpement’ (1989) referred to in Yala (n 11) 113.

<sup>165</sup> By way of example, projects in *Saipem*, the *SGS* cases, *Bayindir* and *Salini* would not pass this test, whereas the type of project in *PSEG Global v Turkey* might qualify as an investment.

state's interests in extending the benefits of investment treaty protection only to investors with sustained involvement in a relevant sector of the economy, to the exclusion of one-off transactions. Importantly, this approach is likely to mitigate the growing perception of investment treaties as an embodiment of exclusively pro-investor policy.

Desirable though it may be, the focus on the nature and extent of engagement in a putative investment project is just a proposal for reform. As is the case with the *Salini* test and Douglas' rights-*in-rem* approach, the proposed solution cannot be read into the definition of investment in BITs or Article 25(1) ICSID. Yet, should states wish to revise investment treaties and define the ambit of treaty protection in more exacting terms, the proposed test can be considered as a possible drafting solution.

## 5. Conclusion

Behind the flexible and open-ended definition of investment lies an ambitious and inadequately formulated promise to protect a wide range of foreign interests whilst also safeguarding access to markets. Investment is a catchphrase for the commitment of resources in various fields of business activity, including finance, services, and trade. In practice, however, extending investment treaty protection to a wide range of economic interests is likely to deepen a growing discontent with investment arbitration.<sup>166</sup> The magnitude of the role vested in investment treaties and in investor-state arbitration calls for a clarification of what investment treaty protection is about. It is true that defining investment 'requires a nice balancing of international interests in the protection of the investment and the interests of the

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<sup>166</sup> See A Van Aaken, 'Perils of Success? The Case of International Investment Protection' (2008) 9 European Business Organization L Rev 1; A Kaushal, 'Revisiting History: How the Past Matters For The Present Backlash Against The Foreign Investment Regime' (2009) 50 Harv Intl L J 491.

host state in regulating the process having its own benefits in mind.’<sup>167</sup> However, relying on arbitral pronouncements in the hope that some acceptable definition would emerge does not seem to be a sensible way forward. The practice of investment arbitration shows that in the absence of a settled meaning of investment, tribunals have adopted markedly different positions. The existing uncertainty about the subject matter of investment treaty protection needs to be addressed through the articulation of treaty objectives, including the objective of economic liberalisation and the protection of foreign business interests abroad. The revision of investment treaty instruments should be regarded as an opportunity to clarify the mandate of investment treaties and investor-state arbitration.<sup>168</sup>

By exposing the breadth of the existing approaches to defining investment, this chapter does not argue for a broad definition of investment. Nor does it support an expansionist view of state responsibility in international investment law. Rather, it purports to show that, until states agree on a more exacting definition of investment, the law as it stands today allows claims brought directly against host states in connection with any commitment of resources in the expectation of a profit. Furthermore, this chapter highlights the fact that under most investment treaties not only the overall investment project, but also its individual elements, such as claims to money and performance having an economic value, as well as other rights incidental to an investment, are entitled to international protection. An historical overview of BITs also supports the conclusion that the original investment treaty mandate has not been confined to the protection of foreign property abroad, but has equally encompassed the entitlement of foreign nationals and enterprises to international remedies for injuries caused by governmental action in relation to contractual undertakings and other interests that

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<sup>167</sup> Sornarajah (n 23) 18.

<sup>168</sup> See Krishan (n 27) 10 (observing that ‘[t]here is no schematic warrant for investor–State tribunals to create the law in this respect; they are simply empowered to determine, on a case by case basis, whether the transaction put before them is an investment or not’).

form part of business undertakings abroad. Hence, the emphasis naturally shifts from 'expropriation' to 'host state interference with a foreign investor's rights arising from an investment'. A state may be held responsible for not only acts that take or destroy the value of an investment as a whole, but also for conduct that divests the investor of individual rights accruing to the investor in connection with its business. Since there remains a need for the clearer articulation of a substantive range of investment treaty instruments, state parties may choose to define an investment in more restrictive terms, and this would in turn scale back the scope of state responsibility towards the investor. Until such time, however, the breadth of 'investment' means that host states can be held responsible for interference with the investor's rights which goes beyond an expropriation of property.

## **CHAPTER II: EXPROPRIATION AS A SUBSTANTIAL DEPRIVATION: TOWARDS A UNIFIED CONCEPT OF AN INVESTMENT TREATY BREACH**

The shift from a broad definition of property to an even broader notion of investment has inevitably affected the ways in which the question of establishing the existence of expropriation has been dealt with in arbitral practice. This chapter will critically examine the sole effect doctrine and the rule of substantial deprivation, both of which investment tribunals frequently rely upon in deciding whether a host state's interference with an investment is expropriatory and subject to the payment of compensation. It will be argued that, despite its prevalence in arbitral practice, the substantial deprivation rule fails to offer a reliable criterion for distinguishing between compensable and non-compensable regulatory measures. First, the 'substantiality' threshold is not only subjective but also can be bypassed through corporate structuring and indirect shareholder claims. Second, the substantial deprivation test has not been applied consistently in cases involving the dispossession of tangible and intangible assets. As the test betrays a preoccupation with the permanence of ownership and physicality, it fails to accommodate the protection of intangible assets and therefore is conceptually ill-founded. Finally, neither a definition of investment nor the standards of treatment other than expropriation support the theory of substantial deprivation. Instead, the formulation of investment treaties expressly extends protection to the whole investment as well as its various strands, regardless of whether the interference with the relevant entitlement is substantial.

### **1. 'Sole effect' doctrine and the rule of substantial deprivation**

#### **1.1. General**

Whilst the fact that an expropriation has occurred may be relatively straightforward to establish in cases involving the physical taking of a property, indirect interference with an investment may not so easily yield to analysis. Indirect—or disguised, constructive, creeping, regulatory—expropriation can be problematic because the title to property frequently remains unaffected and no appropriation by the government takes place. Therefore, the most difficult question is ‘not to determine whether the conditions for a lawful expropriation have been met or not, but rather whether there has been an expropriation at all.’<sup>1</sup> Under the traditional expropriation standard, the fact of expropriation was rarely doubted as it involved an outright taking of assets or a total destruction of the investment through denying the investor a right to operate its business.<sup>2</sup> The terms ‘deprivation’ and ‘expropriation’ were often used interchangeably.<sup>3</sup> Once something of value was taken away, the owner was entitled to an indemnification. Unsurprisingly, as traditional expropriations gave way to indirect state interference with foreign investment,<sup>4</sup> the impact a governmental measure on the claimant’s

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<sup>1</sup> K Hobér, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation* (JurisNet, New York 2007) 14-5

<sup>2</sup> See, for example, the Sicilian sulphur disputes that arose after the Kingdom of the Two Sicilies had entered into a contract granting a monopoly over the extraction of sulphur thus harming the interests of the UK nationals engaged in the sulphur industry in Sicily (discussed in GS Christie, ‘What Constitutes A Taking of Property Under International law’(1962) 38 British Ybk Intl L 307, 320-1).

<sup>3</sup> For an earlier study, see WD Verwey and NJ Schrijver, ‘The Taking of Foreign Property Under International Law: A New Legal Perspective?’ (1984) Netherlands Ybk Intl L 3. More recently, similar findings were made in UNCTAD, *Bilateral Investment Treaties 1995-2006: Trends in Investment Rule-Making* (United Nations, New York 2007) 45-6.

<sup>4</sup> Direct expropriations have not completely receded into the past. See *Bernardus Henricus Funnekotter and ors v Zimbabwe*, Award, 19 April 2009 (ICSID Case No ARB/05/6), a dispute concerning the expropriation of commercial farms as part of the Land Acquisition Programme; *Yaung Chi Oo Trading Pte Ltd v Myanmar*, Award, 31 March 2003 (ASEAN Case No ARB/01/1) (2003) 42 ILM 540, a claim concerning the seizure of a brewery in Mandalay; *Cemex Caracas Investments BV and Cemex Caracas II Investments BV v Venezuela*, Decision on Provisional Measures, 3 March 2010 (ICSID Case No ARB/08/15), a dispute over the nationalisation of the cement business and the confiscation of the cement carrier vessels; *SwemBalt AB v Latvia*, Award, 23 October 2000 (Ad hoc—UNCITRAL Arbitration Rules), a case concerning the confiscation of a vessel (discussed in Hobér (n 1) 58); see also S Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, Oxford 2008) 75-6 (pointing to an ecological expropriation in Peru in the case of *Empresas Lucchetti SA and Lucchetti Peru SA v Peru*, Jurisdiction award, 7 February 2005 (ICSID Case No ARB/03/4), a dispute concerning a plant constructed near a protected wetland). For recent Latin American nationalisations in the energy sector, see M R de Sa Ribeiro, ‘Sovereignty over Natural Resources Investment Law and Expropriation: The Case of Bolivia and Brazil’ (2009) 2 J World Energy L & Business 129; E Eljuri



ability to use and enjoy its investment—or in other words the fact of deprivation—has come to be regarded as a primary condition for establishing a breach of the expropriation standard.<sup>5</sup>

The sole effect doctrine<sup>6</sup> features prominently in the Iran-United States Claims Tribunal rulings in indirect expropriation claims. For instance, in *Tippetts*, the tribunal addressed a claim of expropriation that had allegedly been caused by the appointment of a new manager to the partnership which the claimant formed with the local engineering firm. In an often-cited passage, the decision held that ‘the intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.’<sup>7</sup> In the practice of investment arbitration, the tribunal in *Metalclad v Mexico* was among the first panels to endorse the sole effect approach in the context of determining the host state responsibility for regulatory interference with an investment.<sup>8</sup> It construed the expropriation standard in Article 1110 NAFTA as justifying the finding of expropriation whenever the interference with the use of investment ‘has the effect of depriving the owner, in whole or in significant part, of the use or

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and C Treviño, ‘Venezuela: On the Path to Complete Oil Sovereignty’, or the Beginning of a New Era of Investment?’ (2009) 2 J World Energy L & Business 259; E Eljuri and JC Daniela, ‘The 2007 Nationalization of the Venezuelan Orinoco Oil Belt’ (2008) 2 OGEL, available at <<http://www.ogel.org>>; G Rachadell de Delgado and N Vojvodic, ‘Nationalization Trends in the Venezuelan Oil Industry’ (2008) 2 OGEL, available at <<http://www.ogel.org>>.

<sup>5</sup> R Dolzer, ‘Indirect Expropriations: New Developments?’ (2002) 11 NYU Envtl L J 64, 79; A Hoffman, ‘Indirect Expropriation’ in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 156; C Schreuer, ‘The Concept of Expropriation under the ECT and other Investment Protection Treaties’ in C Ribeiro, *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington, NY 2006) 145; H Sedigh, ‘What Level of Host State Interference Amounts to a Taking under Contemporary International Law?’ (2001) 2 J World Investment & Trade 631, 638; JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 316-7; A Reinisch, ‘Expropriation’ in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 444-6.

<sup>6</sup> Dolzer *ibid* 79; see also LI Fortier and SL Drymer, ‘Indirect Expropriation in the Law of International Investment: I Know When I See It, or Caveat Investor’ (2004) 19 ICSID Rev – Foreign Investment L J 293, 308-13.

<sup>7</sup> (1984) 6 Iran USCTR 219, 225-6; see also *Phelps Dodge Corporation v Iran* (1986) 10 Iran-USCTR 121, 130: ‘[t]he Tribunal fully understands the reasons why the Respondent felt compelled to protect its interests through this transfer of management, and the Tribunal understands the financial, economic and social concerns that inspired the law pursuant to which it acted, but those reasons and concerns cannot relieve the Respondent of the obligation to compensate Phelps Dodge for its loss.’

<sup>8</sup> *Metalclad Corporation v Mexico*, Award, 25 August 2000 (ICSID Case No ARB (AF)/97/1) (2001) 40 ILM 36

reasonably-to-be-expected economic benefit of property.’<sup>9</sup> A decade later, the effects-based analysis still holds sway. Recently, a NAFTA tribunal in *Corn Products v Mexico* held that governmental measures which have a detrimental effect on an investor’s markets, even if they are discriminatory, would not constitute an expropriation unless they had the effect of destroying the business in question.<sup>10</sup> This decision represents the far end of the spectrum whereby the effect is regarded as the sole criterion in the expropriation analysis, to the exclusion of other factors such as the character of the conduct.<sup>11</sup>

Although the sole effect doctrine has not been the only dominant mode of thinking in arbitral practice,<sup>12</sup> it continues to exert a considerable influence on the process of defining the scope of protection against expropriation in investment treaty law. The doctrine continues to influence arbitral decision-making through the tendency among the tribunals to establish the existence of expropriation by reference to the degree of deprivation inflicted on the investor as a result of the host state interference.<sup>13</sup> As stated by the tribunal in *Pope & Talbot*, expropriation requires a ‘substantial deprivation.’<sup>14</sup> After having observed that it might sometimes be uncertain whether a particular interference is expropriatory, the tribunal found that the proper test would be to examine whether the challenged regulation is ‘sufficiently restrictive to support a conclusion that the property has been ‘taken’ from the owner.’<sup>15</sup> More recently, the tribunal in *Continental Casualty v Argentina* similarly pointed to impact as a

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<sup>9</sup> Ibid para 103.

<sup>10</sup> *Corn Products International Inc v Mexico*, Decision on Responsibility, 15 January 2008 (ICSID Case No ARB(AF)/04/1) para 93.

<sup>11</sup> *Nykomb Synergetics Technology Holding AB v Latvia*, Award, 16 December 2003 (SCC Case No 118/2001) para 33.

<sup>12</sup> For alternative approaches to interpreting and applying the expropriation standard, see Chapter III.

<sup>13</sup> For discussion, see A Reinisch, ‘Expropriation’ in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 438-42; also A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 344.

<sup>14</sup> *Pope & Talbot Inc v Canada*, Interim Award, 26 June 2000 (Ad hoc—UNCITRAL Arbitration Rules) para 102.

<sup>15</sup> Ibid.

criterion in determining the expropriatory character of a government's conduct:

There are certain types of measures or state conduct that are considered a form of expropriation because of their material impact on property...One may distinguish between: (a) outright suppression or deprivation of the right of ownership, usually by its forced transfer to public entities; (b) limitations and hampering with property, short of outright suppression or deprivation, interfering with one or more key features, such as management, enjoyment, transferability, which are considered as tantamount to expropriation, because of their substantial impact on the effective right of property. Both of these types of measures entail indemnification under relevant international treaties...<sup>16</sup>

The rule of substantial deprivation reflects an attempt to gear the international rules governing expropriation to cases which fall short of a physical deprivation and total destruction of an investment.<sup>17</sup> Since governmental measures may indirectly bring about a diminution in the investment's value or otherwise hinder the use and enjoyment of the investment without dispossessing the investor of its control and management rights, the substantial deprivation test envisages the possibility of the investor being entitled to compensation in a case where such governmental measures pass a certain threshold. As the test requires a deprivation to be substantial, it can be seen as a compromise between a total exemption of regulatory measures from the compensation requirement and an imposition on the government of an obligation to indemnify the investor every time a regulation interferes with the use and enjoyment of an investment.

Although the substantial deprivation test has been hailed for its ability to serve as a factual criterion for determining the existence of a compensable expropriation,<sup>18</sup> the

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<sup>16</sup> *Continental Casualty Company v Argentina*, Award, 5 September 2008 (ICSID Case No ARB/03/9) para 276.

<sup>17</sup> See J Hertz, 'Expropriation of Foreign Property' (1941) 35 AJIL 243, 251 (noting that the question of degree does not arise in connection with express takings of individualised pieces of property but becomes relevant if a disputed measure indirectly interferes with property, i.e. diminishes its value through certain acts).

<sup>18</sup> See Dolzer (n 5) 79; Hoffman (n 5) 168; also Newcombe and L Paradell (n 13) 343: 'A substantial deprivation is a necessary *factual* predicate for a determination of *legal* liability for expropriation' (emphasis original); Z Douglas and J Paulsson, 'Indirect Expropriation in Investment Treaty Arbitrations' in N Horn and S Kröll, *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The Hague 2000) 145. See also A Kolo and T Waelde, 'Environmental Regulation, Investment Protection and "Regulatory Takings" in International Law'

feasibility of the test and its conceptual foundations are doubtful. It has been correctly observed that the meaning of ‘substantial deprivation’ is relative.<sup>19</sup> A deprivation must be substantial but with respect to what?<sup>20</sup> If the host state withdraws one of an investor’s many licences, would such a withdrawal amount to a substantial deprivation? What if the investor’s licence remains intact but the host government adopts a new regulation significantly reducing the profitability of the investor’s business under that licence? In either case, the investor suffers a certain degree of deprivation. Not only is it unclear when the threshold of substantiality is deemed to be satisfied but determining the existence of the requisite degree of deprivation is also problematic. Should the existence of a deprivation be ascertained by reference to an investment as a single unit, to an asset that such an investment comprises, or to the value of an investment? As will be shown below, the substantial deprivation test is open to different interpretations and therefore cannot serve as a reliable criterion for establishing the existence of a compensable expropriation.

## 1.2. Substantial deprivation and ‘conceptual severance’

The investor can bypass the substantial deprivation test by resorting to so-called conceptual severance, whereby an investment is presented as consisting of several components, with each of these components possessing an economic value. This analytical approach has been successfully deployed in regulatory takings claims before the US courts in a number of cases. As Radin explains, to apply conceptual severance

...one delineates a property interest consisting of just what the government action has removed from the owner, and then asserts that that particular whole thing has been permanently taken. Thus, this strategy hypothetically or conceptually “severs” from

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(2001) 50 ICLQ 811, 839-840.

<sup>19</sup> See S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 188.

<sup>20</sup> Ibid 265-6.

the whole bundle of rights just those strands that are interfered with by regulation, and then hypothetically or conceptually construes those strands in the aggregate as a separate whole thing.<sup>21</sup>

Conceptual severance was a vehicle by which a dissenting judge in *Penn Central*, a well-known US judicial decision in a regulatory expropriation case, arrived at his finding of a taking.<sup>22</sup> In contrast, the majority opinion held that the takings jurisprudence ‘does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated’; rather, the focus should be on the ‘parcel as a whole.’<sup>23</sup> Although conceptual severance has not been uniformly endorsed by the US courts, it has been successfully deployed in a number of cases, including *Nollan v California Coastal Commission*<sup>24</sup> (construing a public access easement as a complete taking) and *Loretto*<sup>25</sup> (placing a cable on the roof of a building was found effectively to destroy the whole bundle of rights).

As far as international investment law is concerned, the idea of conceptual severance was met with a degree of resistance.<sup>26</sup> However, it would be more realistic to acknowledge that the complexity of certain investment transactions and the intricacy of structures utilised in channelling foreign investment across the globe both provide many opportunities to deploy conceptual severance legitimately and without any analytical strain. Not only can an investment be dissected into a number of independent revenue-generating assets, but also the rights the investor possesses over each individual asset can be further segregated into a set of rights having an economic value. Consider, for instance, a concession contract the

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<sup>21</sup> MJ Radin, *Reinterpreting Property* (University of Chicago Press, 1993) 127-8.

<sup>22</sup> *Penn Central Transp. Co. v. New York City* [1978] 438 US 104, 142-44.

<sup>23</sup> 483 U.S. 130-31. See also Radin (n 21) 128.

<sup>24</sup> 483 U.S. 825 [1987]

<sup>25</sup> *Loretto v Teleprompter Manhattan CATV Corp* [1982] 458 U.S. 419. For a critical discussion, see Radin (n 21) 127-30.

<sup>26</sup> See Montt (n 19) 188-91, 265-73; Newcombe and Paradell (n 13) 347-8.

profitability of which is significantly affected by a regulation abolishing VAT refunds. If the concession represents only a minor part of the investor's portfolio in the host state, the investor may not be able to show a substantial deprivation. However, the investment can be structured through the establishment of an offshore subsidiary. Here, the investor can recuperate its loss by channelling an investment claim through the appropriate corporate vehicle. Although the reduction of the concession's profitability might have only marginal effect on the value of the parent company's investment, the investor's subsidiary may be in a position to claim a substantial deprivation because the concession contract was the only significant asset on its balance sheet. Providing that a BIT exists between the host state and the offshore haven where the subsidiary vehicle was incorporated, the investor can satisfy the substantial deprivation rule by resorting to corporate structuring and forum shopping. Although corporate structuring and forum shopping are not entirely compatible with the idea of creating a credible and balanced investment protection regime,<sup>27</sup> the reality is that they do enable investors to satisfy easily the threshold of substantial deprivation.

Furthermore, the recent practice of investment arbitration shows support for conceptual severance. A number of arbitral tribunals have explicitly considered the possibility of a partial expropriation resulting from the deprivation of only part of the investment as opposed to its total or substantial loss.<sup>28</sup> For instance, the tribunal in *SD Myers* expressly held that in some contexts and circumstances it would be appropriate to view deprivation as amounting to an expropriation even if it were partial.<sup>29</sup> In a similar vein, the *Waste*

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<sup>27</sup> For a critical discussion of corporate structuring and forum shopping, see Subedi (n 4) 92 and M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 325-9; however compare SW Schill, *The Multilateralization of International Investment Law* (CUP, Cambridge 2009) 199-235 (dismissing the critique of corporate structuring and forumshopping and considering them as legitimate instruments of multilateralisation).

<sup>28</sup> For an overview, see U Kriebaum, 'Partial Expropriation' (2007) 8 J World Investment & Trade 69, 77-82.

<sup>29</sup> *SD Myers Inc v Canada*, First Partial Award and Separate Opinion, 13 November 2000 (Ad hoc—UNCITRAL Arbitration Rules) para 283.

*Management* tribunal has acknowledged the possibility of a partial expropriation of certain assets, such as the amounts unpaid under a contract.<sup>30</sup> In *Middle East Cement v Egypt*, an overall investment operation was found to be composed of several distinct investments.<sup>31</sup> In its analysis of the investor's expropriation claims, the tribunal separately examined the revocation of the investor's licence to import cement and the seizure of the investor's ship. Hence, the award implicitly supports the position according to which the finding of expropriation does not necessitate evidence of an entire investment being substantially destroyed.<sup>32</sup> The problem of partial expropriation was further addressed in *GAMI v Mexico*. In this case, a dispute arose from the expropriation of five sugar mills owned by GAM, a Mexican holding company in which GAMI Investments (a US corporation) held 14.18% shares. While the act ordering expropriation of the three mills was later reversed by municipal courts, GAMI Investments still contended that the value of its investment in GAM was destroyed by Mexico's conduct in violation of its obligations under Chapter 11 NAFTA. In examining the investor's claim of expropriation, the tribunal distinguished between the substantial diminution in the value of the investor's shareholding in GAM, and the loss inflicted by a formal expropriation of two out of five sugar mills owned by GAM.<sup>33</sup> The tribunal held that for an expropriation claim to succeed, the claimant-investor ought to show a

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<sup>30</sup> *Waste Management Inc v Mexico*, Award, 30 April 2004 (Case No ARB(AF)/00/3) para 141. Similarly, partial expropriation was found in *Eureko v Poland*, although the tribunal did not couch its findings in explicit terms. See *Eureko BV v Poland*, Partial Award and Dissenting Opinion, 19 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) paras 239-241. Similarly, the *EnCana* tribunal held that refunds are capable of being expropriated independently of the overall investment. See *EnCana Corporation v Ecuador*, Partial Award on Jurisdiction, 27 February 2004 (LCIA Case No UN3481) paras 182-183. Also, *Pope & Talbot* and *SD Myers* recognised the opportunity to sell one's product as a property interest. Such interpretation of property opens the door to further conceptual severance. (*Pope & Talbot* (n 14) para 97; *SD Myers Inc v Canada* (n 29) para 232).

<sup>31</sup> *Middle East Cement Shipping and Handling Co Sa v Arab Republic of Egypt*, Award, 12 April 2002 (Case No ARB/99/6) (2003) 18 ICSID Rev 602, paras 105-138.

<sup>32</sup> *Kriebaum* (n 28) 81.

<sup>33</sup> *GAMI Investments, Inc v Mexico*, Final Award, 15 November 2004 (Ad hoc—UNCITRAL Arbitration Rules) paras 127-128.

substantial deprivation or “impairment of value” of its shareholding.<sup>34</sup> Although the investor’s claim of expropriation failed, the tribunal indicated that the dispossession of only one out of five sugar mills would still constitute an expropriation.<sup>35</sup>

It is also worth noting that, in a number of cases, claims of expropriation have been dismissed on the grounds that the degree of deprivation was less than substantial.<sup>36</sup> For instance, in *Telenor Mobile v Hungary* the tribunal adopted the ‘parcel as a whole’ approach and rejected a claim of partial expropriation.<sup>37</sup> The dispute concerned a concession for the operation of public mobile radiotelephone services. The investor claimed that it had been detrimentally affected by changes in the regulatory framework after Hungary introduced a so-called ‘universal telephone service’ which envisaged provision to the public of a minimum set of telecommunication services at a reasonable cost.<sup>38</sup> Hungary set up a fund to finance the unrecovered costs incurred by universal service providers and all telecommunication operators, including the investor, had to contribute to the fund. Telenor contended that the imposition of a levy constituted a regulatory expropriation. The tribunal expressly dismissed the earlier arbitral awards that had recognised the possibility of partial expropriation. In the tribunal’s view, the investment ought to be viewed as a whole and therefore the proper test

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<sup>34</sup> Ibid para 126: ‘Should *Pope & Talbot* be understood to mean that property is taken only if it is so affected in its entirety? That question cannot be answered properly before asking: what property? The taking of 50 acres of a farm is equally expropriatory whether that is the whole farm or just a fraction. The notion must be understood as this: the affected property must be impaired to such an extent that it must be seen as “taken”.’

<sup>35</sup> *GAMI* (n 33) para 127.

<sup>36</sup> *CMS Gas Transmission Company v Argentina*, Award, 12 May 2005 (ICSID Case No ARB/01/8) paras 259-263. Similarly, the possibility of partial expropriation was implicitly rejected in *Nykomb v Latvia* (n 11) para 59; *Occidental Exploration and Production Company v Ecuador*, Award, 1 July 2004 (LCIA Case No UN 3467) para 89; *Marvin Feldman v United States of Mexico*, Award 16 December 2002 (Case No ARB(AF)/99/1) 7 ICSID Rep 341; 142. See Kriebaum (n 28) 74-6.

<sup>37</sup> *Telenor Mobile Communications AS v Hungary*, Award, 22 June 2006 (ICSID Case No ARB/04/15). The ‘parcel as a whole’ rule was applied in *Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency* (2002) 122 S. Ct 1465. See Newcombe & Paradell (n 13) 347-8 (explaining that the parcel as a whole approach militates against conceptual severance by focusing on an investment in its entirety. Under the ‘parcel as a whole’ rule, the property owner cannot divide its bundle of property rights and argue that the strand affected by the regulation has been taken).

<sup>38</sup> Ibid paras 22-23.



should examine whether, viewed as a whole, the investment had suffered substantial erosion of value.<sup>39</sup> It observed that what the claimant had complained of was merely a diminution in the value of its investment. Since the effect of the measures fell short of the substantial economic deprivation of the investment, no expropriation was found to have occurred.<sup>40</sup>

Without disputing the outcome of the decision,<sup>41</sup> it is submitted that the deployment of the substantial deprivation rule in *Telenor* is not well founded and, therefore, should not be seen as a viable method of determining investor claims against regulatory measures. The tribunal's 'parcel as a whole' approach and the rejection of a partial expropriation claim is problematic if viewed against the treatment by arbitral tribunals of partial expropriation claims involving a physical dispossession. First, it transpires from arbitral practice that tribunals are prepared to find expropriation in a case where the investor has been partly dispossessed of its tangible assets. Yet tribunals fail to extend a similar approach to a partial dispossession of intangible interests. Second, the wording of investment treaties can be invoked in support of the view that investors are protected against a total loss of investment as well as a partial loss affecting either the whole investment or its constitutive elements. Each of these arguments will be further explored below.

### 1.3. Substantial deprivation: preoccupation with tangibility and severability

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<sup>39</sup> Ibid para 67.

<sup>40</sup> Ibid paras 71-79.

<sup>41</sup> For different reasons, the disputed conduct ought not to be regarded as expropriatory and hence compensable. As will be argued in Chapter III, the mere fact of deprivation—whether substantial or not—should not constitute a treaty violation. Without examining the degree of deprivation incurred by the investor, the *Telenor* tribunal could have plausibly dismissed the claim of expropriation by reference to the police powers exception and by examining the character of a disputed measure. In fact, the tribunal did acknowledge that certain forms of state interference would not qualify as expropriation. According to the tribunal, '[i]t is well established that the mere exercise by the government of regulatory powers that create impediments to business or entail the payment of taxes or other levies does not of itself constitute expropriation' (ibid 64).

It is usually undisputed that a physical taking of some of an investor's assets amounts to an expropriation even if the remainder of the investment is left intact. An expropriation of two out of five mills arguably provides a sufficient basis to hold the state liable for that partial divestment without imposing an unreasonable threshold of totality or substantiality of a deprivation.<sup>42</sup> As the *GAMI* tribunal held, even the loss of one out of five mills would amount to substantial deprivation and trigger the expropriation standard because the owner has been formally dispossessed of its property.<sup>43</sup> If the investor is entitled to recovery of the loss caused by the formal taking of one out of five mills, it can be argued that the same principle should apply to the investor who suffers a 20% diminution in value of its investment even if the latter case does not involve a formal dispossession. The investor's counsel may well make the case that a regulatory measure causing a loss of 20% of the investor's revenue is just as detrimental as a partial expropriation of physical assets belonging to the investor. The argument rejecting the investor's claim on the ground that the diminution in value of its investment does not involve the loss of tangible assets betrays a preoccupation with physicality<sup>44</sup> and a failure to take into account the fact that the notion of property embraces intangible assets. If a dispossession of one out of many tangible assets meets the substantial deprivation test—or simply does not call for the application of such a test—then it could be argued that there should similarly be no need for satisfying the substantiality threshold in a case involving the loss of an intangible asset. Thus, the substantial deprivation test fails due to its inability to accommodate the reality of modern property which is no longer defined by

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<sup>42</sup> See Kriebaum (n 28) 69 (arguing that if an investment consists of five fields and one of the fields is taken, then expropriation should still be found despite the fact that the taking has not affected an investment in its totality).

<sup>43</sup> *GAMI* (n 33) 172.

<sup>44</sup> As far back as in 1975, Weston criticised the tests of expropriation showing 'an excessive adherence to the notion of "physicality" and "affirmative intervention."' (BH Weston, "'Constructive Takings" under International Law: A Modest Foray into the Problem of "Creeping Expropriation"' (1975-1976) 16 Va J Intl L 103, 118). For a somewhat similar approach, see F Williams, 'International Law and the Property of Aliens' (1928) 9 British Ybk Intl L 1, 25 (criticising as unsound a distinction between takings of tangibles and takings of intangibles, including a right to carry on a particular trade, and arguing that in both cases the substance remains the same).

tangibility and permanence. It also overlooks the fact that the key problem of regulatory expropriation lies in the indirect methods through which it is usually accomplished. Indeed, one of the principal features of indirect expropriation is a government's ability to erode the profitability of an enterprise or otherwise hinder the use and enjoyment of an investment without depriving the investor of its physical assets.

#### 1.4. Substantial deprivation and an asset's capacity to be exploited independently

Without denying the possibility of a state being held responsible for a partial expropriation, Kriebaum has argued that a deprivation should be deemed substantial in the case where an investor has been deprived of a right which is capable of an economic exploitation independently of the remainder of the investment.<sup>45</sup> Under this argument, an expropriation occurs where an investment consists of five fields and only one field is taken<sup>46</sup> or where the investor has been deprived of a licence to export alcoholic beverages but its licence to export cigarettes remains untouched.<sup>47</sup> An oil field and a licence are assets that can be exploited independently. In contrast, an undertaking that taxes would remain stable is not.<sup>48</sup> Similarly, the reduction of a construction project from a six-lane highway to a four-lane highway would not constitute an expropriation because additional lanes are subordinate to the overall investment.<sup>49</sup> The latter entitlements cannot be expropriated because they are ancillary to the

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<sup>45</sup> Kriebaum (n 28) 83. Montt supports the idea that the common denominator can be found in the capacity of an asset to be exploited independently of the remainder of the investment. As he puts it, in establishing whether a deprivation is substantial only an identifiable *distinct* part of an investment should be used as a reference unit (Montt (n 19) 270, emphasis original). Thus, a concession contract is a separate investment that can be individually expropriated, but bundles of rights within that contract are not autonomous and hence cannot be expropriated (ibid).

<sup>46</sup> Kriebaum (n 28) 69.

<sup>47</sup> Ibid 83.

<sup>48</sup> Ibid 83-4.

<sup>49</sup> Ibid.

overall investment operation and, standing alone, have no economic value.<sup>50</sup>

This argument is not entirely convincing. The problem lies in analysing intangible property rights within the narrow constraints of the paradigm of traditional property where assets are viewed as necessarily tangible, separable and transferrable (and hence severable). It is clear that despite embracing the possibility of certain intangible assets (such as licences) being segregated into a number of separate units, Kriebaum stops short of applying the same approach consistently in relation to other intangible assets. Her interpretation of an asset's 'capacity to be exploited independently' rests on the understanding of an investment in terms of a physical unit rather than a conglomerate of rights possessing an economic value. It could, however, plausibly be argued that a right to a tax refund has an economic value and can be exploited for generating cash revenues or re-invested.<sup>51</sup> It is true that 'the key function of property is less the tangibility of things, but rather the capability of a combination of rights in a commercial and corporate setting and under a regulatory regime to earn a commercial rate of return.'<sup>52</sup> In economic terms, the profitability of an enterprise may hinge on a right to receive certain tax refunds, and the deprivation of that right may lead to economic loss equivalent to or greater than the loss caused in the event of a physical taking of one of the investor's concessions. For the same reason, a concession contract for the construction and operation of a certain number of lanes in the highway project can be seen as an interest

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<sup>50</sup> Ibid 84. See also Montt (n 19) 272 (noting that where state measures do not destroy assets but augment liabilities, the limited chances to establish indirect taking should be regarded as a desirable outcome, unless the measure at issue threatens the 'financial integrity' of the enterprise).

<sup>51</sup> For instance, the *EnCana* tribunal dismissed Ecuador's objection that a right to obtain VAT refunds did not constitute an expropriation. Although the tribunal noted that the investor did not invest in certificates entitling it to VAT refunds, the disputed claim fell under the definition of investment in the BIT which included "claims to money" and "returns." Furthermore, the tribunal stressed that '[t]he right under the law of the host State to refunds of VAT in respect of the past acquisition of goods and services is a material benefit, and it does not matter whether refunds take the form of tax credits or rights to actual payment of the amount due' (*EnCana v Ecuador* (n 30) paras 182-183).

<sup>52</sup> Kolo and Waelde (n 18) 835. See also BA Wortley, *Expropriation in Public International Law* (University Press, Cambridge 1959) 9, referring to the German legal doctrine whereby the notion of ownership in the context of expropriation was understood to refer to 'every legally protected position of monetary value.' Such understanding of property and ownership is centred not on the object as such but rather on its value.

capable of generating revenue. It can be argued that the reduction of the number of highway lanes is likely to bring about a corresponding decrease in the amounts payable to the investor for the performed work. In particular, if the project envisages the investor's right to manage the highway, the number of lanes becomes a crucial factor in the assessment of the project's overall capacity to generate revenues. Once acknowledged that the value of an asset is in its capacity to create wealth, both a licence and an undertaking of a fixed tax regime can be seen as assets capable of being exploited independently.

### 1.5. Partial expropriation (deprivation) and the definition of investment in BITs

Arguments against partial expropriation also fail because neither the substantial deprivation test, with its emphasis on the parcel-as-a-whole approach, nor the notion of an asset's capacity to be exploited independently, find support in investment treaty texts. In defining a protected investment, BITs do not distinguish between assets that 'can be exploited independently' and those that are 'subordinate to an overall investment.' Precisely because the definition of investment in BITs commonly includes 'claims to performance under the contract' and 'investment returns', it is clear that not only an overall investment but its elements are entitled to protection.<sup>53</sup> The *Chemtura v Canada* tribunal acknowledged the fact that both an overall investment and specific assets can be evaluated as part of an examination of whether a deprivation is substantial enough to constitute an expropriation.<sup>54</sup> Indeed, if the parcel-as-a-

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<sup>53</sup> BITs almost invariably include claims to money and performance having an economic value in the list of covered investments. See the UK Model BIT (2005), the Germany Model BIT (2005) and the 1997 Model BIT of China. See also M Hunter and A Barbuk, 'Reflections on the Definition of an 'Investment'' in G Aksen and RG Briner (eds), *Global Reflections on International Law, Commerce and Dispute Resolution: Liber Amicorum in honour of Robert Briner* (ICC Publishing, Paris 2005) 381-399, 390.

<sup>54</sup> *Chemtura Corporation v Canada*, Award, 2 August 2010 (Ad hoc—UNCITRAL Arbitration Rules) para 249. The tribunal observed that '[i]t would make little sense to state a percentage or a threshold that would have to be met for a deprivation to be "substantial" as such *modus operandi* may not always be appropriate. For instance, one could think of cases where one specific asset (a building, a piece of land, a line of business) which represents

whole approach and the notion of an asset's capacity to be exploited independently were to be accepted, a range of rights and interests arising from an investment would be left unprotected. Trademarks, goodwill, and commercial secrets are frequently included in the definition of investment.<sup>55</sup> Although these interests are subordinate to an overall investment and can hardly be exploited independently, excluding them from the scope of investment treaty protection by reference to the parcel-as-a-whole argument would run contrary to the principle of effective treaty interpretation. The idea of an asset's capacity to be exploited independently seems to be based on severability, which was long regarded as a defining characteristic of property. As discussed in the previous chapter, the concept of property has spread beyond its traditional boundaries of tangibility, severability and transferability.<sup>56</sup> Furthermore, as the notion of investment is not limited to property but comprises the whole process of committing resources in an expectation of profits, its entitlement to protection cannot be defined by such notions as severability.<sup>57</sup>

Even if the approach to defining investment in existing BITs were to be revised, it would be imprudent to limit investment treaty protection to an investment as a whole only, to the exclusion of rights and interests arising from the investor's commitment of resources. Long before the rise of investment treaties, it was acknowledged by the international law doctrine that problems raised by expropriation and the limitation of rights cannot be dealt with separately, and that the term expropriation ought to cover partial deprivations also.<sup>58</sup> Since investment treaties are designed to protect investments, it would hardly be an effective

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a part of the value of all the different assets held by a foreign investor in the host State has been entirely expropriated. In such case, applying a percentage or threshold approach to the overall assets held by the investor in the host State would preclude the deprivation from being "substantial", whereas applying the same assessment to the specific asset in question would lead to the opposite conclusion' (ibid).

<sup>55</sup> See Protocol I of the Algeria—Germany BIT (signed 11 March 1996, entered into force 30 May 2002).

<sup>56</sup> See Ch 1, § 4.2 (B).

<sup>57</sup> See Ch 1, § 3.2.

<sup>58</sup> See Wortley (n 52) 7.

solution to limit the scope of a treaty to an investment and exclude various rights arising thereof. It bears emphasis—again—that the distinctive feature of an indirect state interference is its potential to erode the profitability of an investment without destroying it but rather hindering the enjoyment and use of it. No matter how narrowly an investment is defined in modern international agreements, a cautious drafter is likely to include further reference to claims and rights arising in connection with such an investment. It would be incompatible with the idea of effective protection to limit the scope of a treaty to ‘identifiable distinct parts’ of an investment, ‘assets capable of being exploited independently’, and ‘an undertaking as a whole.’ So far as the host state’s regulatory freedom is concerned, limiting the protection to a whole investment, to the exclusion of rights and claims arising from such an investment, would not effectively shield the host state from responsibility. As will be shown in the following section, under non-expropriatory standards of treatment, the investor’s claim against the host state is not subject to a substantial deprivation test; instead, the investor can challenge the host state’s conduct if it interferes with its entitlements arising from an investment.

## 2. Less than substantial loss can be recovered under other investment treatment standards

The validity of a distinction between partial and total deprivation—and the very use of the substantial deprivation rule—is further challenged by the fact that a regulatory measure inflicting a partial loss is still actionable as a breach of fair and equitable treatment (FET), national treatment (NT) and other investment treaty standards. For instance, an investor claiming damages for a breach of FET is not required to show that a deprivation is substantial. Non-expropriatory breaches of investment treaties do not prompt an exercise in segregating

investment into distinct strands in order to establish the existence of a substantial deprivation. Arbitral practice is replete with decisions where a successful claim under the FET, NT, and arbitrary measures standard entitled investors to a remedy despite the fact that no expropriation had been found.

For instance, in *CMS v Argentina*,<sup>59</sup> the investor contended that the governmental measures suspending adjustment of the gas tariffs and the abandonment of the foreign exchange regime had wiped out the value of its shareholding in TGN, an Argentinean gas-transportation company.<sup>60</sup> The tribunal rejected a claim of expropriation as the degree of loss incurred by the claimant did not rise to the level of a substantial deprivation.<sup>61</sup> Nevertheless, Argentina was held responsible for the violation of the FET standard, including a failure to ensure clarity and predictability of the investment framework.<sup>62</sup> Although the degree of deprivation incurred by the investor did not amount to an expropriation, the tribunal awarded compensation in the amount corresponding to the fair market value of the investment – a traditional expropriation remedy.<sup>63</sup> In other words, the investor received what it would have otherwise been entitled to if its claim of expropriation had succeeded.

Another example is the award in *PSEG v Turkey*, where a claim of indirect expropriation was brought by the investor in connection with its concession to build a coal-fired electric energy production facility.<sup>64</sup> Although the contract received initial governmental approval, the project never materialised owing to a series of changes in the legal framework and a subsequent failure to renegotiate the contractual terms. The investor contended that the

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<sup>59</sup> *CMS Gas v Argentina* (n 36).

<sup>60</sup> *Ibid* para 256.

<sup>61</sup> *Ibid* paras 260-264.

<sup>62</sup> *Ibid* paras 275-281.

<sup>63</sup> *Ibid* para 410 ('While this standard figures prominently in respect of expropriation, it is not excluded that it might also be appropriate for breaches different from expropriation if their effect results in important long-term losses').

<sup>64</sup> *PSEG Global Inc and Konya Ilgin Elektrik Üretimve Ticaret Ltd Şirketi v Turkey*, Award and Annex, 19 January 2007 (Case No ARB/02/5).



government's conduct amounted to a covert and incidental interference with the investment leading to the termination of the project and the destruction of the investment's value.<sup>65</sup> The tribunal disagreed. It held that for an expropriation to occur there ought to be some form of deprivation affecting the control of the investment.<sup>66</sup> The tribunal was not persuaded that any extreme forms of interference took place in the given case.<sup>67</sup> Although the governmental misconduct did not rise to the level of regulatory expropriation, it was sufficient to establish a breach of FET leading to the award of damages.<sup>68</sup>

In a similar vein, a less than substantial deprivation did not prevent the tribunal in *Azurix v Argentina* from granting an award of compensation representing the fair market value of an investment. In this case, a dispute arose in connection with the concession for the provision of a drinking water and sewerage service.<sup>69</sup> The claimant contended that the abandonment of the tariff regime agreed with the concessionaire, as well as the politically motivated actions by the provincial government, violated Argentina's obligations under the United States-Argentina BIT. The tribunal found that the impact on the investment did not rise to the level of expropriation because Azurix

...did not lose the attributes of ownership, at all times continued to control ABA and its ownership of 90% of the shares was unaffected. No doubt the management of ABA was affected by the Province's actions, but not sufficiently for the Tribunal to find that Azurix's investment was expropriated.<sup>70</sup>

However, the tribunal found the host state responsible for arbitrary conduct resulting from the actions of the provincial authorities, which called for the non-payment of the bills, making it

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<sup>65</sup> Ibid para 273.

<sup>66</sup> Ibid para 278.

<sup>67</sup> Ibid para 279.

<sup>68</sup> Ibid. See also paras 238-256 (the tribunal held that a breach of FET was the consequence of inconsistent administrative acts, the roller-coaster of continuing legislative changes, and a failure to negotiate in good faith).

<sup>69</sup> *Azurix Corp v Argentina*, Award, 23 June 2006 (ICSID Case No ARB/01/12).

<sup>70</sup> Ibid para 322.

impossible for the concession-holder to resume billing.<sup>71</sup> It also held Argentina responsible for a violation of the FET standard and for a failure to accord full protection and security, in particular by failing to provide a secure investment environment.<sup>72</sup> Hence, the claimant was awarded the payment of the fair market value of the investment.<sup>73</sup>

As the foregoing examples show, host state interference with a foreign investment can be subject to a duty to compensate even in the absence of a substantial deprivation.<sup>74</sup> Likewise, the investment treaty standards other than expropriation do not call for drawing doubtful distinctions between an overall investment and its subordinate elements. The existence of alternative grounds on which the investor can claim compensation without having to establish a substantial deprivation explains the growing reliance on non-expropriatory standards.<sup>75</sup> The non-expropriatory standards offer a solution to an all-or-nothing dilemma under the standard of expropriation.<sup>76</sup> If interferences of a lesser magnitude can give rise to compensation under the FET standard or the prohibition of arbitrary and discriminatory conduct, there would seem to be no reason for retaining the rule of substantial deprivation as a prerequisite for establishing expropriation. Doubts arise about the theoretical and practical value of a rule which the investors can circumvent by resorting to non-expropriatory standards of treatment.

It can be argued that the possibility of recovery under non-expropriatory standards

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<sup>71</sup> Ibid para 390-393.

<sup>72</sup> Ibid para 406-408.

<sup>73</sup> Ibid para 425-430.

<sup>74</sup> Further examples of this approach can be found in *Sempra*, *Enron*, *Occidental*, *BG Group*, and *National Grid* (see below nn 87-90). See Sornarajah (n 27) 333-4 (stressing that recourse to alternative causes of action expands the range of situations in which the host state can be held liable even if the claim of expropriation fails).

<sup>75</sup> See Newcombe & Paradell (n 13) 351 (suggesting that where the state fails to honour its commitments or representations, but there is no substantial deprivation of the underlying acquired rights, the investor's claim is better framed as a denial of fair and equitable treatment or breach of another minimum standard).

<sup>76</sup> C Schreuer, 'Interrelationships of Standards' in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 1-3; J Coe and N Rubins, 'Regulatory Expropriation and the *Tecmed* Case: Context and Contributions' in T Weiler, *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, 2005) 602.

may not always be open to foreign investors.<sup>77</sup> For instance, investors may be significantly disadvantaged under the BITs with a limited consent to arbitration.<sup>78</sup> However, tribunals can depart from the sole effect approach and adopt an alternative test allowing the finding of an expropriation in the case where the degree of deprivation is less than substantial. The award in *Saipem v Bangladesh* provides a pertinent example.<sup>79</sup> In *Saipem*, a dispute arose from the judicial intervention in arbitral proceedings instituted by an investor in pursuit of its contractual right.<sup>80</sup> While the investor contended that the conduct of the Bangladeshi courts constituted a denial of justice in violation of FET, the primary claim was for expropriation, which under the applicable BIT was the sole ground giving rise to the jurisdiction of an ICSID tribunal.<sup>81</sup> If the tribunal had confined itself to a traditional ‘substantial deprivation’ approach, no finding of expropriation would have ensued because the loss suffered by the investor did not constitute a substantial deprivation. The impossibility of meeting the substantial deprivation threshold would have been fatal to the investor’s case as it would have divested the tribunal of its jurisdiction over the dispute. Aware of these limits to the investor’s ability to claim under the BIT, the tribunal held that the ‘particular circumstances’ of the dispute called for an inquiry into whether the disputed conduct was also ‘illegal’ for the

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<sup>77</sup> BITs may contain carve-out provisions for taxation measures and, consequently, the investor can litigate a dispute arising from a tax measure only if that measure constitutes an expropriation. See, e.g. *EnCana v Ecuador* (n 30). See also *Fireman's Fund Insurance Company v Mexico*, Award, 17 July 2006 (ICSID Case No ARB(AF)/02/01) para 203, where a dispute arose in connection with the provision of financial services and the tribunal was competent to decide only claims of expropriation. Although the disputed conduct did not amount to an expropriation, the tribunal noted that it could give rise to a claim of discrimination under Articles 1102, 1105, and 1405 NAFTA. However, these provisions fell outside the tribunal’s competence.

<sup>78</sup> Some BITs provide only for arbitration of disputes arising from expropriation, to the exclusion of disputes that may stem from a breach of other substantive guarantees. See, e.g. Article 12 (2) (a) the China – Australia BIT (1988). See also U Kriebaum, ‘Regulatory Takings: Balancing the Interests of the Investor and the State’ (2007) 8 J World Investment & Trade 717, 718-9 (noting that despite a decline in the number of expropriation awards, the standard of expropriation retains its importance as some BITs provide no binding dispute settlement for breaches other than expropriation). A similar problem may arise in a situation where an investor seeks indemnification under an insurance policy, including the OPIC and MIGA schemes, and the finding of an expropriation is instrumental.

<sup>79</sup> *Saipem v Bangladesh*, Award 20 June 2009 (ICSID Case No ARB/05/7).

<sup>80</sup> *Ibid* para 216.

<sup>81</sup> *Ibid* para 121.

purpose of establishing expropriation.<sup>82</sup> Despite the tribunal's caveat that its 'legality' analysis did not constitute a departure from the sole effect doctrine, the reasoning in the relevant part of the award compels the contrary conclusion: the tribunal did not complement the substantial deprivation analysis by the test of legality, but rather substituted the former with the latter. The *Saipem* award highlights that (1) tribunals can avoid the substantial deprivation rule by adopting a different stance on what constitutes an expropriation, and (2) allowing only a deprivation of a certain magnitude to be compensated is unjust, particularly in the circumstances where the wrongfulness of the disputed conduct and the existence of the loss are evident.

### 3. Deprivation: an economic loss or wrongful interference?

Another problem with the sole effect analysis is that it remains unclear whether a substantial deprivation denotes an interference with the investor's ownership and control rights or a certain magnitude of economic loss, i.e. the decrease in the value of investment. The *Pope & Talbot* tribunal held that the conduct of a host state would be expropriatory if it involves detention of the investor's employees, appropriation of the proceeds of the company's business, interference with the management or shareholders' activities, preventing the investor from paying dividends or other actions 'ousting the investor from full ownership and control.'<sup>83</sup> Thus, the tribunal applied the substantial deprivation test in terms of an interference with the investor's rights over its enterprise.<sup>84</sup> This understanding of the

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<sup>82</sup> Ibid para 134. The tribunal, however, did not specify the 'particular circumstances' that justified the adoption of the legality test for the purpose of establishing an expropriation.

<sup>83</sup> *Pope & Talbot* (n 14) para 100.

<sup>84</sup> This approach mirrors customary international law where the prevailing tendency has been for 'a diminution in value to remain uncompensated so long as rights of use, exclusion and alienation remain' (R Higgins 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 *Recueil des Cours* 267,

substantiality requirement was subsequently endorsed in a number of investment awards.<sup>85</sup>

In contrast, the tribunal in *Sempra v Argentina* held that the substantial deprivation threshold presupposed that the investor was no longer in control of its business operation *or* that the value of the business was virtually annihilated.<sup>86</sup> The tribunal established the existence of a substantial deprivation by reference to both the loss by the investor of its rights of ownership and control over the business *and* the economic loss reflected in the decrease of the economic value of the business. Similarly, in *Occidental v Ecuador* the existence of a substantial deprivation was determined on the basis of the tribunal's findings as to the effect of the disputed measures on both the fundamental rights of ownership *and* the reasonably to be expected economic benefit.<sup>87</sup> However, none of these awards has discussed the interplay between the interference with the rights of ownership and the loss of the investment value in the assessment of the degree of deprivation.

A third strand of cases includes *Tecmed v Mexico*<sup>88</sup>, *Parkerings v Lithuania*,<sup>89</sup> and

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<sup>85</sup> *Enron Corporation and Ponderosa Assets, LP v Argentina*, Award, 22 May 2007 (ICSID Case No ARB/01/3) para 245. See also *Walter Bau AG v Thailand*, Award, 1 July 2009 (Ad Hoc—UNCITRAL Arbitration Rules) para 10.16; *BG Group plc v Argentina*, Final Award, 24 December 2008 (Ad hoc—UNCITRAL Arbitration Rules) paras 270-271; *Corn Products v Mexico* (n 10) para 92; *Nykomb Synergetics v Latvia* (n 11) para 120. For earlier cases where the finding of expropriation turned on the interference with the management and control of an investment, see *Biloune and Marine Drive Complex Ltd v Ghana Investments Centre and the Government of Ghana*, Award 27 October 1989, 95 ILR 184, and *Benvenuti & Bonfant v Congo*, Award, 15 August 1980, ICSID Reps 335. See also R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP, Oxford 2008) 106-7 (analysing partial expropriation through the lens of control); Salacuse (n 5) 304-5 (considering an unjustified interference with the management as one of the forms in which expropriation can be carried out); Fortier and Drymer (n 6) 301 (noting that 'the interference must be of certain magnitude, degree, and intensity').

<sup>86</sup> *Sempra Energy International v Argentina*, Award, 18 September 2007 (ICSID Case No ARB/02/16) para 285.

<sup>87</sup> *Occidental v Ecuador* (n 36) para 88-89. See also *LG&E v Argentina* where in rejecting the claim of expropriation, the tribunal discussed the substantiality of deprivation criterion by reference to both the rights of ownership and the enjoyment and an economic value of an investment. (*LG&E Energy Corp and ors v Argentina*, Decision on Liability, 3 October 2006 (ICSID Case No ARB 02/1) (2007) 46 ILM 36, paras 189-192, 198-200). Also, *Metalclad v Mexico* (n 8) paras 103-104; *National Grid Plc v Argentina*, Award, 3 November 2008 (Ad Hoc – UNCITRAL Arbitration Rules) para 154.

<sup>88</sup> *Técnicas Medioambientales Tecmed SA v Mexico*, Award, 29 May 2003 (ARB(AF)/00/2) 10 ICSID Rep 130, para 115.

<sup>89</sup> *Parkerings-Compagniet AS v Lithuania*, Award on jurisdiction and merits, 14 August 2007 (ICSID Case No ARB/05/8) para 455.

*Saipem v Bangladesh*.<sup>90</sup> Characteristic to this group of cases is the assessment of the degree of deprivation by reference to a radical or substantial decrease in the economic value of investment. Here, the principal focus of the analysis is on the loss in the value of an investment.<sup>91</sup>

The award in *Biwater Gauff v Tanzania*, representing a fourth category of case, posits that a substantial deprivation does not necessitate the existence of economic loss.<sup>92</sup> In addressing the claim of expropriation brought in connection with a termination of the investor's lease, the tribunal held that

...whilst accepting that effects of a certain severity must be shown to qualify an act as expropriatory, there is nothing to require that such effects be economic in nature. A distinction must be drawn between (a) interference with rights and (b) economic loss. A substantial interference with rights may well occur without actually causing any economic damage which can be quantified in terms of due compensation. In other words, the fact that the effect of conduct must be considered in deciding whether an indirect expropriation has occurred, does not necessarily mean an *economic* test.<sup>93</sup>

In the tribunal's view, the absence of economic loss or damage was primarily a matter of causation and quantum and, therefore, the suffering of substantive and quantifiable economic loss by the investor was not a pre-condition for the finding of an expropriation.<sup>94</sup> For instance, the host state interference might have been 'overtaken by other events' or might not be

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<sup>90</sup> *Saipem v Bangladesh* (n 79) para 129. See also *Compañía de Aguas del Aconquija SA and Vivendi Universal SA v Argentina*, Award, 20 August 2007 (ICSID Case No ARB/97/3) para 7.5.11 (the existence of a substantial deprivation is evidenced by a loss of economic value); *Glamis Gold Ltd v United States*, Award, 14 May 2009 (Ad Hoc – UNCITRAL Arbitration Rules) 14 May 2009, para 356; *Bogdanov and ors v Moldova*, Award, 22 September 2005 (Ad hoc—SCC Arbitration Rules) (2006) 3 Stockholm Intl Arbitration Rev, para 79; *CME Czech Republic BV v Czech Republic*, Partial Award and Separate Opinion, 13 September 2001 (Ad hoc—UNCITRAL Arbitration Rules) para 591; *Telenor v Hungary* (n 33) paras 71-79; *Eureko v Poland* (n 24) paras 239-241; *EnCana v Ecuador* (n 30) para 74. See also Schreuer (n 76) 1 ('for an indirect expropriation the investor must be deprived of the economic benefits of its investment entirely or in substantial part').

<sup>91</sup> See Montt (n 19) 263 (characterising this approach as an economic test).

<sup>92</sup> *Biwater Gauff (Tanzania) Ltd v United Republic of Tanzania*, Award and Dissenting Opinion, 24 July 2008 (Case No ARB/25/22)

<sup>93</sup> *Ibid* para 464.

<sup>94</sup> *Ibid* para 465.

quantified in financial terms.<sup>95</sup> In the case before the tribunal, an actual economic loss resulted from the poor bid, coupled with numerous management and implementation difficulties, which led to the company's inability to generate the income which had been foreseen.<sup>96</sup> By the time the respondent engaged in a series of acts which led to unreasonable and unjustified interference with the management and operation of the investor's enterprise (including the withdrawal of tax exemptions, occupation of the facilities, usurpation of control and the deportation of employees<sup>97</sup>), the investment had no economic value.<sup>98</sup> The tribunal held that in such circumstances the investor might still be entitled to declaratory or restitutionary relief.<sup>99</sup> The tribunal relied on the commentary to the International Law Commission (ILC) Draft Article 2 stating that the requirement of damages as part of establishing an international wrong would depend on the content of the primary obligation that had allegedly been violated. For instance, a treaty obligation to enact a uniform law is breached by the failure to enact the law, and it is not necessary for another state party to point to any specific damage it has suffered by reason of that failure.<sup>100</sup>

The expropriation analysis in *Biwater* raises a number of questions. The majority of the tribunal were correct in their finding, at the quantum phase, that Tanzania's obligation to compensate would arise only if the wrongful acts of the government had destroyed the value of the investment.<sup>101</sup> However, despite referring to the International Court of Justice (ICJ) decision in *ELSI* as part of its discussion of causation, the tribunal adopted a view of expropriation that differs fundamentally from the approach taken by the ICJ.<sup>102</sup> In *ELSI*, the

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<sup>95</sup> Ibid.

<sup>96</sup> Ibid paras 486, 789.

<sup>97</sup> Ibid para 519.

<sup>98</sup> Ibid paras 485, 792.

<sup>99</sup> Ibid para 465.

<sup>100</sup> Ibid para 466 (citations omitted).

<sup>101</sup> Ibid paras 787, 796-799.

<sup>102</sup> *Elettronica Sicula S.P.A. (ELSI) (United States of America v. Italy)* [1989] ICJ Rep 15.

ICJ pointed to the fact that the management of ELSI, remaining in full control of the enterprise, had been unable to carry out an orderly liquidation of the company. It therefore could not persuasively claim that the subsequent requisition and liquidation deprived it of its management and control rights.<sup>103</sup> Its allegations of expropriation were therefore dismissed.<sup>104</sup> Indeed, how can an investment be expropriated if it has already been lost? The *Biwater* tribunal could have similarly indicated that in other circumstances the unreasonable and unjustified conduct of the respondent would constitute an expropriation, but in the given case no finding of expropriation ought to be made because the disputed investment had lost its value before the impugned measures were taken.<sup>105</sup>

It is, however, worth noting that by treating the existence of an economic loss as a matter of quantum the *Biwater* tribunal correctly distinguished between two key elements of an investment treaty breach: a wrongful act and an injury caused thereby.<sup>106</sup> Nonetheless, the tribunal's reasoning begs the question as to the status of expropriation as a distinct international standard. By alluding to the possibility of injunctive relief in a case where no

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<sup>103</sup> Ibid para 101.

<sup>104</sup> Ibid para 119. See also a recent award in *Fireman's Fund v Mexico* (n 77). In this case, a dispute arose from the alleged failure by Mexico to recapitalise BanCreceer, a Mexican bank. The tribunal rejected the claim of expropriation on the ground that by the time the allegedly expropriatory conduct took place there was little or no value left of the claimant's investment in GFB of which BanCreceer was the main asset. Hence, the tribunal concluded that a lack of effort (even if discriminatory) by a host state to rescue an investment that has become virtually worthless, is not a taking of that investment. Similarly, see *Noble Ventures Inc v Romania*, Award, 5 October 2005 (ICSID Case No ARB/01/11) para 216 (no expropriation found to have occurred because there was nothing to expropriate).

<sup>105</sup> It is also important to note that *Biwater* is not the first case where a finding of expropriation was made despite the fact that an investment had lost its value before the disputed conduct took place. See *CCL v Republic of Kazakhstan* ["Refinery" Case] (2005) 1 Stockholm Intl Arbitration Rev 123, para 174, where the tribunal held that the conduct of the General Prosecutor and the Kazakh courts were expropriatory. The tribunal then proceeded to analyse the existence of the loss caused to the investor. It concluded that by the time an expropriation took place, the value of investment was reduced to nil due to the attachment of most of its assets in debt collection proceedings pursued by a private company against the Refinery (ibid para 175).

<sup>106</sup> See J Crawford, *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries* (CUP, Cambridge 2002) 228; AK Bjorklund, 'Causation, Morality, and Quantum' (2009) 32 Suffolk Transnatl L Rev 435, 440-1 (noting that an injury is distinct from the wrongful act and that the obligation of a state to make reparation depends on the existence of material or moral damage).



economic loss has been inflicted,<sup>107</sup> the award seems to suggest that the host state can be ordered to refrain from interfering with foreign investment even where such interference does not affect the investment in economic terms.<sup>108</sup> If the host state can be ordered to refrain from a certain type of conduct regardless of whether economic harm has already been caused or is anticipated to occur, the focus shifts from the protection against an uncompensated dispossession to the pre-emption of any potentially detrimental governmental conduct. If damage is not required for establishing expropriation, expropriation would denote not the taking of something of value but rather an unjustified interference with an investment.<sup>109</sup> Once stripped of its traditional function of protection against a dispossession, expropriation turns into ‘just another’ standard replicating the tasks already vested in other investment protection standards which protect investments against various forms of unjustified interference.

#### 4. Towards a unified concept of an investment treaty breach?

As the foregoing discussion shows, the rule of substantial deprivation does not provide a reliable criterion for determining the existence of an expropriation and the host state’s obligation to compensate the investor. First, the availability of corporate structuring and indirect shareholder claims allows the substantial deprivation requirement to be sidestepped.

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<sup>107</sup> The possibility of injunctive relief is largely incompatible with the traditional view according to which the state has a right to expropriate, subject to certain conditions. I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 508-9; Subedi (n 4) 121. For earlier writings on this point, see CF Amerasinghe, *State Responsibility for Injuries to Aliens* (Clarendon Press, Oxford 1967) 130-1; EJ de Arechaga, ‘State Responsibility for the Nationalization of Foreign Owned Property’ (1978) 11 NYU J Intl L & Pol 179.

<sup>108</sup> The availability of injunctive relief in the case of expropriation has been highlighted by the tribunal in *Enron Corporation and Ponderosa Assets LP v Argentina*, Decision on Jurisdiction, 14 January 2004 (ICSID Case No ARB/01/3) 11 ICSID Reports 295, para 81. For a critique, see Subedi (n 4) 79.

<sup>109</sup> Compare the view adopted by the tribunal in *National Grid* as to the contents of a primary obligation enshrined in the expropriation clause: ‘The engagement of the parties in the Treaty is a negative engagement not to nationalize, expropriate or subject investments of investors to measures having an equivalent effect, unless three conditions are met: public purpose, non-discrimination and “prompt, adequate and effective compensation”’ (*National Grid Plc v Argentina* (n 87) para 146).

Second, if a partial deprivation affecting *physical* assets is considered expropriatory and capable of triggering the state's obligation to compensate, it would be unsound to deny the investment treaty protection in the case of partial deprivation of an intangible right. Furthermore, the substantial deprivation rule is at odds with the definition of investment in BITs, which extends protection not only to the whole investment operation and distinct identifiable assets involved therein but also to rights and interests arising from the investment. Importantly, principles of state responsibility in international law do not distinguish between a total and partial harm.<sup>110</sup>

The theoretical and practical utility of the substantial deprivation rule is further significantly eroded by the growing practice under which investors are entitled to compensation for losses incurred because a host government violates the standards of treatment, such as FET, national treatment, and the prohibition of arbitrary and discriminatory measures. So far as most standards of treatment are concerned, an investor does not need to show a deprivation of a certain magnitude as a condition to obtaining compensation. Instead, the host state responsibility for a breach of standards other than expropriation hinges on the existence of an international wrongfulness in the form of unfair and inequitable treatment, discrimination or arbitrariness. The question arises as to whether the effect-focused analyses should be abandoned in favour of a unified concept of an investment treaty breach which presently lies beneath non-expropriatory standards of treatment. This issue will be further explored in Chapter III.

The decreasing relevance of expropriation in the context of an indirect interference

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<sup>110</sup> See Article 31 of the Draft articles on Responsibility of States for Internationally Wrongful Acts, which prescribes that (1) the responsible state is under an obligation to make full reparation for the injury caused by the internationally wrongful act; (2) injury includes any damage, whether material or moral, caused by the internationally wrongful act of a state. (ILC, 'Report on the work of its fifty-third session' (23 April - 1 June and 2 July - 10 August 2001) UN Doc A/56/10, 91).

with foreign investment may seem to be a problem, particularly in respect of the BITs which provide for arbitration of expropriation cases only. Such BITs are driven by the desire to limit investment arbitration to expropriation, which has traditionally been viewed as involving a total or substantial loss. Nonetheless, despite the state's intention to limit its exposure to investment arbitration through a limited consent to arbitration, it may still end up being held responsible for an interference that falls below the level of a substantial deprivation but is nevertheless found to constitute an expropriation.<sup>111</sup> The possibility of conceptual and physical severance and *ad hoc* departures from the sole effect analysis make it possible for investors and tribunals to circumvent the threshold of a substantial deprivation. BITs limiting consent to arbitration of expropriation cases only do not shield host states.<sup>112</sup> In contrast, the adoption of a unified concept of an investment treaty breach, focusing on the international legality of governmental conduct and any resulting loss, seems to offer a viable alternative.

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<sup>111</sup> See Montt (n 19) 260 (suggesting that the substantial deprivation test is a more restrictive test compared to other tests). It is however difficult to agree with that view, particularly in light of the availability of conceptual and physical severance of investment as well as the existence of a partial expropriation.

<sup>112</sup> Unless tribunals construe the limited consent narrowly and deny jurisdiction. See, e.g., *Berschader and Berschader v Russian Federation*, Award and Correction, 21 April 2006 (SCC Case No 080/2004) paras 153-156. In this case, the arbitration clause in the applicable BIT was limited to disputes as to the amount or mode of compensation for an act of expropriation. The tribunal upheld the host state's jurisdictional objection that the issue whether an expropriation had taken place was a different matter and was reserved for determination by a Russian Arbitration Court. A similar stance was adopted in *RosInvest Co UK Ltd v Russian Federation*, Jurisdiction award, 5 October 2007 (SCC Case No V079/2005) paras 105-123.

### **CHAPTER III: TOWARDS A UNIFIED CONCEPT OF AN INVESTMENT TREATY BREACH**

#### **THE CHARACTER OF A DISPUTED GOVERNMENTAL ACTION AS A KEY CONDITION IN ESTABLISHING THE HOST STATE'S OBLIGATION TO PAY COMPENSATION**

While the sole effect approach, with its yardstick of 'substantial deprivation', no longer provides a workable criterion in determining the existence of a compensable event, arbitral practice reveals a burgeoning trend toward the adoption of alternative methods of determining claims of indirect expropriation. This move coincides with the rise in the number of awards rendered against host states under standards of treatment, such as FET, national treatment, and the prohibition of arbitrary and discriminatory measures. This chapter examines the character-focused approaches to state responsibility for interference with foreign investment. It traces recent developments in investment treaty practice and arbitration whereby the existence of expropriation as a ground of state responsibility for regulatory action is determined through analysis of the character of a disputed action and its international legality. It argues that the shift from the sole effect doctrine has the potential for a more balanced, conceptually sound, and practically viable framework for determining host state liability for interference with foreign investment. As the finding of a breach of investment treaty standards other than expropriation hinges on the character of the disputed governmental conduct in question, this chapter analyses whether the standard of expropriation, with its focus on the fact of deprivation, retains any role as a distinct standard of investment protection.

1. The shift from the sole effect to character-focused approaches in addressing expropriation claims: the police powers doctrine

## 1.1. Arbitral practice

Although the sole effect doctrine and the substantial deprivation rule both continue to dominate expropriation analyses, the recent practice of investment arbitration exhibits a growing trend towards considering the character of a government's disputed conduct as a key criterion in establishing state responsibility to the investor. Among some of the earlier cases involving investment disputes, the award in *Middle East Cement* is notable for the tribunal's emphasis on discrimination and breach of due process of law as key elements justifying the finding of expropriation.<sup>1</sup> The tribunal held that expropriation 'does not cover any losses occurring to an investor due to commercial risks or due to procedures of the State authorities and courts as long as they are under due process of law and not discriminatory.'<sup>2</sup> Subsequently, following the rise in the number of regulatory expropriation claims, tribunals increasingly recognised the need for alternative approaches to determining host state responsibility for an allegedly expropriatory regulation. The *Methanex v United States* and *Saluka v Czech Republic* awards are leading cases in articulating the expropriation analysis focused on the character of a disputed governmental action. Both awards are notable for their departure from the classical method under which the assessment of the legality of the conduct of the host state was undertaken as part of establishing whether an expropriation was lawful and not as part of establishing whether an expropriation had occurred.<sup>3</sup> *Methanex* arose in connection with the Californian government ban on the sale and use of a gasoline oxygenate additive called Methyl Tertiary Butyl Ether ('MTBE'). Methanex, as the largest supplier of

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<sup>1</sup> *Middle East Cement Shipping and Handling Co Sa v Arab Republic of Egypt*, Award, 12 April 2002 (ICSID Case No ARB/99/6) (2003) 18 ICSID Rev- FILJ 602.

<sup>2</sup> Ibid para 153.

<sup>3</sup> U Kriebaum, 'Regulatory Takings: Balancing the Interests of the Investor and the State' (2007) 8 J World Investment & Trade 717, 726.

methanol to Californian producers of MTBE, contended that the ban amounted to an expropriation in violation of Article 1110 NAFTA. The tribunal regarded the character of the disputed measures to be decisive in establishing the existence of an expropriation. It held that

...as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process ... 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.<sup>4</sup>

The tribunal concluded that the ban was made for a public purpose, was non-discriminatory and was enacted in accordance with due process. It held that ‘from the standpoint of international law, the California ban was a lawful regulation and not an expropriation.’<sup>5</sup>

In *Saluka*, a claim of expropriation was brought in connection with an alleged failure by the Czech government to rescue a failing bank of which the investor was a major shareholder.<sup>6</sup> In order to prevent an imminent banking collapse, the government decided to put the bank into forced administration. In considering whether the imposition of forced administration amounted to expropriation, the tribunal noted that

[i]t is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.<sup>7</sup>

The tribunal then pointed to conditions under which the government would be absolved from responsibility for interference with a foreign investment. By reference to the Harvard Draft Convention, the tribunal indicated that no obligation to compensate would arise if the disputed conduct (1) was non-discriminatory; (2) was not an unreasonable departure from the

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<sup>4</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) Part IV Chapter D, para 7.

<sup>5</sup> Ibid, Part IV Ch. D, para 15.

<sup>6</sup> *Saluka Investments BV v Czech Republic*, Partial Award, 17 March 2006 (PCA—UNCITRAL Arbitration Rules).

<sup>7</sup> Ibid para 255.

principles of justice recognised by the principal legal systems of the world; (3) was not an abuse of the powers of the government.<sup>8</sup> Having examined the disputed measure against these criteria, the tribunal concluded that the disputed conduct did not rise to the level of a breach under the expropriation clause of the applicable BIT.

In *Link–Trade v Moldova*, a dispute arose in connection with the investor’s business as a duty free importer of consumer products into the Free Economic Zone of Chisinau.<sup>9</sup> The investor contended that the law introducing a change in the rates of duties and VAT exemptions destroyed the economic validity of its investment and constituted an indirect expropriation. The tribunal admitted that fiscal measures might cause the taxpayer to surrender part of his income or property to the state. However, in the tribunal’s view, the character of the disputed measures was decisive in establishing the existence of expropriation:

[f]iscal measures only become expropriatory when they are found to be an abusive taking. Abuse arises where it is demonstrated that the State has acted unfairly or inequitably towards the investment, where it has adopted measures that are arbitrary or discriminatory in character or in their manner of implementation, or where the measures taken violate an obligation undertaken by the State in regard to the investment.<sup>10</sup>

In *Bayindir v Pakistan*, the tribunal considered a conduct-based analysis to be crucial in a determination of whether an expropriation has occurred.<sup>11</sup> After identifying the assets that were allegedly expropriated by the state in the exercise of its sovereign powers, the tribunal held that, in order to establish the existence of an expropriation, analysis ought to focus on the lack of public purpose, discrimination and a breach of due process, as well as an absence of

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<sup>8</sup> Ibid paras 256-257. For the Harvard Draft Convention, see LB Sohn and RR Baxter, ‘Responsibility of States for Injuries to the Economic Interests of Aliens’ (1961) 55 AJIL 554.

<sup>9</sup> *Link–Trading Joint Stock Company v Moldova*, Final Award, 18 April 2002 (Ad hoc—UNCITRAL Arbitration Rules).

<sup>10</sup> Ibid para 64.

<sup>11</sup> *Bayindir Insaat TurizmTicaretve Sanayi A Ş v Pakistan*, Award, 24 August 2009 (ICSID Case No ARB/03/29) para 446.

compensation and departure from general principles of treatment.<sup>12</sup> In addressing the character of the disputed governmental interference with the investor's rights under the concession contract, the tribunal discussed whether the conduct was in conformity with the contract and whether the fair and equitable treatment was violated.<sup>13</sup>

The *Waste Management* award similarly adopted a conduct-based assessment as part of its expropriation analysis. In addressing the investor's claim brought in connection with a failed concession contract, the tribunal held that 'it is not the function Article 1110 to compensate for failed business ventures, absent *arbitrary* intervention by the State amounting to a virtual taking or sterilising of the enterprise.'<sup>14</sup> More recently, the legality test was adopted, albeit somewhat controversially, in *Saipem v Bangladesh*.<sup>15</sup> At the centre of the dispute was the investor's claim that an interference by the Bangladeshi courts with the arbitration of contractual claims resulted in expropriation. The tribunal pointed out that under the 'sole effect' doctrine the deprivation of Saipem's ability to enjoy the benefits of the ICC award was not sufficient to conclude that the courts' intervention had amounted to an expropriation.<sup>16</sup> Rather, the particular circumstances of the dispute called for an inquiry into whether the disputed conduct was also 'illegal' for establishing the existence of expropriation.<sup>17</sup> In addressing the question of the legality of the courts' intervention with the ICC arbitration, the tribunal found that the Bangladeshi courts had abused their supervisory jurisdiction over the arbitration process by revoking the arbitrators' authority without any

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<sup>12</sup> It must be noted that while the tribunal adopted a conduct-based analysis as part of its expropriation inquiry, it also considered the substantiality of impact of the alleged conduct and placed emphasis on whether the alleged conduct was exercised by the state in its capacity as a sovereign (see *ibid* paras 459, 474).

<sup>13</sup> *Ibid* paras 469, 481.

<sup>14</sup> *Waste Management Inc v Mexico*, Award, 30 April 2004 (ICSID Case No ARB(AF)/00/3) para 160.

<sup>15</sup> *Saipem v Bangladesh*, Award 20 June 2009 (ICSID Case No ARB/05/7).

<sup>16</sup> *Ibid* paras 129-133.

<sup>17</sup> *Ibid* para 134. The tribunal, however, did not specify the 'particular circumstances' that justified the adoption of the legality test for the purpose of establishing an expropriation.



justification.<sup>18</sup> According to the tribunal, the standard that the Bangladeshi courts had used in considering the legality of the ICC arbitrators' conduct and the manner in which the standard had been applied to the facts of the case constituted an abuse of right.<sup>19</sup>

## 1.2. Investment treaty practice

The emphasis on the character of governmental measures can be traced in investment treaty instruments. For example, the 1985 Convention Establishing the Multilateral Investment Guarantee Agency excludes non-discriminatory measures of general application from the scope of expropriation.<sup>20</sup> The relevant provision reads as follows:

Any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of host ownership or control of, or a substantial benefit from, his investment, *with exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territory.*<sup>21</sup>

The shift from the sole effect doctrine to a multi-factor analysis features prominently in the recent generation of BITs and FTAs. For instance, Annex A of the 2009 Canada - Czech Republic BIT clarifies the standard of expropriation in Article VI, stating that

[t]he determination of whether a measure or series of measures of a Contracting Party constitute an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:

...

iii) the character of the measure or series of measures.

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<sup>18</sup> Ibid paras 159-161.

<sup>19</sup> Ibid para 170.

<sup>20</sup> The Convention Establishing the Multilateral Investment Guarantee Agency (1985) 24 ILM 1605.

<sup>21</sup> Ibid 1611. See also C Schreuer, 'The Concept of Expropriation under the ECT and other Investment Protection Treaties' in C Ribeiro, *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington, NY 2006)113.

...

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, non-discriminatory measures of a Contracting Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.<sup>22</sup>

An identical provision can be found in the recent US FTAs and the 2004 US Model BIT.<sup>23</sup> Although the explanatory clause in the addendum refers also to other elements of analysis, such as the impact of measures and the extent to which they interfere with investment-backed expectations, the inclusion of the character of disputed measures as a prerequisite for the finding of expropriation provides the much-needed legal basis to support the shift away from the sole effect analysis.

### 1.3. Doctrinal approaches

The idea that the character of a government's action will frequently be decisive in determining the existence of expropriation has long been recognised in scholarly writing. The doctrinal codification of the international law on state responsibility in the Harvard Draft Convention provides the most influential example.<sup>24</sup> It acknowledges that, subject to procedural and substantive legality conditions, no international wrong results from an uncompensated taking that is carried out as part of the normal operation of the laws or from the pursuit of important public policy objectives.<sup>25</sup> Recent scholarly analyses similarly draw a distinction between a normal regulation and the abuse of sovereign powers through

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<sup>22</sup> See Annex A to Article VI.

<sup>23</sup> See the text of the US Model BIT at < <http://ita.law.uvic.ca/documents/USmodelbitnov04.pdf> > accessed 30 October 2010.

<sup>24</sup> (1961) 55 AJIL 515.

<sup>25</sup> Ibid 554.

illegitimate interferences in foreign investment activities.<sup>26</sup> As summarised in the recent commentary, ‘the character, meaning the purpose and context of the governmental measure also enters into the analysis – i.e., whether the measure is normal regulation taken to promote a recognised “social purpose” or the “general welfare” when non-discriminatory and in good faith.’<sup>27</sup> Instead of being limited in their role to the post-factum assessment of the legality of an expropriation, the non-discrimination, public purpose and due process criteria have been geared to establish whether an expropriation has occurred.<sup>28</sup>

The focus on the character of a governmental measure in determining the existence of the host state’s responsibility is commonly regarded as the application of the police powers doctrine.<sup>29</sup> In the words of the Iran-US Claims Tribunal in *Sedco*, 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” within the accepted police power of states.’<sup>30</sup> An investor-state tribunal in *Tecmed* has similarly referred to ‘the principle that the State’s exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever

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<sup>26</sup> See R Dolzer and F Bloch, ‘Indirect Expropriation: Conceptual Realignments?’ (2003) 5 Intl L F 155; AS Werner, ‘Indirect Expropriation: The Need for a Taxonomy of “Legitimate” Regulatory Purposes’ (2003) 5 Intl L F 166; I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 509 (‘State measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation’). For recent analyses supporting the finding of the state responsible for an interference that violates certain conduct requirements, such as due process and non-discrimination, see M Gutbrod and S Hindelang, ‘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 Disenchanting Comparative Analysis’ (2006) 7 J World Investment & Trade 59, 63; V Lowe, ‘Regulation or Expropriation?’ (2002) 55 Current Legal Problems 447, 459; S Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, Oxford 2008) 76, referring to the CAFTA-DR Article 10-C (3)(b). For an earlier work endorsing a similar theory, see BH Weston, “Constructive Takings” under International Law: A Modest Foray into the Problem of “Creeping Expropriation” (1975-1976) 16 Va J Intl L 103, 126-130 (pointing to coercion and violation of minimum human rights as factors indicating that regulation is expropriatory).

<sup>27</sup> K Yannaca Small, ‘Indirect Expropriation and the Right of the Government to Regulate Criteria to Articulate the Difference’ in C Ribeiro (ed) *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington, NY 2006) 161.

<sup>28</sup> Kriebaum (n 3) 726.

<sup>29</sup> See *ibid*.

<sup>30</sup> *Sedco Inc v Iran* (1985) 9 Iran-USCTR 248, 275.

is undisputable.’<sup>31</sup> Yet analysing indirect expropriation claims merely in terms of the police powers doctrine would be incorrect. A host state becomes exempt from an obligation to compensate not simply because its conduct falls within the police powers exception but because it is also non-discriminatory, non-arbitrary and does not transgress due process of law. It is vital that the emphasis is on the character and not on the fact that a regulation is an exercise of police powers.

Some of the criticisms advanced against the character-focused approaches to determining claims of expropriation reflect this problem with applying the police powers doctrine.<sup>32</sup> One major criticism is directed against the requirement of ‘public purpose’, which is frequently referred to as ‘legitimate welfare objective’. It has been observed that since virtually any regulatory interference may be in the public interest, the character-focused analysis that includes a public purpose criterion will be problematic from the perspective of investment protection.<sup>33</sup> Facing an almost insurmountable barrier of proving that a disputed regulation is against public purpose, foreign investors may have to ‘bear the economic burden of nearly every realization of a public interest through regulatory measures.’<sup>34</sup> Consequently, the concept of indirect expropriation would lose its meaning.<sup>35</sup> It is submitted that these concerns over the growing emphasis on the character of the disputed conduct in deciding expropriation claims are misplaced. First, the requirement that the act of a government be for a public purpose is not a dominant criterion in the character-focused expropriation analysis that the *Methanex* and other investment tribunals have endorsed. By merely arguing that a

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<sup>31</sup> *Técnicas Medioambientales Tecmed SA v Mexico*, Award, 29 May 2003 (ARB(AF)/00/2) 10 ICSID Rep 130, para 119.

<sup>32</sup> Schreuer (n 21) 111 rejecting the idea that arbitrariness and discrimination should be relied on in establishing expropriation.

<sup>33</sup> Kriebaum (n 3) 726.

<sup>34</sup> Ibid.

<sup>35</sup> Kriebaum (n 3) 726-7.

governmental measure has been adopted in pursuit of a legitimate public interest, the state cannot escape its responsibility; instead, it must show that the disputed governmental act is also non-discriminatory and in compliance with due process of law.<sup>36</sup> In the case where a government's policy is designed to achieve certain welfare objectives, the host state bodies remain bound by the standard of non-discrimination, non-arbitrariness, and due process. As noted above, it is important to distinguish between the two major pillars of the police powers doctrine. These are (1) the principle of sovereignty and freedom to exercise its legislative and regulatory functions in the public interest, and (2) the requirement that in adopting certain policies governments must comply with internationally recognised standards of non-discrimination, non-arbitrariness, and due process.<sup>37</sup> The fact that the disputed conduct of a government is justified by reference to some welfare objective or other valid regulatory purpose cannot alone determine the outcome of the related claim of expropriation but rather operates as an indication that certain governmental acts do not give rise to compensation unless discriminatory, arbitrary or otherwise in violation of international law.

Second, contrary to the existing arguments outlined above, analysing claims of expropriation against the character-focused criteria does not deprive investors from protection against the exercise of regulatory power by host states where such power is considered to be internationally impermissible. If a claim of expropriation fails, the investor can—in many cases—obtain redress through contending that there has been a breach of an FET, national

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<sup>36</sup> See A Newcombe, 'The Boundaries of Regulatory Expropriation in International Law' (2005) 20 ICSID Rev – Foreign Investment L J 1, 25 ('The fact that intent is unnecessary does not make it irrelevant to the determination of whether or not a government measure is expropriatory... That intent is not a necessary element of expropriation simply means that a government cannot use lack of intent as a defence to a claim of expropriation'); also K Byrne, 'Regulatory Expropriation and State Intent' (2000) Canadian Ybk Intl L 89 (discussing the relevance of intent and its impact on the finding of an expropriation). See also above nn.4 -5 and accompanying text.

<sup>37</sup> See American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (American Law Institute Publishers, St Paul, Minnesota 1987) vol I §712(1); P Muchlinski, *Multinational Enterprises & the Law* (OUP, Oxford 2007) 588. For the historical origins of the police powers doctrine, see FA Mann, 'Outlines of a History of Expropriation' (1959) 75 LQR 188.

treatment, or arbitrary measures standard.<sup>38</sup> Indeed, the emerging tendency for establishing the existence of expropriation by reference to the character of conduct that has been challenged has coincided with the growing recourse to non-expropriatory standards, such as national treatment, non-arbitrariness and FET.<sup>39</sup> Under these standards, the investor's entitlement to compensation does not depend on the degree of deprivation. Establishing a non-expropriatory breach of treaty requires evaluating a disputed measure against the relevant standard of treatment. It is the general concept of international legality that underlies the concept of state responsibility for a breach of non-expropriatory standards of treatment.

## 2. Inadequacy of the expropriation model for claims of 'indirect takings'

The rise in prominence of non-expropriatory standards of treatment and the vagaries of the substantial deprivation test raise the question of whether expropriation, as a distinct standard of protection, retains its role in investment treaty law. As shown in *Methanex*, under the emerging trend for analysing expropriation claims by focusing on the character of a government's disputed conduct,<sup>40</sup> the factors of discrimination, arbitrariness, and a violation of due process of law are regarded as prerequisites for the host's state responsibility. The same concept of illegality lies beneath non-expropriatory standards of treatment. Under both the new approach to expropriation and also the approach to non-expropriatory standards, compensation is payable for loss which is caused by conduct in violation of non-discrimination, due process and non-arbitrariness requirements. In other words, the mere fact

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<sup>38</sup> Exceptionally, some BITs allow for arbitration of only a certain category of dispute, such as claims relating to compensation for an expropriation.

<sup>39</sup> See Chapter II. Also, T J Grierson-Weiler and IA Laird, 'Standards of Treatment' in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 269; J Coe and N Rubins, 'Regulatory Expropriation and the *Tecmed* Case: Context and Contributions' in T Weiler (ed) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, London 2005) 602; C Schreuer, 'Interrelationships of Standards' in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 1-3.

<sup>40</sup> The trend is exemplified in *Methanex*, *Saluka* and *Link Trading*, see nn. 4-9 above.

that the investor incurred loss is not sufficient to give rise to the state's obligation to compensate.

In contrast, under the traditional standard of expropriation, the non-discrimination and due process of law requirements usually operate as the conditions of legality of an expropriation, i.e. in establishing whether an expropriation the existence of which has already been confirmed is illegal.<sup>41</sup> Unlike the emerging expropriation analysis and the recent approaches to establishing breaches of non-expropriatory standards, the traditional expropriation rule limits the application of non-discrimination and due process requirements to a *post facto* assessment of conduct that has already been found to be expropriatory. This approach is illustrated in *ADC v Hungary*.<sup>42</sup> The case involved the cancellation of a concession for the management of an airport. A tribunal held that the cancellation was expropriatory.<sup>43</sup> Only after having established the existence of an expropriation did the tribunal proceed to analysing whether such an expropriation was lawful. Guided by the expropriation standard in the applicable BIT, the tribunal examined whether the cancellation of the contract was discriminatory, in violation of due process of law and accompanied by the payment of compensation. This analysis is based on the idea that expropriation is *prima facie* lawful and becomes illegal if any of the conditions for the lawfulness have not been complied with.<sup>44</sup>

It can be argued that the wider adoption of the police powers doctrine can optimise the

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<sup>41</sup> See, e.g. A Reinisch, 'Legality of Expropriations' in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008), A Sheppard, 'The Distinction between Lawful and Unlawful Expropriation' in C Ribeiro, *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington NY 2006) 170, Schreuer (n 21), also S Ripinsky and K Williams, *Damages in International Investment Law* (British Institute of International and Comparative Law, London 2008) 65-6; M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 406.

<sup>42</sup> *ADC Affiliate Ltd and ADC & ADMC Management Ltd v Hungary*, Final award on jurisdiction, merits and damages (ICSID Case No ARB/03/16).

<sup>43</sup> *Ibid* para 476.

<sup>44</sup> Sornarajah (n 41) 406.

existing approaches to expropriation. If the sole effect doctrine is replaced by character-focused analyses, the expropriation standard could arguably be applied along with other standards of treatment in dealing with regulatory interference claims. However, embracing the police powers doctrine would not solve the problems underlying the existing role of expropriation and non-expropriatory standards in determining the scope of state responsibility in investment treaty law. It is submitted that the traditional expropriation model fails to furnish an appropriate legal framework for analysing claims that arise from host state interference with foreign investment; hence, it should be replaced by a more feasible standard. The inadequacy of the expropriation standard stems from the compensation requirement. The problem is that under the traditional expropriation maxim, as reinforced in recent practice and scholarship, compensation is a mandatory requirement: an expropriation is illegal if it has not been compensated for. The status of this requirement in customary international law was fiercely debated by a large group of states, culminating in the adoption by the UN General Assembly of its groundbreaking resolutions.<sup>45</sup> In the face of resistance and ensuing uncertainty of the customary international law on expropriation, the compensation rule was introduced by its proponents through the backdoor, in bilateral agreements for the promotion and protection of investments with countries which had previously opposed the customary status of the compensation rule.<sup>46</sup> The result is a remarkable uniformity among a growing

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<sup>45</sup> On the UN GA Resolution No 1803 (14 December 1962) and No 3281 (12 December 1984) and their impact on customary international law, see D Johnson, 'The effect of the resolutions of the General Assembly of the UN' (1955) 32 *British Ybk Intl L* 97; R Dolzer, 'New Foundations of the Law of Expropriation of Alien Property' (1981) 75 *AJIL* 553; R Higgins, 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 *Recueil des Cours* 259; Subedi (n 26) 22-6. These selected pieces of writing represent only a fraction of the large body of literature generated by the UN Resolutions above and the subsequent adopted documents.

<sup>46</sup> See WD Verwey, NJ Schrijver, 'The Taking of Property Under International Law: A New Legal Perspective?' (1984) *Netherlands Ybk Intl L* 3; T Guzman, 'Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties' (1998) *Va J Intl L* 639; KJ Vandeveld, 'The Bilateral Investment Treaty Program of the United States' (1988) 21 *Cornell Intl L J* 201; JW Salacuse, 'The Treatification of International Investment Law' (2007) 13 *L & Business Rev Am* 155.



body of BITs and FTAs which invariably include the prohibition of uncompensated expropriation.<sup>47</sup> A typical treaty clause on expropriation reads as follows:

Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization ("expropriation"), except:

- (a) for a public purpose;
- (b) in a non-discriminatory manner;
- (c) on payment of prompt, adequate, and effective compensation; and
- (d) in accordance with due process of law and Article 5 [Minimum Standard of Treatment](1) through (3).<sup>48</sup>

Under the ordinary and effective interpretation of this provision, the state is allowed to expropriate only if it complies with the public purpose, non-discrimination, due process, and compensation requirements.<sup>49</sup> In practical terms, however, compensation is the dominant criterion. The plain meaning of the treaty terms suggests that expropriation becomes illegal unless it is accompanied by the payment of compensation.<sup>50</sup> For example, an expropriation

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<sup>47</sup> See UNCTAD, *Taking of Property* (United Nations, New York and Geneva 2000) 26-31; Ripinsky & Williams (n 41) 78-9 (identifying about two thirds of existing BITs endorsing the adequate compensation standard as part of the expropriation clause).

<sup>48</sup> The 2004 US Model BIT, available at < <http://ita.law.uvic.ca/documents/USmodelbitnov04.pdf> > accessed 31 October 2010. See also UNCTAD (n 47).

<sup>49</sup> Reinisch (n 41) 176 (noting that while customary international law remains unclear, investment treaties clearly state the rules on legality of expropriation).

<sup>50</sup> See *Siemens AG v Argentina*, Award and Separate Opinion, 6 February 2007 (ICSID Case No ARB/02/8) paras 349-352 and *Compañía de Aguas del Aconquija SA and Vivendi Universal SA v Argentina*, Award, 20 August 2007 (ICSID Case No ARB/97/3). The *Vivendi* tribunal expressly held that non-payment of compensation would amount to a violation of the treaty (ibid para 7.5.21.). This view may be at odds with the approach taken by international tribunals which found that non-payment of compensation ought not to render expropriation unlawful. For instance, the *Aminoil* award and some of the awards handed down by the Iran-United States Claims Tribunal, including *INA*, *Sedco*, *American International Group*, and *Starrett Housing* involved the finding of a lawful expropriation. Non-payment of compensation does not render an expropriation unlawful. (See M Mohebi, *The International Law Character of the Iran-United States Claims Tribunal* (Kluwer Law International, Boston 1999) 289). Ripinsky & Williams (n 41) 69 correctly observed that '[c]ases of indirect

can be for a public purpose, non-discriminatory and compliant with due process, yet in accordance with the traditional view—supported by a treaty text and contradicted only by a handful of decisions—the non-payment of compensation would nevertheless render such an expropriation illegal and give rise to the host state’s responsibility in international law. As a result, the requirements of public purpose, non-discrimination and due process become almost irrelevant at the stage of determining a breach. Instead, they can merely affect the quantum of compensation payable to the investor for its expropriated investment.<sup>51</sup> The traditional expropriation maxim thus translates into a rule that any deprivation caused by a governmental measure must always be compensated.<sup>52</sup> In *Santa Elena*, this theory culminated in the much-criticised arbitral pronouncement that

[E]xpropriatory 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: where property is expropriated, even for environmental purposes – whether domestic or international – the state’s obligation to pay compensation remains.<sup>53</sup>

For the reasons explained below, this approach is unsustainable and renders the expropriation model inadequate for determining host state responsibility for interference with foreign investment. First, the expropriation standard fails to accommodate the contemporary role of

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expropriation would, almost by definition, fall within the scenario of unlawful expropriation, because the expropriating State does not usually acknowledge the very fact of expropriation, and consequently does not provide for payment of any compensation.’ Also *ibid* 67, discussing the caselaw of the ECtHR which takes a position similar to Mohebi’s argument. The relevance of these views for investment treaty disputes is however belied by the fact that the latter are governed by international investment treaty texts which provide only for a very limited possibility of expropriation being found lawful. The ordinary reading of the expropriation standard in most BITs commands the finding of an illegal expropriation unless compensation has been provisioned.

<sup>51</sup> See *ADC* (above n 42). See also PM Norton, ‘Back to the Future: Expropriation and the Energy Charter Treaty’ in T Walde (ed), *The Energy Charter Treaty: An East-West Gateway for Investment and Trade* (Kluwer Law International, London 1996) 374 (noting that non-discrimination, public purpose and due process are considered ‘...primarily as adding an additional sense of grievance in cases where the host state has, in the first instance, failed to pay the investor “prompt, adequate, and effective compensation.” Perhaps most significantly, that sense of grievance could affect an arbitral tribunal’s determination of an investment’s fair market value’).

<sup>52</sup> If a governmental measure is discriminatory or violates due process, then the investor may be entitled to a higher compensation. See above n 41-42 and accompanying text.

<sup>53</sup> *Compañía del Desarrollo de Santa Elena SA v Costa Rica*, Final Award, 17 February 2000 (ICSID Case No ARB/96/1) (2000) 439 ILM 1317, para 171.

the state as a regulator. Second, the expropriation standard is inconsistent with the paradigm of state responsibility that forms the foundation of non-expropriatory standards of treatment. Each of these arguments will be further explored in the following section.

## 2.1. Investment treaties are not insurance policies

A disadvantage of the traditional expropriation model is that it does not account for the fact that an economic loss can be incurred due to the interplay of market forces and individual risk. In a modern global economy, this interplay is largely informed by the interventionist role of a state. Regardless of whether one supports, or opposes, state intervention in economic affairs, it is hardly possible to deny that regulation has become a prominent characteristic of governance.<sup>54</sup> Governments frequently adjust the outcome of market processes by ‘taxing here, subsidizing there, regulating everywhere.’<sup>55</sup> Such is the depth and breadth of regulation in a contemporary state that it can justly be regarded as an inalienable element of any business environment. With the rise of the regulatory state, a risk that investment may be affected by regulation can be regarded as part of a normal business risk which the investor needs to take into account and, if necessary, insure against. Foreign investors, like their domestic counterparts, are not insulated from the effects of omnipresent regulation. It is therefore unreasonable for investors to expect that the state will always bear the cost of regulation by paying compensation every time regulatory action affects the value of investments. Arbitral tribunals and scholars have frequently stressed the fact that investment treaties are not insurance policies against a business risk. As indicated by the ICJ in *Barcelona Traction*,

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<sup>54</sup> See generally BA Ackerman, *Private Property and the Constitution* (Yale University Press, New Haven and London 1977). See further P Muchlinski, ‘“Caveat Investor?” The Relevance of the Conduct of the Investor Under The Fair and Fair Equitable Treatment Standard’ (2006) 55 ICLQ 527, 528 (noting that ‘administrative action is a highly complex, and virtually indispensable, part of the modern governance’).

<sup>55</sup> Ackerman (n 54) 1.

...when a State admits into its territory foreign investments or foreign nationals ... it is bound to extend to them the protection of the law. However, it does not thereby become an insurer of that part of another State's wealth which these investments represent.<sup>56</sup>

The NAFTA tribunal in *Azinian v Mexico* similarly emphasised that investors, frequently and variously affected by regulation, should not expect that investment treaties would provide a satisfaction guarantee:

It is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities, and disappointed yet again when national courts reject their complaints. It may safely be assumed that many Mexican parties can be found who had business dealings with governmental entities which were not to their satisfaction; Mexico is unlikely to be different from other countries in this respect. NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment, and nothing in its terms so provides.<sup>57</sup>

Likewise, the *Feldman v Mexico* tribunal warned against construing investment treaties as instruments of compensation for any loss that may investors may incur as a result of governmental action. The tribunal remarked that

Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary law recognises this.<sup>58</sup>

Indeed, investment treaties are not intended to insulate investors from risks inherent in conducting business abroad;<sup>59</sup> rather they guarantee against treatment that is contrary to the basic principles of international law, such as non-discrimination, non-arbitrariness and due

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<sup>56</sup> *Barcelona Traction, Light & Power Co., Ltd. (Belgium v Spain)* (1970) ICJ Rep 3, para 87.

<sup>57</sup> *Azinian and ors v Mexico*, Award on Jurisdiction and Merits, 18 October 1999 (ICSID Case No ARB (AF)/97/2) (2000) 39 ILM 537, para 83.

<sup>58</sup> *Marvin Feldman v United States of Mexico*, Award 16 December 2002 (Case No ARB(AF)/99/1) 7 ICSID Rep 341, para 103.

<sup>59</sup> JE Stiglitz, 'Regulating Multinational Corporations: Towards Principles of Cross-Border Legal Frameworks in a Globalized World Balancing Rights with Responsibilities' (2008) 23 Am U Intl L Rev 451, 46 (arguing that 'normally, free market advocates view markets as more efficient than government in providing insurance. Is there a rationale, in this case, to rely on publicly provided insurance?'). See *Maffezini v Spain*, Award 13 November 2000 (ICSID Case No ARB/97/7) (2001) 16 ICSID Rev-FILJ 248, para 64 (holding that BITs 'are not insurance policies against bad business judgments'), also Muchlinski (n 54) 542.

process of law. As regulation has become an inalienable part of a business environment, investors cannot claim compensation every time a governmental decision negatively affects the value of their investment. Here lies the inadequacy of the expropriation standard. Once it is recognised that *any* regulation can entail negative change in the value of an investment,<sup>60</sup> the existence of the economic loss alone ceases to form a justifiable basis for an obligation to compensate.<sup>61</sup> The standard of expropriation, with its emphasis on the fact of deprivation as a sole criterion, translates into a duty not to regulate unless compensation is provided for. It does transform investment treaties into insurance policies against a regulatory risk.

## 2.2. Prohibiting regulation or abuse of power?

Understanding the role of regulation in economic relations both globally and at the national level, however, does not mean the exemption of states from responsibility to investors. It has been rightly observed that a ‘blanket exception for regulatory measures would create a gaping loophole in international protection against expropriation.’<sup>62</sup> In his analysis of risk and its relationship to the international standard of treatment, Brownlie pointed out that ‘whatever risks the alien investor may be expected to reckon with, it is arguable that he cannot be expected to accept a distorted and unforeseeable manipulation of the legal procedures of the host state.’<sup>63</sup> What is (and should be) prohibited under international law: any regulation that

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<sup>60</sup> Newcombe (n 36) 46 (observing that ‘many regulations result in some form of wealth deprivation’ and arguing that deprivation alone does not provide a sound policy rationale for providing compensation).

<sup>61</sup> D Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (CUP, Cambridge 2008) 33 (pointing out that ‘the takings rule potentially poses a significant barrier for the ability of states to intervene in the marketplace’).

<sup>62</sup> *Pope & Talbot Inc v Canada*, Interim Award, 26 June 2000 (Ad hoc—UNCITRAL Arbitration Rules) para 99.

<sup>63</sup> I Brownlie, ‘Treatment of Aliens: Assumption of Risk and the International Standard’ in W Flume and others (eds), *International Law and Economic Order: Essays in honour of F.A. Mann* (Verlag C.H.Beck, München 1977) 319, referring to the Separate Opinion of Judge Cros in the *Barcelona Traction* case (1970) ICJ Rep 4, 274.

entails a diminution in the investment's value or arbitrary, abusive and discriminatory measures that cause an economic loss? In order to protect an investor from the detrimental effects of a government's action, it is important to distinguish between a permissible regulation and an unlawful exercise of state powers. Unlike the traditional expropriation analysis, an inquiry focusing on the nature of a government's conduct does not aim to exempt all regulatory measures from state responsibility in international law. Rather, it intends to ensure that investors are protected against acts and omissions that are discriminatory, arbitrary, or contrary to due process of law. Focusing on the manner in which the host state interferes with the foreign investment enables the ascertainment of whether a disputed governmental act involves ideological hostility, xenophobic sentiment, political preference, corruption or represents a generally innocuous regulatory activity in pursuit of legitimate economic or social objectives.<sup>64</sup>

### 2.3. The theoretical underpinnings of state responsibility for expropriation and non-expropriatory breaches: expropriation as a loss

It has been suggested that the resilience of expropriation—or its ubiquitous presence among standards—is a ‘by-product of intended redundancy on the part of over-cautious treaty drafters.’<sup>65</sup> Especially in the context of indirect state interference with foreign investment, the reliance on the doctrine of expropriation has been explained as the result of ‘a reluctance to give up a paradigm of law that was developed in the context of direct expropriations, despite

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<sup>64</sup> Sornarajah identifies eight different forms of risks to which investors are exposed: political hostility, nationalistic concerns, reneging on promises made by previous governments, deterioration in the law-and-order situation in the country, internal corruption, changes affecting an industry on a global scale, renegotiation or termination of contracts due to changed circumstances, and economic regulation. (Sornarajah (n 41) 70). While the latter three categories would seem to represent a *prima facie* lawful regulation, they too remain subject to the conduct analysis.

<sup>65</sup> Grierson-Weiler & Laird (n 39) 269.

the fact that their legal form has meanwhile undergone a change.’<sup>66</sup> A similar disinclination to give up the concept of expropriation as a distinct international delict can be discerned in scholarship. For example, Montt argues that that expropriation ‘must necessarily be defined as something less extensive than ‘unlawful harm caused by the government’ lest the notion of expropriation is equated with ‘state liability for injuries to investors’.’<sup>67</sup> The argument points to a long tradition of reserving expropriation for cases dealing with full or substantial deprivations of property rights.<sup>68</sup> This understanding of expropriation is somewhat outdated and therefore inaccurate. As a matter of the international law doctrine, expropriation has been traditionally regarded as one among many forms of delictual responsibility.<sup>69</sup> It is true that not all harm caused unlawfully to an investor would constitute expropriation; indeed, the investor may suffer moral and physical injury without being deprived of its investment. However, so far as the economic loss suffered by an investment is concerned, it is undeniable from both a semantic and legal perspective that the effect of a governmental action, i.e. its negative impact on the value and ownership of the investment, amounts to harm. The very fact that expropriation is frequently analysed in terms of the sole effect doctrine and the related rule of substantial deprivation indicates that an expropriation is commonly understood as an economic loss.

Understanding expropriation in terms of an economic harm is instrumental to conceptualising the foundations of state responsibility for interference with foreign

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<sup>66</sup> A Hoffman, ‘Indirect Expropriation’ in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 152.

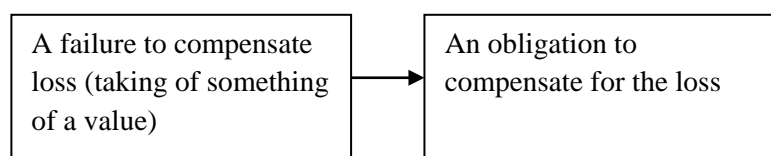
<sup>67</sup> S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 233.

<sup>68</sup> Ibid 233-4.

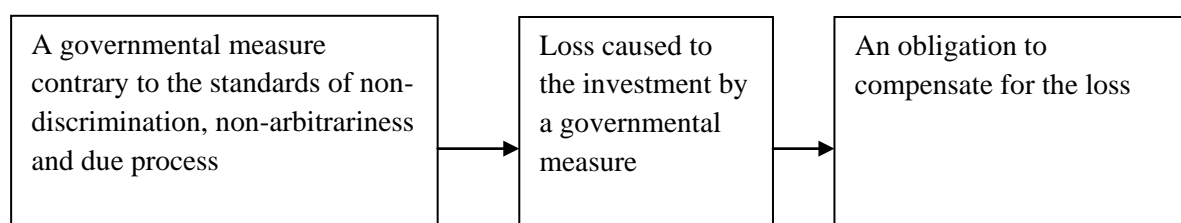
<sup>69</sup> Brownlie (above n 26) 506. That expropriation was one subcategory of state responsibility for injury to foreigners is evidenced by the history of the codification of international rules on state responsibility. See the Special Rapporteur’s Forth Report on State Responsibility, FV Garcia Amador, ‘Responsibility of the State for Injuries Caused in its Territory to Persons or Property of Aliens – Measures Affecting Acquired Rights’ UN Doc. A/CN.4/119, Yearbook of International Law Commission (1959-II), see also CF Amerasinghe, *State Responsibility for Injuries to Aliens* (Clarendon Press, Oxford 1967) 121-32.

investment. In contrast with expropriation, which is traditionally deemed as internationally wrongful merely because something of value has been taken and not compensated for, international wrongfulness of non-expropriatory breaches lies in the character of a disputed governmental action, i.e. the presence of discrimination, arbitrariness, and a breach of due process. Analyses applied by arbitral panels in ruling on non-expropriatory treaty breaches are in line with an emerging shift to a character-focused approach in expropriation disputes, and reflect a different, more adequate understanding of the host state's role in regulating foreign investment.<sup>70</sup> Unlike the general prohibition of uncompensated regulation, state responsibility under non-expropriatory standards of treatment is based on the idea that states should exercise their regulatory functions subject to the restraints of international law, including the principles of non-discrimination, non-arbitrariness, and due process of law. The difference in the legal basis underlying state responsibility for expropriation and non-expropriatory standards of treatment can be presented as follows:

#### I. Expropriation (the traditional model)



#### II. Non-expropriatory standards of treatment



<sup>70</sup> As noted earlier, the finding of a non-expropriatory treaty breach hinges on the presence of discrimination, due process, arbitrariness; the fact of deprivation is more relevant at the stage of determining a remedy.



It is clear that the ultimate gravamen of the investor claims under either expropriation or non-expropriatory standards is the economic loss. Yet the asymmetry in the foundation of state responsibility for expropriation and that for non-expropriatory breaches is created by the fact that unlike other standards, the fact of loss dominates the expropriation analysis, with the character of a government's conduct remaining largely irrelevant.<sup>71</sup> Furthermore, under the expropriation standard, compensation is both a condition of legality ('expropriation is illegal unless compensated for') and a remedy ('an uncompensated expropriation must be remedied by the payment of compensation'<sup>72</sup>). In contrast, for the host state to be held liable under a non-expropriatory standard of treatment, the existence of an uncompensated economic loss alone will not suffice. Here, the host state will be liable once their disputed conduct is found to have contravened the standard of national treatment, arbitrary measures or FET. The fact that the investor has suffered a certain loss becomes relevant at a later stage, as part of determining the quantum of damages.<sup>73</sup> Non-expropriatory standards therefore provide a better framework for determining a host state's responsibility for interference with foreign investment. First, compensation is not one of the mandatory conditions triggering a finding of state responsibility, but rather a remedy to which the investor will be entitled to in the event that the host state acted in a manner contravening a certain standard. Second, non-expropriatory standards of treatment do not entitle the investor to redress for *any* deprivation but only for measures that are discriminatory, in violation of due process, arbitrary or abusive. Hence, the comparative advantage of non-expropriatory standards is that they (1)

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<sup>71</sup> This holds true in investment treaty law. The ECHR approaches differ.

<sup>72</sup> There is disagreement as to whether an illegal expropriation should attract a different remedy, i.e. higher damages.

<sup>73</sup> Unless the remedy sought is injunctive relief. See *ATA Construction, Industrial and Trading Company v Jordan*, Award, 12 May 2010 (ICSID Case No ARB/08/2). For criticism of the exercise by tribunals of injunctive powers, see Subedi (n 26) 79 (cautiously regarding the possibility of preventative measures in expropriation claims which the tribunal in *Enron v Argentina* found to be within the competence of international tribunals).

accommodate the application of the police powers doctrine without exempting host states from responsibility for governmental measures, and (2) do not shield investors from normal regulatory risks.

### 3. Expropriation: A Redundant Standard

#### 3.1. Expropriation as a prohibition of lawful measures

While acknowledging the difference in the legal bases of state responsibility for expropriation and non-expropriatory breaches, it can be argued that the two may still coexist and perform their own functions. There is a scope for an argument that by imposing an obligation to compensate for deprivation, the expropriation standard aims to ensure that investors are not left to carry the burden of a lawfully caused harm. For instance, an environmental decree may be for a public purpose (non-arbitrary), non-discriminatory and adopted in compliance with due process of law. Should the investor alone carry the burden of a loss if the society as a whole is to benefit? In the given example, the standard of expropriation would arguably shield the investor from having to bear the loss caused by otherwise lawful measures. Therefore, it could be argued, expropriation should retain its place in investment treaty instruments along with non-expropriatory standards of treatment which prohibit certain forms of internationally illegal action, such as discrimination, arbitrary conduct, and abuse of power.

It is submitted that a distinction between lawful and unlawful harm also fails to furnish an adequate analytical framework for determining a host state's liability for interference with a foreign investment. Insisting that expropriation protects against both lawful and unlawful deprivations transforms state responsibility in investment treaty law into strict (or absolute)

liability. Indeed, once we accept that a government should always pay for the loss caused to an investor—regardless of whether such loss has been inflicted by a lawful or unlawful measure—then any diminution in the investment’s value will have to be compensated. Not only is such a guarantee undesirable from a policy perspective, but it is also very broad as it postulates state responsibility for *any* degree of loss caused by *any* kind of measure.

### 3.2. The test of proportionality as a means of discerning between compensable expropriation and non-compensable regulation

It might, however, be argued that the standard of expropriation is designed to protect not against any loss but only against the loss which, although caused by a lawful measure, is disproportionate. Indeed, one of the popular solutions for the problems presented by an overreaching expropriation standard is the test of proportionality, which commands that ‘the disadvantages caused by the measure must not be disproportionate to the aims used.’<sup>74</sup> In accordance with this test, any loss can be weighed against the aims pursued by the measure at issue. Thus, the harm caused by a lawful measure, such as an environmental decree, would be compensable if it is disproportionate. Without denying the possibility of deploying the

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<sup>74</sup> Case C-331 / 88 *R v Ministry of Agriculture, Fisheries and Food, ex parte Fedesa* [1990] ECR I-4023, para 13. For discussion of the doctrine generally, see AT Yutaka, *The margin of appreciation doctrine and the principle of proportionality in the jurisprudence of the ECHR* (Intersentia, Antwerp 2002); R Thomas, *Legitimate expectations and proportionality in administrative law* (Hart, Oxford 2000). For the application in investment treaty law, see Montt (n 67) 221 (arguing for the use of the proportionality test in investment arbitration); JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 313-5, 317; L Ives Fortier and SL Drymer, ‘Indirect Expropriation in the Law of International Investment: I Know When I See It, or Caveat Investor’ (2004) 19 ICSID Rev – Foreign Investment L J 293, 300; Kriebaum (above n 3) 231 (suggesting that the test of proportionality should be used in combination with the sole effect approach); A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 363-6. For the leading authorities on the test of proportionality in investment arbitration, see *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, Award of 29 May 2003 (ICSID Case No. ARB(AF)/00/2) (2003) 23 ILM 133, para 122 (‘there must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure...’) and *LG&E Energy Corp and ors v Argentina*, Decision on Liability, 3 October 2006 (ICSID Case No ARB 02/1) (2007) 46 ILM 36, para 195.

proportionality rule at a certain stage in the determination of state responsibility, it is submitted that such a possibility does not justify the existence of the expropriation standard as a standalone treaty provision. In fact, the wording of the expropriation standard would militate against the application of the proportionality test. Consider a scenario involving an environmental decree which, although non-discriminatory and compliant with due process, causes a loss of revenue on the part of the investor. Does the loss constitute an uncompensated expropriation and give rise to state responsibility? As the investor incurs only a partial deprivation, it can be argued that the means justified the ends and that no compensation should be payable. However, one may object to the proportionality test on the ground that the applicable BIT extends protection not only to the whole investment but also to investment returns.<sup>75</sup> It is possible to argue that the loss of investment returns is not to be evaluated against the whole investment but instead should be treated as a standalone entitlement. In other words, while the loss of revenue may not involve the loss of the whole investment, if viewed as a separate asset it would be sufficient to trigger the state's obligation to compensate.<sup>76</sup> Here, the ordinary meaning of the expropriation clause, coupled with the definition of an investment, would support the existence of an obligation to compensate any expropriation: both that which involves the dispossession of the whole investment (a total expropriation) and that which involves only the loss of a certain entitlement, such as the loss of investment returns. Since the application of the proportionality test may deprive the investor from compensation for an expropriation of its revenue, the test would not quite be compatible with the protection afforded to the investor under the BIT. This downside of the proportionality test has been acknowledged by the supporters of maximal investment

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<sup>75</sup> See Ch I.

<sup>76</sup> For conceptual severance techniques and partial expropriation, see Ch II.

protection.<sup>77</sup>

Applying the proportionality test is thus fraught with problems, stemming primarily from the wording of expropriation clauses in investment treaty instruments. Since the proportionality test may exempt certain measures from the payment of compensation on the ground that they are proportionate, the test would run counter to the prohibition of uncompensated expropriation. Yet, ordering a government to pay for a partial loss caused by a lawful governmental ban would be undesirable from a policy perspective. Deployed by a pro-investor oriented tribunal which is aided by the wording of BITs, the proportionality test would not shield host states from having to compensate for any diminution in the value of an investment.

#### 4. The proposed framework

The foregoing discussion urges us to revise the existing approaches to expropriation. It is argued that the standard of expropriation is inadequate for dealing with investor claims against governmental measures detrimentally affecting the value of an investment. A typical expropriation clause in an investment treaty instrument, supported by the definition of an investment, provides for the payment of compensation for any deprivation and thus transforms international investment treaties into blanket protection against any regulatory risks. Undesirable as it is from a policy perspective, the standard of expropriation is also inconsistent with the paradigm of state responsibility which underlies the non-expropriatory standards of treatment, such as FET, the prohibition of arbitrary and discriminatory measures, and the national treatment standards. The crucial difference lies in the fact that the non-

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<sup>77</sup> See, for example, Kriebaum (above (n 3) 728-9, arguing that despite its virtues the test of proportionality would lead to unacceptable results as it may rule out compensation to a deprived investor).

expropriatory standards of treatment do not outlaw any regulatory measures but only prohibit certain types of governmental conduct, such as abuse of power, arbitrariness, and violation of due process. It is therefore submitted that the non-expropriatory standards of treatment provide a better and more sound analytical and legal framework for determining state responsibility in international investment law. Once we acknowledge that the standard of expropriation fails to furnish an adequate basis for distinguishing between permissible regulation and compensable deprivation, it becomes effectively redundant.

As an alternative to the prohibition of expropriation, this thesis proposes adopting a standard that would reflect a realistic understanding of not only the role regulation plays in economic relations but also the fact that international investment instruments do not provide insurance against regulatory changes. Beneath the proposed framework lies the idea that state responsibility in international investment law is a corrective mechanism aimed at remedying the loss inflicted on an investment by wrongful governmental conduct. It can be expressed in the following tentative formulation:

Each contracting party shall accord investments fair and equitable treatment by refraining from measures that are discriminatory, arbitrary, in violation of due process of law, or otherwise contrary to a state's obligations under international law.

By doing away with the mandatory compensation requirement, the proposed standard introduces a uniform framework for analysing investor claims against a host state. That is, for a host state's liability to arise, it would be necessary to show the violation of an investment treaty obligation and the loss inflicted upon an investor. This paradigm is designed to replace an asymmetrical relationship between expropriation and non-expropriatory standards of treatment which currently defines state responsibility under existing investment treaties.

Beyond doubt, a proposal of this kind is not easy to implement due to reluctance and unease on the part of investment treaty drafters. Expropriation has long been one of the

central investment protection standards. At the same time, investment treaty instruments and arbitral awards appear to be showing signs of departure from the traditional model. Some treaties have already clarified that non-discriminatory regulatory actions in pursuit of public welfare objectives do not constitute expropriation; nor does an adverse effect on the economic value of an investment provide a sufficient basis for concluding that an expropriation has occurred.<sup>78</sup> The *Methanex* and *Saluka* awards have marked the trend for a greater acceptance of the police powers exception and the related shift of emphasis from the effect of governmental conduct to the character of such conduct. Although fragmentary and unsystematic, such drafting solutions and arbitral approaches support a conclusion that, ultimately, it is possible to abandon the expropriation standard which mandates compensation for every act negatively affecting the value of an investment. Likewise, the rise to prominence of non-expropriatory standards and the emergence of a single standard of regulatory treatment have already been acknowledged in academic writing.<sup>79</sup>

The abandonment of expropriation is not intended as an expansion of host state responsibility to foreign investors. It is not suggested that investors should always carry the burden of loss caused by regulatory measures. Instead, it is submitted that state responsibility should arise where the interference by a government with foreign investment contravenes international rules of non-discrimination, non-arbitrariness, and due process of law. Such framework is already in place under non-expropriatory standards of FET, national treatment and the prohibition of arbitrary measures. The rules of non-discrimination, non-arbitrariness and due process of law operate as international legal restraints on the exercise of regulatory powers by host states and allow a line to be drawn between a permissible regulation and that

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<sup>78</sup> See the expropriation clause in the recent generation of the US BITs as well as the Norwegian Model BIT (with commentary), available at <<http://ita.law.uvic.ca/investmenttreaties.htm>> accessed 31 October 2010.

<sup>79</sup> See, e.g. Weiler & Laird (n 39) and Schreuer (n 39).

which requires compensation. In contrast with the existing guarantee against uncompensated expropriation, they do not intrude upon a normal exercise of regulatory power; nor do they call for the payment of compensation simply because the investor has suffered a loss in value of its investment or otherwise been restricted in the use and enjoyment of it.

Doing away with the expropriation clause in favour of non-expropriatory standards of treatment is not a cure-all for the problems surrounding the institution of state responsibility in investment treaty law. In the following chapters, attention will be drawn to various aspects of the interpretation and application of non-expropriatory standards in investment arbitration. In particular, the discussion will revolve around the standards of non-discrimination, due process, observance of undertakings, and fair and equitable treatment. Along with highlighting the increasing recourse to standards of treatment other than expropriation in challenging a host state's interference with foreign investments, chapters IV to VII will attempt to outline the contours of a more sustainable, credible and balanced mechanism of investment protection.



## **CHAPTER IV: DISCRIMINATORY TREATMENT AS A GROUND OF THE HOST STATE'S RESPONSIBILITY FOR INTERFERENCE WITH FOREIGN INVESTMENT**

This chapter will focus on the principle of non-discrimination and its transformation from a legality criterion in the expropriation analysis to a stand-alone ground of state responsibility under non-expropriatory standards of treatment. While the shift from the traditional effect-based expropriation model to character-focused non-expropriatory standards is desirable, certain interpretive aspects of the non-discrimination standards are problematic due to their potential impact on the scope of state responsibility for interference with foreign investment. In keeping with the central idea of the thesis, this chapter will examine whether investment treaty practice and arbitral decisions provide for the optimal balance between the protection of investment and the host state's regulatory freedom. After outlining the move towards a greater substantive role for the principle of non-discrimination in investment treaty law, the chapter will analyse the problems arising from (1) a broad application of the like circumstances requirement, (2) the multiplicity and overlap between the investment treaty standards prohibiting discrimination, and (3) an overreaching arbitral scrutiny of host state justifications for differential treatment. This chapter will conclude with the discussion of the non-discrimination standards and their impact on a host state's regulatory freedom in adopting measures aimed at the protection and maintenance of national security, including emergency measures.

### **1. The traditional role of the non-discrimination rule under the expropriation standard**

In traditional international law on treatment of foreigners abroad, the rule of non-

discrimination operated as a restraint on the exercise by sovereign states of their right to expropriate. In its decision in *Oscar Chinn*,<sup>1</sup> the PCIJ confirmed that international law forbids discrimination based on nationality and involving differential treatment as between persons belonging to different national groups.<sup>2</sup> The principle of non-discrimination was repeatedly invoked in early nationalisation cases, including the *Anglo-Iranian Oil Company* case<sup>3</sup>, the 1956 nationalisation of the Suez Canal Company<sup>4</sup>, the 1959 nationalisation of Dutch-owned enterprises,<sup>5</sup> and the 1971 Libyan Oil Concessions cases.<sup>6</sup> As evidenced by state practice and international decisions, discrimination would normally render the act of expropriation unlawful.<sup>7</sup>

Early customary views on expropriation have continued to influence the interpretation of the non-discrimination rule in investment treaty law. There is widespread agreement that, as far as the treaty standard of expropriation is concerned, non-discrimination operates as a legality requirement and is therefore limited to the assessment of the lawfulness of an

<sup>1</sup> *Oscar Chinn* [1934] PCIJ Rep Series A/B No 63.

<sup>2</sup> Ibid 87.

<sup>3</sup> See the United Kingdom memorial in *Anglo-Iranian Oil Company*, which stated that '[a] measure of expropriation or nationalization, even if not unlawful on any other ground, becomes unlawful under international law, if in effect it is exclusively or primarily directed against foreigners as such...' (ICJ Pleadings, *Anglo-Iranian Oil Company* Case, Memorial Submitted by the Government of the United Kingdom of Great Britain and Northern Ireland of 10<sup>th</sup> October 1951, 93). See also W McKean, *Equality and Discrimination under International Law* (Clarendon Press, Oxford 1983) 196-7.

<sup>4</sup> It was invoked by the British Foreign Secretary, Mr Lloyd, in the Security Council. See *New York Times*, 6 Oct 1956, 3.

<sup>5</sup> In its Note of December 18, 1959 regarding nationalisation by Indonesia of Dutch-owned businesses, the Netherlands submitted that the right of sovereign states to nationalise the property of foreign nationals was subject to the proviso that such nationalisation ought not to be of a discriminatory nature. The Note stated that Indonesian nationalisation measures could not be regarded as valid under international law since they were only directed against Dutch property and motivated by political considerations relating to the dispute over Netherlands New Guinea. (Netherlands Note of December 18, 1959 (1960) 54 AJIL 484, 486).

<sup>6</sup> The expropriation was retaliation for the UK's refusal to react to the occupation by Iran of three islands in the Gulf. The British Minister of State for Foreign and Commonwealth Affairs issued a statement that 'the taking of the property of [the Claimant] is not a legitimate act of nationalisation because it is discriminatory against the company and for purposes which are not admissible in international law.' (Hansard HC vol 828 col 312 (21 December 1971 WA), cited in *British Petroleum v Libyan Arab Republic* 53 ILR 297, 316). Addressing a claim against the Libyan Government, an arbitral tribunal in *BP v Libya* held that '[t]he taking by the Respondent of the property, rights and interests of the Claimant clearly violates public international law as it was made for purely extraneous political reasons and was arbitrary and discriminatory in character (*British Petroleum v Libyan Arab Republic* (1979) 53 ILR 297, 329).

<sup>7</sup> McKean (n 3) 194-197.

expropriation.<sup>8</sup> However, it would seem that in the context of regulatory interference with foreign investment, the role of non-discrimination should not be limited to the *post facto* determination of whether an expropriation is lawful. Investment tribunal awards show a growing trend towards acknowledging non-discrimination as one of the criteria in establishing if certain governmental conduct constitutes an indirect expropriation.<sup>9</sup> For instance, a claim of expropriation in *Methanex* concerned an allegedly discriminatory governmental measure.<sup>10</sup> At heart of the dispute was the executive order adopted by the governor of California which provided for the gradual removal of MTBE (a methanol-based source of octane and oxygenate) from gasoline. An investor, the largest supplier of methanol to the Californian producers of MTBE, contested that the measures were motivated by discriminatory intent to prevent MTBE and methanol from competing with ethanol in the oxygenate market, contrary to the NAFTA Chapter 11 provisions on national treatment, fair and equitable treatment, and expropriation. The investor contended that expropriation had occurred when its shares of the California and U.S. oxygenate market ‘were taken by patently discriminatory measures and handed over to the domestic ethanol industry.’<sup>11</sup> In addressing the claim of expropriation, the tribunal observed that a discriminatory regulation against a foreign investor was a key

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<sup>8</sup> See R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP, Oxford 2008) 90-1, A Reinisch, ‘Legality of Expropriations’ in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 186-90; C Schreuer, ‘The Concept of Expropriation under the ECT and other Investment Protection Treaties’ in C Ribeiro, *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington, NY 2006) 145; UNCTAD, *International Investment Agreements: Key Issues* (United Nations, New York 2004) 235; JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 321-2; A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 373. For a recent award, see *ADC Affiliate Ltd and ADC & ADMC Management Ltd v Hungary*, Final award on jurisdiction, merits and damages (ICSID Case No ARB/03/16) paras 441-443, 476 (analysing discrimination as a criterion of legality of expropriation affecting the quantum of compensation).

<sup>9</sup> See Chapter III. That discrimination has been increasingly recognised as an important factor in determining expropriation, see C McLachlan, L Shore and M Weiniger, *International Investment Arbitration: Substantive Principles* (OUP, Oxford 2007) 308. Also the Restatement (Third) of the Foreign Relations Law of the United States.

<sup>10</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345.

<sup>11</sup> *Ibid*, Part II, Ch.D, para28.

requirement for establishing expropriation.<sup>12</sup> It held that

...as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and which affects, inter alios, a foreign 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.<sup>13</sup>

The tribunal concluded that the ban was made for a public purpose, was non-discriminatory and was accomplished with due process. It held that, ‘from the standpoint of international law, the California ban was a lawful regulation and not an expropriation.’<sup>14</sup>

*Eureko v Poland* lends further support to the position which regards discrimination as one of the conditions for establishing an indirect expropriation.<sup>15</sup> Although the tribunal made no explicit determination as to the role of discrimination as a factor in the expropriation analysis, the reasoning in the relevant part of the award suggests that the existence of discrimination was critical to its finding of an expropriation. The dispute concerned the host state’s failure to comply with its commitments under the share purchase agreement that had been concluded as a part of privatisation of PZU, a leading state-owned insurance company. The share purchase agreement envisaged the sale of 51% of the shares in PZU to Eureko. Having acquired a 20% stake in PZU, the foreign investor found itself in ‘an epicenter of the Polish party politics’<sup>16</sup> which led to the withdrawal of the government from the share purchase agreement and addenda. The investor contended that the governmental conduct was in breach of the obligation not to impair by unreasonable or discriminatory measures the

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<sup>12</sup> Ibid, Part IV, Ch. D, para 7

<sup>13</sup> Ibid.

<sup>14</sup> Ibid, Part IV, Ch. D, para 15.

<sup>15</sup> *Eureko BV v Poland*, Partial Award and Dissenting Opinion, 19 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) 12 ICSID Reps 335.

<sup>16</sup> Ibid para 43.

operation, management, maintenance, use, enjoyment or disposal of investment.<sup>17</sup> The tribunal found that the respondent government ‘acted not for cause but for purely arbitrary reasons linked to the interplay of Polish politics and nationalistic reasons of a discriminatory character.’<sup>18</sup> In particular, it noted that in changing the privatisation strategy, the Council of Ministers had been motivated by a desire to exclude foreigners from the control over the insurance business in question.<sup>19</sup> Such a finding was material to the tribunal’s conclusion that the government’s refusal to honour its commitments under the share purchase agreement amounted to deprivation of the foreign investor’s contractual rights and was ‘expropriatory in substance and effect.’<sup>20</sup> The decision suggests that had there been no discrimination behind the government’s failure to comply with its commitments under the share purchase agreement, the tribunal would have been less inclined to grant the investor’s claim of expropriation.

Beyond arbitral decisions, discrimination features prominently among the criteria for distinguishing between expropriation and non-compensable regulation in investment treaty instruments, including the recent generation of Free Trade Agreements. By way of example, the Central America-Dominican Republic-United States FTA and the United States-Singapore FTA contain an identical provision envisaging that ‘except in rare circumstances, *non-discriminatory regulatory actions* by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, *do not constitute indirect expropriation.*’<sup>21</sup> Similarly, the 1985 Convention establishing the

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<sup>17</sup> See *ibid* para 77 referring to Art 3.1. of the Poland— Netherlands BIT.

<sup>18</sup> *Ibid* para 233. This conclusion was reached on the basis of evidence, including statements made by the government officials that the change of the privatisation strategy and the withdrawal from the share purchase agreement had been justified by the need to retain control over PZU ‘given the strategic importance of PZU and the fact that most of the financial sector in Poland is already in foreign hands’ (*ibid* para 213).

<sup>19</sup> See *ibid* para 218.

<sup>20</sup> *Ibid* para 240-242.

<sup>21</sup> Such wording has been adopted in the Letter of Exchange on Expropriation which forms part of the U.S.

Multilateral Investment Guarantee Agency excludes non-discriminatory measures from the ambit of expropriation.<sup>22</sup>

The shift from interpreting non-discrimination as a condition of lawful expropriation to being one of the criteria for establishing whether an expropriation has occurred reflects fundamental changes in the international law of foreign investment. The scope of international investment law is no longer limited to protecting investors against a physical taking of property and transfer of ownership to the host state. Rather, investors can seek protection against an indirect interference by the host governments exercising their regulatory functions. Discriminatory conduct may give rise to a host state's responsibility in international law regardless of whether such conduct amounts to a deprivation falling within the scope of the traditional expropriation standard. Unlike the traditional effects-based analysis of expropriation claims, which mirrors the hitherto prevailing cases of direct takings of foreign assets, the focus of arbitral inquiry is gradually shifting to the character of host state conduct, including its compliance with the principle of non-discrimination enshrined in the standards of national treatment, the prohibition of arbitrary and discriminatory measures, and fair and equitable treatment. There is growing support for the view that only where the state fails to comply with its international obligations (which include the obligation to refrain from discriminatory conduct proscribed by customary international law and specific treaty obligations) does the investor become entitled to compensation for the losses incurred. The changing role of non-discrimination in the investment treaty context is in keeping with the

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Singapore FTA, and Annex 10-C to the CAFTA-DR FTA. See <[http://www.sice.oas.org/Trade/USA-Singapore/USASingind\\_e.asp](http://www.sice.oas.org/Trade/USA-Singapore/USASingind_e.asp)>, and <[http://www.ustr.gov/Trade\\_Agreements/Bilateral/CAFTA/CAFTA-DR\\_Final\\_Texts/Section\\_Index.html](http://www.ustr.gov/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/Section_Index.html)>(emphasis added).

<sup>22</sup> See Article 11 of the Convention stating that 'Any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of host ownership or control of, or a substantial benefit from, his investment, with exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territory'(The Convention Establishing the Multilateral Investment Guarantee Agency (1985) 24 ILM 1605, 1611).

idea that international investment treaties are not insurance policies protecting against normal business risks. Rather, investment treaties are designed to ensure that host states treat investors in accordance with basic international guarantees.

## 2. Discrimination and non-expropriatory standards of treatment: the potential for expanding state responsibility in investment treaty law

### 2.1. General

The role of the non-discrimination rule as a restraint on the exercise of regulatory powers is particularly salient under non-expropriatory standards of investment protection. In recent investment treaties, non-discrimination has been subsumed under the national treatment standard, most-favoured-nation (MFN) clauses, the prohibition of arbitrary and discriminatory measures, and FET.<sup>23</sup> There is a series of arbitral awards, in which the alleged discrimination was analysed solely as a part of the national treatment standard, FET, or the obligation to refrain from arbitrary and discriminatory measures. The characteristic feature of this category of disputes is that host states were held responsible for the loss incurred by the investor because of discriminatory measures even despite the fact that no expropriation had occurred. For instance, in *SD Myers v Canada*,<sup>24</sup> a claim of discrimination was addressed under Article 1102 NAFTA, which contained a national treatment standard. The investor contended that an interim order banning the export of PCB-contaminated waste constituted a disguised

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<sup>23</sup> See Newcombe and Paradell (n 8) 298-307 (outlining the scope of the non-discrimination requirement and pointing to an overlap between FET, ADM, national treatment and MFN standards); also UNCTAD, *National Treatment* (United Nations, New York 1999) 11-2; J Coe and N Rubins, 'Regulatory Expropriation and the *Tecmed* Case: Context and Contributions' in T Weiler (ed) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, London 2005) 602.

<sup>24</sup> *SD Myers Incorporated v Canada*, First Partial Award and Separate Opinion, Ad hoc—UNCITRAL Arbitration Rules, 13 November 2000 (2001) 40 ILM 1408.

discrimination.<sup>25</sup> It also claimed that the promulgation of the export ban amounted to a breach of fair and equitable treatment under Article 1105.<sup>26</sup> The tribunal agreed. It found that the export ban favoured Canadian nationals over non-nationals.<sup>27</sup> It further held that the measures effectively prevented the investor from carrying out its remediation business, which was a clear disadvantage in comparison to its Canadian competitors.<sup>28</sup> As the tribunal dismissed the claim of expropriation due to the temporary nature of the export ban,<sup>29</sup> its final determination of Canada's responsibility to the investor was based on the finding of discrimination in violation of the national treatment and FET standards of Chapter 11 NAFTA.

Another interesting example is provided by the award in *Occidental v Ecuador*, in which a dispute arose from a decision denying the reimbursement of VAT on purchases made in the course of exploration, production and exportation of oil.<sup>30</sup> The investor contended that Ecuador's refusal to grant VAT refunds amounted to a violation of several provisions of the BIT, including the expropriation standard. The tribunal dismissed the claim of expropriation as in its view 'there had been no deprivation of the use or reasonably expected economic benefit of the investment, let alone measures affecting a significant part of the investment.'<sup>31</sup> However, this finding did not prevent the tribunal from awarding damages for discriminatory conduct. The tribunal found that the investor had received a less favourable treatment than that accorded to national enterprises.<sup>32</sup> It therefore held Ecuador responsible for a breach of the national treatment standard and granted compensation corresponding to the

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<sup>25</sup> Ibid para 130.

<sup>26</sup> Ibid para 136.

<sup>27</sup> Ibid para 193.

<sup>28</sup> Ibid.

<sup>29</sup> Ibid para 287.

<sup>30</sup> *Occidental Exploration and Production Company v Ecuador*, Award, 1 July 2004 (LCIA Case No UN 3467).

<sup>31</sup> Ibid para 89.

<sup>32</sup> Ibid para 177.



amount of disputed VAT refunds.<sup>33</sup>

Discrimination in breach of non-expropriatory standards of treatment has formed the basis of host state responsibility in a number of arbitral awards.<sup>34</sup> The existing practice points to the emerging concept of an investment treaty breach where the key criterion of illegality is the character of the disputed governmental conduct. The shift from expropriation to non-expropriatory standards of treatment is not, however, a panacea. Unlike the traditional expropriation model, host state responsibility for discriminatory acts does not hinge on the magnitude of deprivation. Thus, the investor does not need to bear the risk of regulatory interference until such time as the resulting deprivation becomes substantial; virtually any loss on the part of a foreign investor can be compensated once the investor succeeds in establishing a case for discriminatory treatment. As a consequence, the scope of the host state's responsibility to a foreign investor will essentially depend on how far a tribunal is prepared to go in interpreting the investment treaty standards prohibiting discrimination and promoting equality among foreign and domestic investors. In order to strike the right balance between the protection of investment and the host state's freedom to regulate, it is necessary to ensure that the non-discrimination principle is construed in a way that distinguishes between a permissible differentiation and prejudice. A broad interpretation of the non-discrimination standards may lead to the relocation of the regulatory risks from a foreign investor to a host state.

## 2.2. The 'Like Circumstances' Analysis

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<sup>33</sup> Ibid para 208.

<sup>34</sup> See e.g. *Marvin Feldman v United States of Mexico*, Award 16 December 2002 (Case No ARB(AF)/99/1) 7 ICSID Rep 341; *Nykomb Synergetics Technology Holding AB v Latvia*, Award, 16 December 2003 (SCC Case No 118/2001); *Saluka Investments BV v Czech Republic*, Partial Award, 17 March 2006 (PCA—UNCITRAL Arbitration Rules), *Eastern Sugar BV v Czech Republic*, Partial award and partial dissenting opinion, 27 March 2007 (SCC Case No 088/2004).

## A. General

An economic rationale for the non-discrimination rule in investment treaty law is to ensure the same competitive conditions for both foreign and domestic investors and to prevent the host state from favouring domestic investors or investors from other states.<sup>35</sup> Both the national treatment standard, with its origin in international trade agreements, and the prohibition of discriminatory measures originating in customary international law, are contingent standards because they require the comparison of the treatment received by the claimant investor with that accorded to other investors.<sup>36</sup> In both cases, in order to establish discrimination it is necessary to examine whether the foreign investor and the enterprise which allegedly received better treatment are in like circumstances.<sup>37</sup> The importance of comparing the investors in like circumstances has long been recognised in international law on the protection of foreign interests abroad. For instance, in addressing a claim by a group of Dutch companies challenging the validity of the Indonesian measures on nationalisation of tobacco plantations, the Bremen Court of Appeals held that ‘the equality concept means only that equals must be treated equally and that the different treatment of unequals is admissible.’<sup>38</sup> In *Oscar Chinn*, the ‘like circumstances’ test was among the principal grounds on which the PCIJ rejected a claim of a discriminatory expropriation. The claim concerned an allegedly discriminatory measure which ordered Unatra, a national transportation company, to lower its carriage charges thus depriving Mr. Chinn of any prospect to carry out his business

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<sup>35</sup> UNCTAD, *National Treatment* (n 23) 8, P Muchlinski, *Multinational Enterprises & the Law* (OUP, Oxford 2007) 621, also Newcombe & Paradell (n 8) 148, noting that the commitment to non-discrimination has important political rationales such as the promotion of multilateralism and the prevention of conflicts). For the history of the non-discrimination principle, see EA Lang, ‘Equal Access/Non-discrimination and Legitimate Discrimination in International Economic Law’ (1995-1996) 14 *Wis Intl LJ* 246.

<sup>36</sup> See *Nykomb v Latvia* (n 34) para 4.3.2 (a).

<sup>37</sup> UNCTAD (n 23) 33-4.

<sup>38</sup> M Domke, ‘Indonesian Nationalization Measures Before Foreign Courts’ (1960) 54 *AJIL* 305, 315.

profitably. The court acknowledged that the special treatment had been accorded to Unatra due to its special position as a company under state supervision. It held that ‘the inequality of treatment could only have amounted to a discrimination forbidden by the Convention if it had applied to concerns in the same position as Unatra, and this was not the case.’<sup>39</sup> Since customary international law and recent arbitral practice endorse the like circumstances test as part of the non-discrimination analysis,<sup>40</sup> it seems to be a safe conclusion to draw that a comparison should always be made between the like situations, regardless of whether the wording of the standard in a treaty expressly provides so.<sup>41</sup> The crucial question is how to determine the appropriate comparator. As will be shown below, the choice of comparator has a significant bearing on the scope of state responsibility.

## B. Determining the appropriate comparator

There is no uniformity in determining the appropriate comparator in arbitral practice. One criterion is the existence of a competitive relationship between the foreign and domestic investors at issue. For instance, in *SD Myers* the tribunal had to assess the allegedly discriminatory character of a regulation prohibiting exports of PCB contaminated waste. It compared the investor with its Canadian competitors in PCB waste remediation.<sup>42</sup> However, the fact that a foreign investor and a domestic concern that has received better treatment operate in the same sector of economy and are in a competitive relationship may not, in itself,

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<sup>39</sup> *Oscar Chinn* (n 1) 87.

<sup>40</sup> See nn. 37, 39-40, also *Saluka v Czech Republic* (n 34) para 313.

<sup>41</sup> In some German BITs the national treatment standard does not expressly refer to the ‘like circumstances’ requirement. An arbitrary measures clause, too, omits reference to like or similar circumstances.

<sup>42</sup> *SD Myers* (n 24) para 251. The tribunal relied on OECD, *National Treatment for Foreign-Controlled Enterprises*: ‘As regards the expression ‘in like situations’, the comparison between foreign-controlled enterprises established in a Member country and domestic enterprises in that Member country is valid only if it is made between firms operating in the same sector.’

result in the conclusion that they are in like circumstances.<sup>43</sup> As observed in *United Parcel Service v Canada*, ‘it is possible for two investors or enterprises to be in the same sector or to be in competition and nonetheless be quite unlike in respect of some characteristic critical to a particular treatment.’<sup>44</sup> In this case, the dispute concerned the treatment of goods imported through the investor-run courier services and those imported using the services of Canada Mail. The majority of the tribunal held that, despite the investor and its competitor being engaged in the same business sector, they were not in like circumstances because of different characteristics of the imported goods.<sup>45</sup>

One problematic aspect of the like circumstances test is the possibility of setting too broad a basis for comparing between two enterprises. The broader the range of comparators to choose from, the greater the possibility that a disputed measure might be found to be discriminatory and amounting to an investment treaty breach. For example, in *Occidental v Ecuador*, an investor claimed that a refusal to grant VAT refunds was in violation of the national treatment standard because companies engaged in the export of other goods, such as flowers, mining and seafood products had been entitled to the refunds. The tribunal held that the ‘like circumstances’ prerequisite ought not to be confined to companies operating in the same sector but called for comparison between exporters generally.<sup>46</sup> It held that

...like situations cannot be interpreted in the narrow sense advanced by Ecuador as the purpose of national treatment is to protect investors as compared to local producers, and this cannot be done by addressing exclusively the sector in which that particular activity is undertaken.<sup>47</sup>

By comparing the investor’s situation with that of a broad range of exporters, the tribunal

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<sup>43</sup> Newcombe & Paradell (n 8) 165.

<sup>44</sup> *United Parcel Service of America Inc v Canada*, Award and separate opinion, 24 May 2007 (Ad hoc—UNCITRAL Arbitration Rules), Separate Opinion of Dean Ronald A Cass, para 16.

<sup>45</sup> *Ibid* paras 117-119.

<sup>46</sup> *Occidental* (n 30) para 168.

<sup>47</sup> *Ibid* para 173.

reached the conclusion that the investor was subjected to less favourable treatment. The breadth of this approach has been correctly criticised. It has been observed that by choosing *all* exporters as the appropriate comparator group, the tribunal ‘has made it easier for investors to establish a BIT violation.’<sup>48</sup> Although the investor received less favourable treatment than that accorded to the locally owned flower export companies, ‘the relevant issue was whether there was a legitimate rationale for differential regulatory treatment between different categories of exporters.’<sup>49</sup> Following the ruling in *Occidental*, states wishing to avoid liability would need to treat all exporters alike, notwithstanding policy reasons that might call for different taxation of vital industries.<sup>50</sup> Indeed, the tribunal’s interpretation of the like circumstances requirement considerably curbs a state’s power to exercise its essential regulatory powers, while also transforming investment treaties into guarantees against any regulatory change that may detrimentally affect foreign investors.

### C. Regulatory purpose test

As an alternative to existing approaches, it has been suggested that the purpose of an allegedly discriminatory regulatory measure, and not the existence of a competitive relationship, should be central to the determination of whether the investor is in ‘like circumstances’ with a domestic enterprise.<sup>51</sup> According to this argument, two firms in a competitive relationship and operating in the same sector of the economy may not be in like circumstances because of a legitimate policy basis for distinguishing between them. For instance, a firm may be subject to different pollution emission standards because it is located in an environmentally sensitive

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<sup>48</sup> SD Franck, International Decision: *Occidental Exploration & Production Co v. Republic of Ecuador* (2005) 99 AJIL 676, 679. See also M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 338; Salacuse (n 8) 249.

<sup>49</sup> Newcombe & Paradell (n 8) 176.

<sup>50</sup> Ibid. See also Muchlinki (n 35) 624 (noting that the approach adopted by the *Occidental* tribunal was at odds with the policy that encourages comparison within the same industrial sector).

<sup>51</sup> Newcombe & Paradell (n 8) 165.

area, putting it in different circumstances to an otherwise similar firm located in a different area.<sup>52</sup> Only if differential treatment is unrelated to environmental issues, will the two firms be in like circumstances.

The regulatory purpose is relevant not only at the first step of analysis in determining the appropriate comparators but also as part of establishing legitimate, non-protectionist justifications for the disputed treatment.<sup>53</sup> As stated by the tribunal in *Pope & Talbot*, the like circumstances analysis must address ‘any difference in treatment, demanding that it be justified by showing that it bears a reasonable relationship to rational policies not motivated by preference of domestic over foreign owned investments.’<sup>54</sup> However, the test may also fail if a regulatory purpose is construed in an overly broad fashion. Consider a hypothetical case involving two businesses affected by a tax regulation. If taxation generally (as opposed to a specific tax measure) were to be seen as a broadly defined regulatory purpose through which the likeness of two companies’ situations is to be determined, virtually *any* two businesses can be found in like circumstances. Governments would need to apply identical tax rates across industries and abandon the differentiation between various economic sectors requiring distinct taxation policies. While the regulatory purpose test does offer a useful alternative to otherwise inconsistent and generous interpretations of ‘like circumstances’, one should be cautious in defining what constitutes the regulatory purpose at issue. General purposes behind governmental policies should never be relied upon in identifying the appropriate comparator category. The effective application of the regulatory purpose test necessitates narrowing the

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<sup>52</sup> Ibid 176.

<sup>53</sup> Newcombe & Paradell (n 8) 176.

<sup>54</sup> *Pope & Talbot Inc v Canada*, Award on the Merits of Phase 2, 10 April 2001 (Ad hoc—UNCITRAL Arbitration Rules) para 79. See also *GAMI Investments, Incorporated v Mexico*, Final Award, 15 November 2004 (Ad hoc—UNCITRAL Arbitration Rules) para 114 (the measure must be plausibly connected with a legitimate goal of policy); *Saluka* (n 34) para 307 (any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment).

analysis to specific and distinct objectives of a particular governmental measure. Only if focused on a discrete and sufficiently nuanced objective of a governmental act, can the ‘regulatory purpose’ test offer a feasible approach to analysing breaches of national treatment and other standards prohibiting discrimination.

It is submitted that while the regulatory purpose test can be used in examining claims of discrimination, other factors, such as the existence of a competitive relationship (reasonably narrowed to a certain sector), also remain relevant. For instance, in *Corn Products v Mexico*,<sup>55</sup> the tribunal analysed both factors. The dispute concerned the imposition of a 20% excise tax on any drink that used a sweetener not made from cane sugar. The investor was a major manufacturer of a high fructose corn syrup (HFCS), a sweetener made from yellow corn and used in soft drinks. The introduction of an excise tax led to the closure of one of the investor’s plants and the significant reduction of its overall production in Mexico. The investor contended that the effect of the tax was to cause its customers to switch from HFCS to sugar cane sweeteners, thereby destroying its market and amounting to a discriminatory treatment in violation of Article 1102 NAFTA.<sup>56</sup> The tribunal reasoned that it was necessary to begin with a comparison between domestic and foreign investors operating in the same business or economic sector as the claimant. It found that Mexican sugar producers operated in the same business or economic sector as the investor:

...when it came to supplying sweeteners to the soft drinks industry, their products were in direct competition with one another, treated both by customers and by Mexican law as being interchangeable. The purpose of the HFCS tax was avowedly to alter the terms of competition between them.<sup>57</sup>

The tribunal also inferred the existence of a competitive relationship from the fact that the

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<sup>55</sup> *Corn Products International Inc v Mexico*, Decision on Responsibility, 15 January 2008 (ICSID Case No ARB(AF)/04/1).

<sup>56</sup> Ibid para4.

<sup>57</sup> Ibid para 120.

investor and the Mexican sugar producers lobbied against each other.<sup>58</sup> As regards the purpose of the regulatory measure, the tribunal pointed to Mexico's submission that the HFCS tax had been intended as a countermeasure targeting the United States for a failure to open its markets to Mexican sugar imports.<sup>59</sup> Since the countermeasure was designed to affect the competition between HFCS and sugar, producers of these directly competitive products were found to be in like circumstances.<sup>60</sup> The *Corn Product* award provides an example of a multifactor approach to the comparison task. The tribunal did not confine its analysis to the fact that both the investor and the sugar producers were engaged in the same sector of economy. Nor did it adopt the regulatory purpose test as the sole method of examining the like circumstances prerequisite. Rather, in order to establish that *Corn Products* was in like circumstances with the Mexican sugar producers, the tribunal properly examined the competitive relationship between the two groups, the substitutability of HFCS and sugar, and the objective and effect of the taxation measure. So far as the claim under Article 1102 is concerned, the *Corn Product* award illustrates an example of a balanced and sound analysis. Lest investment treaties transform into insurance against a regulatory change, the like circumstances analysis, as a key element of establishing discriminatory conduct in violation of investment treaty standards, should be subject to a multifactor analysis distinguishing an unjustified differentiation from a legitimate exercise of regulatory powers.

### 2.3. Justifying a de facto differentiation

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<sup>58</sup> See *ibid* para 135 (the tribunal holding that '[f]ar from suggesting that they are not in like circumstances, [lobbying] tends to suggest the opposite; it is precisely because they are in close competition that they lobby against each other – if they were not competing in the market for what are effectively interchangeable products, they would not trouble to maintain such lobbying activities').

<sup>59</sup> *Ibid* para 136. For the background of the countermeasure, see paras 32-48.

<sup>60</sup> *Ibid* para 136.



## A. Investment treaties and state aid

Investment tribunals have recognised that any difference in treatment should be justified by showing that it bears a reasonable relationship to rational policies not motivated by preference of domestic over foreign-owned investments.<sup>61</sup> In practice, however, arbitral approaches to justifications for allegedly discriminatory conduct tend to expand the scope of state responsibility under investment treaty instruments. For example, in *Saluka v Czech Republic*, a dispute arose from the government's refusal to provide financial assistance to IPB, one of the Big Four banks.<sup>62</sup> Due to a 'bad debt' problem, which resulted in large non-performing portfolios and insufficient regulatory capital, IPB failed to meet the liquidity requirements and was placed under forced administration, followed by the sale of its assets to its competitor. The tribunal found the government responsible for its discriminatory response to the bad debt problem in the Czech banking sector, in particular because the government provided financial assistance to three of the Big Four banks to the exclusion of IPB, and thereby created an environment impossible for the survival of IPB.<sup>63</sup> It found the government in breach of its obligation to provide fair and equitable treatment and to refrain from unreasonable or discriminatory measures.<sup>64</sup> The tribunal pointed out that fair and equitable treatment must not be construed to include the general prohibition of state aid,<sup>65</sup> and that although state aid 'tends to distort competition and to undermine the level playing field for competitors, States cannot be said to be generally bound by international law to refrain from using this tool.'<sup>66</sup> Nevertheless, the tribunal held that the host state was bound to provide financial assistance in

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<sup>61</sup> See n 54 above.

<sup>62</sup> N 34 above. See also V Balas, 'Saluka Investments BV (The Netherlands) v The Czech Republic: Comments on the Partial Arbitral Award of 17 March 2006' (2006) 7 J World Investment & Trade 371.

<sup>63</sup> *Saluka* (n 34) para 466.

<sup>64</sup> *Ibid* para 280.

<sup>65</sup> *Ibid* para 445.

<sup>66</sup> *Ibid*.

a way that did not amount to an unfair or inequitable treatment of a foreign investor and that the provision of state aid to specific firms or industries must not be discriminatory or unreasonably harmful for the foreign investor.<sup>67</sup>

The *Saluka* award raises the question of whether simply by virtue of state obligations under international investment agreements foreign investors should be entitled to expect that the government will step in to help overcome financial difficulties without any prior assurance to this effect given by the government to the investor at the time the latter decided to invest. Particularly problematic is the tribunal's approach to determining whether a refusal to provide financial assistance to IPB was reasonably justified. The tribunal found that all four banks were in like circumstances because of their similar strategic importance and exposure to the bad debt problem stemming from inadequacies of the legal regime relating to creditors' rights.<sup>68</sup> It then rejected the respondent's justification for its refusal to provide financial assistance to IBP by reference to the fact that three of the Big Four banks were banks in which the state had a major shareholding interest, while IPB was regarded as 'a private institution whose fate was a matter for its private shareholders.'<sup>69</sup>

It transpires from the facts of the case that the decision to provide financial assistance to three of the four banks was part of the government's privatisation strategy. At the time IPB was in the process of being privatised, the government clearly stated its negative approach to financing bad loans.<sup>70</sup> The government was also careful in making no promise that its privatisation strategy would remain the same.<sup>71</sup> After IPB had been privatised and the bad debt problem worsened, the government changed its policy and provided financial support

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<sup>67</sup> Ibid para 446.

<sup>68</sup> Ibid para 322.

<sup>69</sup> Ibid para 83.

<sup>70</sup> Ibid para 324.

<sup>71</sup> Ibid.

during the course of the privatisation of the remaining banks.<sup>72</sup> The subsequent provision of state aid to other three banks was linked to the fact that the government still had large blocks of shares in those banks. Despite admitting that it was not proper to second-guess governmental privatisation policies, the tribunal held that the Czech Republic was still under an obligation not to treat investors in a discriminatory manner, including when implementing its privatisation strategies.<sup>73</sup> In the tribunal's view, it was reasonable for the investor to expect that in the event of serious financial problems the Czech Government would consider and provide financial support equally to all of the Big Four banks.<sup>74</sup> Notably, the tribunal admitted that no explicit assurance from the government was required to justify the reasonableness of such expectations.<sup>75</sup>

The tribunal's analysis of the reasons underlying the Czech government's refusal to grant state aid to IBP provides an example of an overreaching scrutiny. The tribunal did not confine itself to examining whether justification was provided for the differential treatment of the investor or whether such justification was reasonably related to the governmental decision at issue. Rather, it went further to question whether the governmental decision was rational. While some believe that such a strict scrutiny is indispensable in drawing the line between permissible and impermissible distinctions,<sup>76</sup> the better view is that tribunals should exercise reasonable self-restraint by adopting a more deferential approach. It is not argued here that tribunals should turn a blind eye to the substance of a disputed policy. The substance of a

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<sup>72</sup> Ibid para 325.

<sup>73</sup> Ibid para 337.

<sup>74</sup> Ibid para 329.

<sup>75</sup> Ibid.

<sup>76</sup> Such an argument has been advanced in the discussion of the arbitrary measures standard by V Heiskanen, 'Arbitrary and Unreasonable Measures', in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 87, 106. However, compare S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 343-7 (pointing to the perils of heightened scrutiny) and R Happ, 'Dispute Settlement under the Energy Charter Treaty' (2002) 45 *German Ybk Intl L* 331 (rejecting the substantive scrutiny approach in his discussion of the reasonable measures standard) .

policy or a decision remains relevant as long as it helps to establish extraneous motives on the part of the government, such as when the treatment of the investors is driven by considerations relating to nationality.<sup>77</sup> Yet the primary focus of an inquiry should remain on whether justification for allegedly discriminatory conduct has been offered and whether it is related to the disputed treatment. In *Saluka*, the tribunal should have analysed whether the difference in the governmental strategy at the time of the privatisation of IPB and other Big banks was driven by legitimate economic considerations. It was not for the tribunal to penalise the government for its privatisation strategy.<sup>78</sup>

#### B. Discrimination and allocation of production quotas

The award in *Eastern Sugar v Czech Republic* also turned on the justification for differential treatment.<sup>79</sup> The dispute concerned the allocation of a quota among sugar producers, and in particular, the opening of an existing cartel to newcomers.<sup>80</sup> Eastern Sugar entered the Czech sugar industry as a strategic player with a market share of 31.03% of the white sugar tonnage produced in the country, competing with two other major sugar producers.<sup>81</sup> It was the time when the Czech Republic was in the process of adapting its legislative and regulatory system to standards set forth in the Europe Agreement of 1993. As part of the transition process, successive steps were taken to adapt the Czech sugar regime to that of the European Union.

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<sup>77</sup> For instance, in *SD Myers* (n 24) paras 161-193, the tribunal had firm evidence in support of the finding that, in imposing a ban on export of PCB waste, the Canadian government was driven by an intention to protect the Canadian PCB remediation industry from foreign competitors. For discussion, see T Weiler, 'A First Look at the Interim Awards in *S.D. Myers, Inc v. Canada*: It is Possible to Balance Legitimate Environmental Concerns with Investment Protection?' (2001) 24 *Hastings Intl & Comp L Rev* 173.

<sup>78</sup> A strategy that favours granting state aid to certain industries only has recently been adopted by many governments. See section 4 below.

<sup>79</sup> *Eastern Sugar BV v Czech Republic* (n 34).

<sup>80</sup> *Ibid* para 198.

<sup>81</sup> *Ibid* para 235.

As observed by the tribunal, in the period preceding the accession it was reasonable for sugar producers to expect that the regulation of the sugar market in the Czech Republic would replicate the main features of the existing protectionist regime in the EU. To protect local beet-growers, the EU member governments maintained heavy import duties on sugar and related products, fixed minimal purchase prices for sugar beet, and made intervention purchases of sugar. Another feature of the EU sugar regime was that due to the low sugar content of beet and accordingly high cost of transportation, sugar factories would normally process sugar beet from nearby growers.

In 2000, the Czech Government adopted the First Sugar Decree which was intended to introduce a sugar regime similar to those in EU member states already operating under the EU sugar regime.<sup>82</sup> The decree provided for the allocation of a quota of domestic sugar sales based on production during the previous five years. It also ‘flexibilised’ the quota allocation by giving the state a ‘reserve quota’ which could be distributed between new entrants.<sup>83</sup> The tribunal accepted the claimant’s allegation that the reserve quota was politically established. It also characterised the opening of the cartel of sugar producers to newcomers as illogical.<sup>84</sup> Under the Second Sugar Decree, the reserve was further increased and made available to new entrants only.<sup>85</sup> The Second Sugar Decree also provided for a reduction of quota if the historical quota went unused.<sup>86</sup> The Third Sugar Decree totally abandoned the allocation of quota based on the historical production levels. Instead, the quota was set based on production levels achieved during two particular days. This caused the reduction of the quota of Eastern Sugar which had earlier closed its factory in Modrany and shifted the production to other

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<sup>82</sup> Ibid paras 245-7.

<sup>83</sup> Ibid para 260.

<sup>84</sup> Ibid para 263-5.

<sup>85</sup> Ibid para 279.

<sup>86</sup> Ibid para 278.

facilities. Eastern Sugar claimed that by adopting a new method of allocating quota the Czech government reacted to the closure of the Modrany factory.<sup>87</sup> The government for its part explained the adoption of the third Sugar Decree by the need to respond to the upheaval among the beet growers.<sup>88</sup> It asserted that the allocation of the remaining quota to a third party investor was aimed at maintaining the growers' activities in the area of Modrany factory, which had been disrupted as a result of the two successive closures of manufacturing facilities by Eastern Sugar.<sup>89</sup>

The tribunal found the Czech Republic responsible for a breach of the treaty obligation not to impair by unreasonable and discriminatory measures the operation, management, maintenance, use, enjoyment or disposal of the foreign investment.<sup>90</sup> While the First and Second Sugar Decrees did not rise to level of a breach of the BIT, the tribunal held that the Third Sugar Decree breached the treaty obligations, 'even if the intent was not to punish Eastern Sugar specifically but more generally to favour newcomers and to preserve the jobs of sugar beet growers.'<sup>91</sup> In the view of the tribunal, the Third Sugar Decree was a discriminatory and unreasonable measure in the sense of Article 3(1) of the Czech-Netherlands BIT.<sup>92</sup> This conclusion is open to criticism for a number of reasons.

Not only did the tribunal fail to examine whether Eastern Sugar and companies which had allegedly received preferential treatment through the allocation of a larger quota, were in like circumstances but it also did not adequately scrutinise whether the differentiation in question was justified by reasonable policy objectives. By dispensing with an analysis of justifications for adopting a certain method of allocating the quota under the Third Sugar

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<sup>87</sup> Ibid para 297.

<sup>88</sup> Ibid para 321.

<sup>89</sup> Ibid paras 326-328.

<sup>90</sup> Ibid para 198.

<sup>91</sup> Ibid para 338.

<sup>92</sup> Ibid.

Decree, the tribunal disregarded the responsibility of the government for protecting its beet-growers. Here, it is worth recalling the often-cited decision of the International Court of Justice in *ELSI*.<sup>93</sup> In that case, the claim of arbitrary and discriminatory measures was brought in connection with the requisition of the plant belonging to a foreign investor following the latter's decision to discontinue production and terminate commercial activities and employment contracts. Although the requisition order adopted by the Mayor of Palermo in response to the investor's decision had subsequently been found unlawful by the reviewing Italian court, the ICJ refused to regard such requisition as a measure of an arbitrary and discriminatory nature. It drew attention to the situation which existed in Palermo at the time of the requisition, in particular, to the threat of sudden unemployment of some 800 workers at one factory.<sup>94</sup> In the Court's view, it was not 'unreasonable or merely capricious for the mayor to seek to use the powers conferred on him by the law in an attempt to do something about a difficult and distressing situation.'<sup>95</sup> Unlike the ICJ in *ELSI*, the *Eastern Sugar* tribunal took little notice of the fact that the government had to deal with the unrest caused by the closure of the factory in Modrany. Instead, it preferred to characterise the Third Sugar Decree as motivated by preferential treatment of newcomers.<sup>96</sup>

The *Eastern Sugar* tribunal's approach raises the question as to how far an arbitral panel can go in its evaluation of the justification advanced by a host state for a government's disputed treatment of a foreign investor. Is it proper for a tribunal to substitute its own view of how production quotas should be allocated? Again, it would seem proper for tribunals to refrain from questioning the substance of any governmental policy. In evaluating a host state's justification for allegedly discriminatory treatment of an investor's investment,

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<sup>93</sup> *Elettronica Sicula S.P.A. (ELSI) (United States of America v. Italy)* [1989] ICJ Reports 15.

<sup>94</sup> *Ibid* para 129.

<sup>95</sup> *Ibid*.

<sup>96</sup> *Eastern Sugar* (n 34) para 337.

tribunals should confine themselves to establishing the existence of a reasonable nexus between a disputed measure and a rational policy objective. Reviewing the substance of a governmental policy transforms arbitral tribunals into courts of appeal and raises concerns over the design of the system of investor-state arbitration and its credibility. Furthermore, a strict scrutiny approach shifts the burden of a regulatory risk to host governments. Under such an approach, investment treaties, including the guarantee of non-arbitrariness and non-discrimination, transmute into the promise of a perfect business environment and the exemption from competition. Instead of encouraging investors to meticulously plan their investment and its protection through a variety of contractual and quasi-contractual techniques, a pro-investor stance in evaluating the existence of discrimination and arbitrariness promotes reliance on broad standards of investment treaties as a guarantee of commercial success.<sup>97</sup>

### *C. Foresti and others v South Africa*

The factual background in the recent ICSID case of *Foresti and others v South Africa*<sup>98</sup> offers an interesting perspective on the impact of BITs on the host state's freedom of decision-making in important socio-economic matters. In this case, a group of investors challenged the adoption by the South African government of the 2004 Mineral and Petroleum Resources Development Act, including the Black Economic Empowerment (BEE) equity divestiture requirement that was intended to encourage greater ownership of mining industry assets by historically disadvantaged South Africans.<sup>99</sup> The investors claimed that as a result of the

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<sup>97</sup> *GAMI* (n 54) para 85 (noting that NAFTA does not entitle an investor 'to act on the basis that a regulatory scheme constitutes a guarantee of economic success').

<sup>98</sup> *Foresti and others v South Africa*, Award, 3 August 2010 (ICSID Case No ARB(AF)/07/1).

<sup>99</sup> *Ibid.* For the background of the policies, see MW Chow, 'Discriminatory Equality v Non-discriminatory Inequality: The Legitimacy of South Africa's Affirmative Action Policies under International Law' (2009) 24



abovementioned policies their mineral rights had been extinguished in violation of the South African BITs with Italy and Luxembourg, including the standards of FET, expropriation and national treatment. The arbitral proceedings were subsequently discontinued by the investors prior to the tribunal's members entering into discussion of the merits of the case. Nevertheless, the case is notable for bringing to the fore a controversial question of whether a policy aimed at restoring the rights of people who have been historically disadvantaged and discriminated against should give rise to a valid claim of discrimination in investment treaty law. It has been argued, in a different context, that no liability for the host state should arise in the case where disputed conduct was intended to rectify the historical injustice.<sup>100</sup> Such objections cannot, however, outweigh legal arguments based on the provisions of international investment agreements. Here, an important role is played by the like circumstances test. If enterprises affected by the BEE policies have all been treated alike, one may be safe to conclude that no differentiation took place. No matter how important the policy by which the host state justifies its treatment of foreign investors is, arbitral tribunals may find it more convenient and less controversial to avoid the discussion of the policy justifications and instead rely on the like circumstances test. While it is important to assess the claim of discrimination holistically, i.e. by way of scrutinising the treatment of similarly situated investors *and* ascertaining whether any differentiation was plausibly related to a legitimate governmental objective, it seems that a major role will often be played by the like circumstances analysis. Clearly, in declining an investor's claim of discrimination, it would be easier for a tribunal to find that no differentiation occurred instead of establishing a

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Conn J Intl L 291.

<sup>100</sup> M Sornarajah, *The pursuit of nationalized property* (M. Nijhoff, Dordrecht 1986) 183-6. This view can draw support from the *Advisory Opinion on the Minority Schools in Albania*, whereby the PCIJ stated that '[E]quality in Law precludes discrimination of any kind, whereas equality in fact may involve the necessity of different treatment in order to obtain a result which establishes equilibrium between different situations' ([1935] PCIJ 19 (Ser A/B N64)).

differentiation and having to discuss the plausibility and legitimacy of justifications advanced by the host state.

### 3. Arbitrary and discriminatory measures: a potential for overlap and redundancy

The prohibition of discriminatory treatment is often included in investment treaties in the form of an obligation not to impair by arbitrary and discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of investments.<sup>101</sup>

In some investment treaties, the prohibition of discriminatory measures forms part of a single standard including FET and umbrella provisions.<sup>102</sup> There are also treaties which prohibit ‘unreasonable or discriminatory’ measure<sup>103</sup> or ‘unjustifiable or discriminatory’ treatment.<sup>104</sup>

Further modalities include the variation in the use of the disjunctive ‘and’ instead of ‘or.’ For instance, the 1991 US–Czechoslovakia BIT proscribes impairment by arbitrary *and* discriminatory measures.<sup>105</sup> The use of the disjunctive ‘and’ was decisive in *Lauder v Czech*

*Republic*, where the tribunal held that in order for the relevant standard to be violated the disputed conduct ought to be both arbitrary and discriminatory.<sup>106</sup> Does the diversity of

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<sup>101</sup> Treaty Between the United States of America and the Republic of Poland Concerning Business and Economic Relations (adopted 21 March 1990, entered into force 6 August 1994) (1990) S Treaty Doc No 101-18. The origin of the arbitrary and discriminatory measures clause can be traced back to post-war FCNs, from which it found its way into the Abs-Shawcross Draft, the OECD Draft Convention, and a great number of BITs. Newcombe & Paradell (n 8) 298-9.

<sup>102</sup> See, e.g., Article 2(2) of the Agreement between the United Kingdom of Great Britain and Northern Ireland and Bosnia and Herzegovina for the Promotion and Protection of Investments (signed 2 October 2002, entered into force 25 July 2003) (2003) 37 UKTS.

<sup>103</sup> See, e.g. Article 3 of the Switzerland – Uzbekistan BIT (Agreement between the Swiss Confederation and the Republic of Uzbekistan concerning the Promotion and Reciprocal Protection of Investments (adopted 16 April 1993, entered into force 5 November 1993) SR 0.975.262.1.).

<sup>104</sup> This formulation can be found in Article 2(3) of the Italy–Ecuador BIT (Agreement between the Government of the Italian Republic and the Government of the Republic of Ecuador on the Promotion and Protection of Investments (adopted 25 October 2001, entered into force 5 November 2005) G.U. 20.07.2004 n.168).

<sup>105</sup> See below n 106.

<sup>106</sup> *Lauder v Czech Republic*, Final Award, 3 September 2001 (Ad hoc—UNCITRAL Arbitration Rules) para 219 (emphasis original): ‘[T]he Arbitral Tribunal considers that a violation of Article II(2)(b) of the Treaty requires both an arbitrary *and* a discriminatory measure by the State. It first results from the plain wording of the

drafting solutions mean that there is a difference in the substantive content of non-discrimination/arbitrary measures standards? As far as the use of varying disjunctives is concerned, the difference may not be material because the arbitrary and discriminatory measures (ADM) standard is almost invariably accompanied by the FET and, in some cases, by the national treatment standard. Thus, where an allegation of discrimination has been brought under a treaty standard that prohibits arbitrary *and* discriminatory conduct, the absence of arbitrariness would not always be decisive because the fact of discrimination alone might suffice to trigger state responsibility under the national treatment and FET standards. In a similar vein, conduct that falls short of constituting discrimination but is nevertheless arbitrary can qualify as a breach of FET, thus rendering the invocation of the ADM standard and the related emphasis on the use of disjunctives unnecessary.

As regards the substantive content of the arbitrary measures standard, arbitral tribunals have widely endorsed the view expressed earlier by the ICJ in *ELSI*, defining arbitrariness as ‘something opposed to the rule of law, ... a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety.’<sup>107</sup> However, investment tribunals have also differed in their interpretations of what amounts to a wilful and shocking violation of the law. For instance, the *Occidental v Ecuador* tribunal held that a lack of clarity in the tax law was arbitrary.<sup>108</sup> In contrast, the tribunal in *Sempra v Argentina* found that a suspension of tariff adjustments, which had led to a significant modification of the

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provision, which uses the word “and” instead of the word “or”. It then results from the existence of Article II(1) of the Treaty, which sets forth the prohibition of any discriminatory treatment of investment, except in the sectors or matters expressly listed in the Annex to the Treaty. If Article II(2)(b) prohibited only arbitrary *or* discriminatory measures, it would be partially redundant to the prohibition of discriminatory measure set forth in Article II(1).’ However, compare *Azurix Corp v Argentina*, Award, 23 June 2006 (ICSID Case No ARB/01/12) para 391 (the tribunal holding that the arbitrariness of the measure was sufficient for establishing a breach).

<sup>107</sup> *ELSI* (n 93) para 128. The *ELSI* definition of arbitrary conduct was endorsed in *Pope & Talbot*, Award on Damages, 31 May 2002 (Ad hoc—UNCITRAL Arbitration Rules) (2002) 41 ILM 1347, paras 63-64, *Noble Ventures Inc v Romania*, Award, 5 October 2005 (ICSID Case No ARB/01/11) para 176.

<sup>108</sup> (n 31) para 163.

investment's regulatory regime, was unfair and inequitable but not arbitrary.<sup>109</sup> The existence of different views on what amounts to a manifest impropriety has led some tribunals to conclude that "arbitrary" should not be equated with "unjustified" and "unreasonable." According to the tribunal in *BG v Argentina*, arbitrariness should involve a breach beyond the ordinary meaning of reasonableness: a withdrawal of undertakings and assurances which induced the investor to make an investment is not arbitrary but is by definition unreasonable.<sup>110</sup> The question is whether this distinction between unreasonable and arbitrary is material or merely reflects the fact that in *BG* the applicable treaty contained no reference to arbitrariness but proscribed unreasonable measures, and the finding of the unreasonableness was enough to hold the state responsible to the investor. It would seem that, had the arbitrariness standard been the only provision that the investor could invoke, the tribunal might have been more inclined to characterise the Argentinean conduct as arbitrary. In the case before it, however, the tribunal had a choice of standards offering a variety of connotations and interpretive approaches. Indeed, although the tribunal refused to equate unreasonableness with arbitrariness, it still found Argentina responsible for a breach of FET *and* unreasonable measures.<sup>111</sup> It is therefore submitted that, despite nuances in the wording of the standards in investment treaties and the corresponding variety of connotations, the terms arbitrary, unreasonable and unjustified can be used interchangeably.<sup>112</sup> Notwithstanding the differences in wording, the form of treatment prohibited by investment treaties is that which is unjustified or justified on improper grounds.<sup>113</sup> What the formulations prohibit is a

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<sup>109</sup> *Sempra Energy International v Argentina*, Award, 18 September 2007 (ICSID Case No ARB/02/16) para 303, 318.

<sup>110</sup> *BG Group plc v Argentina*, Final Award, 24 December 2008 (Ad hoc—UNCITRAL Arbitration Rules) paras 341-343.

<sup>111</sup> *Ibid* paras 303-310.

<sup>112</sup> C Schreuer, 'Protection against Arbitrary or Discriminatory Measures' in RP Alford & CA Rogers (eds), *The Future of Investment Arbitration* (OUP, New York 2009) 183; however, compare Newcombe (n 8) 303.

<sup>113</sup> See, eg. *Lauder* (n 106) para 232, *Siemens AG v Argentina*, Award and Separate Opinion, 6 February 2007

form of decision-making that depends on individual discretion, founded on prejudice or preference rather than on reason or fact.<sup>114</sup> Instead of distinguishing between “arbitrariness” and “unreasonableness” standards, it would seem better to view the relevant clauses as providing for the same standard of treatment.

An overlap between the prohibition of arbitrary and (or) discriminatory conduct and other standards of treatment also renders unnecessary a scrupulous distinction between various versions of ADM clauses. To begin with, the prohibition of arbitrariness is already enshrined in the third prong of the discrimination test.<sup>115</sup> Furthermore, arbitrariness is contrary to FET.<sup>116</sup> Arbitral awards have also construed FET as encompassing the non-discrimination requirement.<sup>117</sup> The overlap that is evident between various treaty provisions inevitably raises the question of whether certain treaty standards are redundant.<sup>118</sup> Indeed, do we need a standalone clause on arbitrary and discriminatory measures if such measures fall within the purview of FET? The possibility of simultaneously claiming a violation of a number of largely overlapping standards has not been adequately addressed in arbitral awards. It remains far from clear whether certain standards should receive priority and whether,

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(ICSID Case No ARB/02/8) para 319.

<sup>114</sup> See *Lauder* (n 106) para 221, also *CMS Gas Transmission Company v Argentina*, Award, 12 May 2005 (ICSID Case No ARB/01/8) (2005) 44 ILM 120, para 291; *Occidental* (n 31) para 162.

<sup>115</sup> See n 54 above. See also I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 523 (pointing out that ‘action which lacks a normal public purpose is arbitrary’).

<sup>116</sup> *Saluka* (n 34) para 309 (the tribunal stating that ‘[a] foreign investor whose interests are protected under the Treaty is entitled to expect that the Czech Republic will not act in a way that is manifestly inconsistent, non-transparent, unreasonable (*i.e.* unrelated to some rational policy), or discriminatory (*i.e.* based on unjustifiable distinctions)’. See also *Petrobart Limited v Kyrgyzstan*, Award, 29 March 2005 (SCC Case No 126/2003) para 422 (refusing to rule separately on a prohibition of unreasonable and discriminatory measures and finding the latter to be subsumed in the FET standard).

<sup>117</sup> For instance, discrimination was found to be covered by FET in the following awards: *SD Myers* (n 15) para 266; *Eureko* (n 15) paras 233-234; *CMS* (n 114) paras 294-295; *Waste Management Inc v Mexico*, Award, 30 April 2004 (Case No ARB(AF)/00/3) (2004) 43 ILM 967, para 98.

<sup>118</sup> See Newcombe and Paradell (n 8) 301 suggesting that where a treaty contains FET, the arbitrary and discriminatory measures standard is superfluous. However, compare Schreuer (n 112) 192 (arguing that despite the existing overlap, arbitrary measures and FET should be treated as two conceptually different standards. It has not, however, been explained where exactly the conceptual difference lies).

despite an overlap, tribunals should consider each claim individually.<sup>119</sup>

It has been suggested that a hierarchy among various standards of treatment can be established depending on the capacity of a standard to embrace violations of other standards.<sup>120</sup> Indeed, arbitral practice provides many examples of decisions where tribunals have characterised FET as an overarching standard of treatment. For instance, in *Saluka v Czech Republic* the host government's refusal to provide state aid to the investor's bank was found to be in violation of the FET provision.<sup>121</sup> Turning to the investor's claim regarding impairment by unreasonable and discriminatory measures, the tribunal found that 'a violation of the non-impairment requirement does not therefore differ substantially from a violation of the "fair and equitable treatment" standard.'<sup>122</sup> It concluded that the host state violated an obligation of fair and equitable treatment and impaired, by unreasonable and discriminatory measures, the enjoyment of investments.<sup>123</sup> Thus, FET was construed to encompass the prohibition of unreasonable and discriminatory measures. A similar approach can be traced in a number of arbitral awards.<sup>124</sup> The *Noble Ventures* tribunal, for instance, observed that FET represents 'a more general standard which finds its specific application in *inter alia* the duty to provide full protection and security, the prohibition of arbitrary and discriminatory measures and the obligation to observe contractual obligations towards the investor.'<sup>125</sup>

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<sup>119</sup> Heiskanen (n 76) 90; also V Heiskanen, "Unreasonable and Discriminatory Measures" as a Cause of Action Under the Energy Charter Treaty' (2007) 10 (3) Intl Arbitration L Rev 104.

<sup>120</sup> Heiskanen (n 76) 93-4.

<sup>121</sup> See n 34 above.

<sup>122</sup> Ibid para 461.

<sup>123</sup> Ibid paras 271, 497-498.

<sup>124</sup> See *MTD Equity Sdn Bhd and MTD Chile SA v Chile*, Award, 25 May 2004 (ICSID Case No ARB/01/7) (2005) 44 ILM 91, para 196 (noting that to a certain extent, the prohibition of unreasonable and discriminatory measures was covered by FET); also *Petrobart* (n 116) para 422.

<sup>125</sup> Ibid para 182. It is worth mentioning that in the tribunal's view, the fact that no arbitrariness and discrimination had been found did not rule out the possibility of the general FET standard being violated. This observation can be construed as implying that FET, while overlapping with other standards, possesses its own, distinct content. However, as manifested in the tribunal's conclusion dismissing the allegation of a breach of FET, its earlier characterisation of the disputed conduct as non-arbitrary and non-discriminatory was decisive in rejecting the claim under the FET provision.

Only the *Nykomb* tribunal has chosen to consider the many claims of an investor under the single umbrella of the ECT provision on unreasonable and discriminatory measures.<sup>126</sup> The *Nykomb* arbitration arose from a contract for the purchase of surplus electric power concluded between Windau and Latvenergo. Latvenergo refused to pay Windau a double tariff for its surplus electric power, while two other enterprises, SIA Latelektro–Gulbene and LiepājasSiltums, continued receiving the double tariff. Along with claiming a breach of Article 10(1) prohibiting unreasonable and discriminatory measures, the investor contended a breach of FET and umbrella provisions.<sup>127</sup> Having upheld the investor’s claim of discrimination, the tribunal found it unnecessary to rule upon other ECT violations asserted by the investor.<sup>128</sup> The tribunal held that in order to establish liability it was sufficient to find that one of the relevant treaty provisions had been violated because the damage caused by the non-payment of the double tariff was the same.<sup>129</sup> When viewed against the circumstances of the case, the *Nykomb* tribunal’s preference for analysing most of the investor’s contentions under the ADM standard can be explained by the fact that in terms of evidential basis the existence of unreasonable and discriminatory measures was relatively easy to establish.<sup>130</sup> The tribunal did not address the relationship between the ADM and other standards of treatment.

It is submitted that the overlapping and therefore redundant standards should be replaced by an overarching treaty provision with clearly outlined parameters of illegality. Judicial economy aside, the elimination of multiple standards prohibiting essentially the same conduct is justified by the need to address the lack of clarity and consistency in arbitral

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<sup>126</sup> *Nykomb* (n 34).

<sup>127</sup> *Ibid* para 4.3.2.

<sup>128</sup> *Ibid*.

<sup>129</sup> *Ibid*.

<sup>130</sup> Heiskanen (n 76) 99.

jurisprudence. Superfluous distinctions between arbitrariness and unfairness often mask the absence of principled analysis and also provide a doubtful basis for the finding of a material breach. The multiplicity of standards also militates against the clarification of the meaning and scope of various standards of treatment.

Should FET be regarded as an overarching standard of treatment? It seems that a distinction between the labels ‘unfair and inequitable’ and ‘arbitrary and discriminatory’ is largely a matter of theory. While arbitrariness and discrimination seem to denote a narrower category of mistreatment, in reality the choice between characterising certain conduct under either label would depend on the convictions of an individual arbitrator. For example, the *Occidental v Ecuador* tribunal held that a denial of tax rebates was arbitrary, even despite the fact that the issue was complex and long contested in the domestic courts.<sup>131</sup> In contrast, the *BG v Argentina* tribunal dismissed the investor’s claim that the dismantling of a tariff regime by the government of crisis-stricken Argentina was arbitrary.<sup>132</sup> As the terms ‘arbitrariness’, ‘unreasonableness’ and ‘unfairness’ can be used interchangeably depending on the circumstances of a dispute and the beliefs of arbitrators, what matters more is not the label but the scope of the standard and the level of scrutiny it prescribes. Unless host states wish to defer the task of determining what is discriminatory, arbitrary or unfair to each individual tribunal, they should seize control over the interpretative process by introducing a more exacting formulation through the adoption of a uniform standard. As will be shown below, the availability of multiple and overlapping causes of action may potentially give rise to liability for regulatory acts in the areas which host states intended to insulate from the strictures of investment treaty protection.

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<sup>131</sup> *Occidental* (n 30) para 163.

<sup>132</sup> *BG* (n 110) para 340.



#### 4. Emergency measures, security concerns and discrimination

##### 4.1. General

The economic events of the last decade have highlighted the importance of a balanced approach to analysing both the claims of discrimination made by foreign investors and also the justifications put forward by the host states.<sup>133</sup> In response to the global financial and economic crisis, governments have adopted various measures, including regulations aimed at bolstering the stability and recovery of the financial services sector and programmes targeting strategic industries (such as the automotive manufacturing industry).<sup>134</sup> Unlike random buy-local campaigns implemented at various times in different countries, the emergency measures have been widespread among both developed and developing economies, thus raising concerns over the dangers of the renewed wave of preferential treatment accorded to local enterprises.<sup>135</sup> Similar to the Czech government's strategy in *Saluka*, many countries have not been prepared to provide assistance to foreign-owned businesses. For instance, the United Kingdom was reported to have refused assistance to LDV, a UK-based and Russian-owned van manufacturer, allegedly on the grounds that it considered that the Russian owner should provide the required support.<sup>136</sup> Likewise, the United States and China have structured their industry stimulus packages in a way that favours domestic enterprises.<sup>137</sup> In Germany, recent legislation on the stabilisation of the financial markets envisages that only financial

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<sup>133</sup> For an overview of emergency measures and their interplay with investment, see UNCTAD, *Third Report on G20 Investment Measures*, Geneva and Paris, 14 June 2010, available at <<[http://www.unctad.org/en/docs/unctad\\_oecd2010\\_en.pdf](http://www.unctad.org/en/docs/unctad_oecd2010_en.pdf)>>. See also S Ripinsky, 'Global Economic Crisis and the Danger of Protectionism: Does International Law Help?' (2009) 1 (3) Amsterdam Law Forum.

<sup>134</sup> See A Aaken and J Kurtz, 'Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law' (2009) 12 J Intl Econ L 859, 862; also K Gordon and J Pohl, 'The Response to the Global Crisis and Investment Protection: Evidence' *Columbia FDI Perspectives*, No. 25, June 17, 2010.

<sup>135</sup> See UNCTAD (n 133).

<sup>136</sup> Ripinsky (n 133).

<sup>137</sup> Aaken & Kurtz (n 134) 869-70.

institutions domiciled in Germany can benefit from the creation of a fund for the recapitalisation of financial services firms through the acquisition of toxic assets and other measures.<sup>138</sup>

A cursory overview of the emergency regulations enacted in different countries raises the question of whether ousting foreign enterprises from the financial rescue and stimulus programmes is discriminatory and should give rise to state liability under international law. Interestingly, it has been suggested that despite the fact that this new protectionism falls under the remit of the law of the World Trade Organisation and investment treaty law, it is international investment law that is more likely than any other area of international economic law to be invoked in legal action initiated by disgruntled foreign enterprises.<sup>139</sup> Not only is investment treaty law characterised by broad coverage and relatively few exceptions but also private investors are not restrained from exercising their right to initiate investor-state arbitration.<sup>140</sup>

In the present economic and political climate, would Russian-owned LDV be entitled to compensation for the discriminatory refusal by the UK government to provide the financial support LDV considers necessary for the survival of the enterprise? If the question was analysed within the broader, overarching framework of issues relating to the credibility and long-term sustainability of investment treaty arbitration, it would be inappropriate to follow the example of the *Saluka* award where the investor's success largely turned on its nationality.<sup>141</sup> One can argue that since *any* business can be disadvantaged because of

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<sup>138</sup> Ibid 864-5. For more detail, see KJ Hopt, C Kupman, F Steffek, 'Preventing Bank Insolvencies in the Financial Crisis: The German Financial Market Stabilisation Acts' (2009) 10 (4) European Bus Organization L Rev 515.

<sup>139</sup> Aaken & Kurtz (n 134) 859-61.

<sup>140</sup> Ibid 860. In this respect investors differ from members of the WTO which may refrain from instituting proceedings against a member which adopts discriminatory measures in response to a financial crisis because of the fear of retaliation (see *ibid*).

<sup>141</sup> See nn 70-78 and accompanying text.

emergency measures and other forms of economic stimulus packages, foreign investors should not be entitled to compensation for such measures simply because of their nationality. Yet the reality is that under the national treatment standard (as well as other treaty provisions on non-discrimination) a foreign investor might be entitled to receive treatment no less favourable than that accorded to national investors. Once a national enterprise obtains a financial stimulus package or other form of state aid, this gives rise to a foreign investor's right to the same treatment.

Another area of governmental decision-making prone to investor-state litigation and claims of discrimination is the admission and operation of sovereign wealth funds. SWFs are defined as 'government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves.'<sup>142</sup> A primary concern behind the SWFs is that government-led enterprises may invest for political reasons and could thus negatively affect national security, financial stability, and corporate governance.<sup>143</sup> Furthermore, many SWFs are controlled by countries that are characterised by a lack of governmental accountability. This enables such SWFs to enter into high-risk investments.<sup>144</sup> The US government opposition to the Dubai Port Deal illustrates the political controversy surrounding the foreign SWF's decision to invest. Dubai Ports World, a government-controlled enterprise,

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<sup>142</sup> Under Secretary of the Treasury for International Affairs David H. McCormick: Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. (2007) (statement of David M. McCormick, available at <<http://www.treas.gov/press/releases/hp681.htm>>). See further Sornarajah (n 48) 5-6 (suggesting that SWFs from southern economies, such as Dubai and Singapore, are likely to dictate the rules of the game as they enter the stage).

<sup>143</sup> E Langland, 'Misplaced Fears Put to Rest: Financial Crisis Reveals the True Motives of Sovereign Wealth Funds' (2009) *Tulane J Intl Comp L* 263, 269. Also, Y Feng, '“We Wouldn't Transfer Title to the Devil”: Consequences of Congressional Politicisation of Foreign Direct Investment on National Security Grounds' (2009) 42 *NYU J Intl L & Pol* 253 (noting that “there is a sense that FDI may serve as a tool for foreign governments to gain footholds in vital industries, to siphon off valuable or sensitive American technologies, or simply to provide a means for sabotage”). See further S Firth and D Juric, 'Can we afford (not) to regulate sovereign wealth funds?' (2008) 11 *JIBFL* 604; K Kalotay, 'The Political Aspect of Foreign Direct Investment: The Case of the Hungarian Oil Firm MOL' (2010) 11(1) *J World Investment & Trade* 647 (examining the acquisition of MOL by the Russian Surgutneftegaz allegedly driven by political and not financial motives).

<sup>144</sup> M Saxon, 'It's Just Business, or Is It? How Business and Politics Collide with Sovereign Wealth Funds' (2009) 32 *Hastings Intl & Comp L Rev* 693.

attempted to acquire a British company that controlled a number of United States ports. Likewise, in 2005 the China National Offshore Oil Corporation failed in its attempt to acquire the American energy company UNOCAL. The US Congress opposed the deal due to fears that the takeover would compromise a strategically sensitive area of the US economy.<sup>145</sup> While a refusal to admit a SWF investment can be justified on security grounds under national legislation,<sup>146</sup> it is possible that such a refusal would be challenged under bilateral investment treaties. In the case where a disgruntled SWF decides to initiate investor-state arbitration against a host state, national treatment, MFN and ADM provisions will provide an ample legal basis for its claims.<sup>147</sup> Both national legislation applying to SWFs and decisions adopted in relation to an individual SWF can potentially lead to host state liability under the relevant investment treaty instruments.<sup>148</sup>

#### 4.2. Preserving the host state freedom to regulate at a time of emergency: pre-emptive drafting solutions

##### A. Carve out provisions

Carve-out clauses exempting certain types of regulatory activity from the application of the national treatment standard may shield host states from liability for decision-making in certain

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<sup>145</sup> Langland (n 143) 269. Also, the German government opposed the acquisition of a holding in telecoms operator Deutsche Telekom AG by a Russian Investor and prevented a Russian-owned state bank from increasing its holding in European Aeronautic Defence & Space Company (W Ben Hamida, 'Sovereign FDI and International Investment Agreements: Questions Relating to the Qualification of Sovereign Entities and the Admission of their Investments under Investment Agreements' (2010) 9 L & Practice Intl Courts & Tribunals 17, 19 ).

<sup>146</sup> For instance, all investment in the US is subject to the Foreign Investment and National Security Act of 2007 (FINSIA). See Saxon (n 144) 701.

<sup>147</sup> Again, the national treatment standard, especially if extended to the pre-entry phase, would provide blanket protection against virtually any measure that hinders the investor's entry. See Sornarajah (n 48) 335-6. (commenting on the effect of national treatment provisions).

<sup>148</sup> M Audit, 'Is the Erecting of Barriers against Sovereign Wealth Funds Compatible with International Investment Law' (2009) 10 (4) J World Investment & Trade 617, 626.

sectors of the economy as well as in areas presenting security concerns.<sup>149</sup> As illustrated in the NAFTA decision in *ADF Group Inc v United States*, investment treaties can contain reservations rendering the national treatment and MFN requirements inapplicable in cases that involve procurement and subsidies or grants by a government or a state enterprise, including government supported loans, guarantees and insurance.<sup>150</sup> Such reservations are contained in Article 1108 (7) of the NAFTA, Article 9(5)(b) of the Canada Model BIT, and Article 14(5)(b) of the US Model BIT.<sup>151</sup> Carve-outs are designed to immunise governmental measures in certain sectors of the economy, such as banking and insurance, and limit a host state's exposure to liability for certain policies and measures, including procurement and subsidies.

In drafting the carve-out provisions it is crucial to remember that non-discrimination is subsumed under the standards of national treatment, FET and ADM. This fact seems to have been overlooked by drafters of the NAFTA (and of some BITs) which contain prudential exceptions excluding the application of the national treatment and MFN provisions only,<sup>152</sup>

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<sup>149</sup> For a comprehensive analysis of the use of reservations in contemporary investment treaty practice, see UNCTAD, *Preserving Flexibility in IIAs: The Use of Reservations* (United Nations, New York 2005). The study observes that '...many countries, independent of their level of development, feel the need to preserve certain economic activities from international obligations. This trend is more pronounced in the case of developing countries, given their need to face greater social and economic problems while also addressing new regulatory challenges with more limited resources and expertise' (ibid, 2). Importantly, while clauses containing reservations, exceptions and carve-out provisions are designed to ensure a larger pool of policy options available to the decision-makers in the host states, such clauses enhance the degree of regulatory transparency by means of indicating the areas of economic activities which are 'sensitive' due to various political and economic concerns (ibid, 13).

<sup>150</sup> In this case, a claim was brought by a Mexican investor disputing the measures requiring that steel, iron and manufactured products to be used in a highway construction project be produced in the United States. The investor contended that such requirements were in breach of, *inter alia*, the national treatment standard set forth in NAFTA Article 1102. The tribunal refused to find the measures inconsistent with NAFTA Article 1102. It observed that even assuming that the contended measures were in breach of national treatment, such measures were exempt from the scope of application of NAFTA Article 1102 due the express proviso made in NAFTA Article 1108 (7) with regard to governmental measures involving procurement, grants and subsidies (*ADF Group Inc v USA*, Award, 9 January 2003 (ICSID Case No ARB(AF)/00/1) (2003) 18 ICSID Review-FILJ 195, para 199).

<sup>151</sup> Treaty texts available at < <http://ita.law.uvic.ca/investmenttreaties.htm>>.

<sup>152</sup> See, for instance, Article IV (1) (b) of the Canada-Czech Republic BIT and Article 14 (5) of the US-Uruguay BIT.

thus leaving open the possibility of host state decisions on state aid and financial guarantees being challenged as arbitrary and discriminatory treatment and a breach of FET. Where an investment treaty contains the traditional arsenal of standards, the carve-out provisions should be formulated broadly so as to pre-empt claims of discrimination being filed under the FET and ADM standards. Once again, it is clear that through eliminating ‘the intended redundancy’, i.e. multiple and overlapping provisions, the contracting state parties will be able to stipulate exceptions in relation to certain areas of decision-making and at the same time will be able to reduce the potential for inconsistency and their exposure to liability which may otherwise result from the existence of multiple standards that cover discriminatory measures.

#### B. Security exceptions

Carve-out provisions are not as ubiquitous as the guarantee of FET and the prohibition of arbitrary and discriminatory measures. For instance, while many BITs of the United Kingdom contain the national treatment standard (in addition to the FET provision and the guarantee against unreasonable and discriminatory impairment), such provisions are not accompanied by reservations similar to those found in the US and Canada BITs.<sup>153</sup> In the absence of carve-out clauses covering the financial service sector and state subsidies, host states remain exposed to investor claims challenging the allocation of financial aid/stimulus packages between domestic and foreign-owned enterprises. Where investment treaties do not contain prudential exceptions, another provision to which the host state may resort in order to avoid responsibility for its decision-making in strategically important areas is the security exception.

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<sup>153</sup> Ibid.

This kind of exception has recently been incorporated in the UK and US model treaties. For example, the Essential Security clause in Article 18 of the US Model BIT stipulates that

Nothing in this Treaty shall be construed ...to preclude a Party from applying measures that it considers necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.<sup>154</sup>

While the interpretation of security clauses by investment tribunals has given rise to controversy and awards of vast amounts in damages,<sup>155</sup> more recent arbitral practice reveals a willingness by tribunals to accept the host state objections to investor claims disputing emergency measures. For instance, as in many cases that have dealt with a security exception in the investment treaty context, the dispute in *Continental Casualty v Argentina* arose following the adoption by the Argentinean government of the ‘Emergency Law and the Capital Control Regime’, which led to the abolition of the existing convertibility regime and the imposition of restrictions on transfers. The tribunal was faced with the question of whether the emergency measures, which had a detrimental economic impact on the investor, precluded state responsibility by falling within the scope of Article XI of the Argentina – US BIT. According to Article XI, the treaty ought not to preclude the application of measures necessary for the maintenance of public order, the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.<sup>156</sup> The tribunal analysed separately the notion of ‘public order’ and ‘essential security.’<sup>157</sup> It held that a significant economic crisis, even if not amounting to a

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<sup>154</sup> Article 18 Uruguay – US BIT (Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment (adopted 4 November 2005 entered into force 1 November 2006) (2006)S Treaty Doc No 109-9 (2006)).

<sup>155</sup> *Continental Casualty Company v Argentina*, Award, 5 September 2008 (ICSID Case No ARB/03/9).

<sup>156</sup> Ibid para 232 (referring to the text of the Treaty Between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment (adopted 14 November 1991, entered into force 20 October 1994)(1993) S Treaty Doc No 103-2).

<sup>157</sup> Ibid paras 174-180.

total collapse of the economy, should fall under the exception in Article XI due to its ramifications on the maintenance of peaceful domestic order and national security.<sup>158</sup>

However, the security exception may not provide a sufficient basis for a state defence against investor claims in relation to an allegedly protectionist allocation of state aid and a discriminatory refusal to admit certain investments. First, it is difficult to predict whether a tribunal called to decide on such a claim would adopt a similar stance to that taken in *Continental Casualty*, or whether it would prefer to follow the suite of other tribunals that had earlier ruled against the invocation of the security exception by the Argentinean government.<sup>159</sup> Second, problems may arise in justifying the emergency measures that are aimed at bolstering the recovery and stability of certain industries: it is possible to argue that, unlike measures that intend to ensure the rescue of strategically important business from a near collapse, stimulus packages do not qualify as measures necessary to maintain national security. Thus, one can argue that in contrast with the rescue of Northern Rock, the failure of which would have tangibly undermined the stability of the whole banking sector in the UK, a regulation entitling certain automotive businesses to a stimulus package could not be characterised as an emergency measure necessary to qualify for the public security and public order exception. Likewise, a host state's refusal to approve an investment by a SWF would only be narrowly covered: while emergency legislation more readily falls under a security

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<sup>158</sup> Ibid. Economic measures aside, the security exception can be invoked in relation to measures aimed at the protection of national security, including those addressing the threat of terrorist attacks. See P Muchlinski, 'Trends in International Investment Agreements: Balancing Investor Rights and the Right to Regulate. The Issue of National Security' (2008-2009) *Ybk Intl Investment L & Pol* 35.

<sup>159</sup> For instance, in *CMS v Argentina* (n 114), the security exception was analysed in conjunction with a defence of necessity in customary international law and, consequently, failed to preclude the host state's liability for emergency measures. For discussion and criticism, see D Foster, "'Necessity knows no law!' - LG&E v Argentina' (2006) 9 *Intl Arbitration L Rev* 149; A Reinisch, 'Necessity in International Investment Arbitration – An Unnecessary Split of Opinion in Recent ICSID Cases?' (2007) 8 *J World Investment & Trade* 191; JC Vinuales, 'State of Necessity and Peremptory Norms in International Investment Law' (2008) 14 *L & Business Rev Americas* 79; K Claussen, *The Casualty of Investor Protection in Times of Economic Crisis* (2009) 118 *Yale L J* 1545; J Kurtz, 'Adjudging the Exceptional at International Investment Law: Security, Public Order, and Financial Crisis' (2010) 59 *ICLQ* 325.



exception, it may be difficult to argue plausibly that the acquisition of a US energy company by a Chinese SWF presents a considerable threat to essential security interests.

Importantly, the formulation of security exceptions in BITs often detracts from their strength and capacity to serve as a defence against investor claims. The scope of exception clauses is frequently limited to certain obligations only. For instance, under Article 7 of the 2005 United Kingdom Model BIT, it is only the application of the national treatment and MFN provisions that security measures are insulated from.<sup>160</sup> The relevant part of the clause reads as follows:

The provisions of this Agreement relative to the grant of treatment not less favourable than that accorded to the nationals or companies of either Contracting Party or of any third State shall not be construed so as to preclude the adoption or enforcement by a Contracting Party of measures which are necessary to protect national security, public security or public order...<sup>161</sup>

As the wording of the exception clause suggests, even where an allegedly discriminatory regulation might qualify as a measure necessary to protect national security, public security or public order, the investor can still invoke FET or the prohibition of unreasonable and discriminatory measures, these two standards falling outside the exception clause and offering an alternative to the national treatment and MFN standards. The investor can argue that since only the national treatment and MFN standard are expressly covered by the security clause, the state should be held responsible for discrimination that is prohibited by other standards of treatment contained in the relevant investment treaty instrument. In order to shield emergency and security measures from investor claims, a more comprehensive approach calls for the formulation of the security clause in such a way that would exempt governmental measures from the application of not only the national treatment and MFN provisions but also from the

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<sup>160</sup> See the Draft Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of [Country] for the Promotion and Protection of Investments (2005, with 2006 Amendments).

<sup>161</sup> Ibid.

application of other treaty provisions that cover discriminatory treatment. Clearly, the availability of multiple but overlapping standards of treatment may have adverse implications. Advantageous though it may be from the investor's perspective, multiplicity and 'intended redundancy' is likely to increase the host state's exposure to arbitral scrutiny and liability for a wide range of governmental decisions. As the host states formerly advocating strong investment protection are increasingly facing investor claims, treaty drafters may now appreciate the need for a clearer demarcation of the line between the areas protected by investment treaty standards and those areas which fall beyond treaty protection. Eliminating overlapping causes of action through the adoption of a single standard of regulatory treatment embracing the guarantees of non-discrimination, non-arbitrariness, and due process could be a way forward. Such a standard could be complemented by additional guarantees only to the extent that these are not covered by its constitutive elements. The availability of multiple and overlapping standards is not only counterproductive but also exacerbates the lack of clarity and creates the potential for expansive interpretation of investment protection standards.

## **CHAPTER V: THE GUARANTEE OF DUE PROCESS AND THE PROHIBITION OF DENIAL OF JUSTICE**

This chapter will examine the guarantee of due process and the prohibition against denial of justice as elements of an emerging standard of state responsibility in investment treaty law. The chapter will begin with highlighting the shift from due process as a condition of lawful expropriation to due process as one of the criteria for establishing the existence of expropriation. It will then focus on the growing role of due process as a key element in establishing a breach of non-expropriatory standards of treatment, including the FET standard. The second part of this chapter will explore the investment treaty protection against denial of justice and the local remedies rule. Along with analysing the scope of judicial expropriation and its relationship with the prohibition of denial of justice, attention will be drawn to a recently emerged standard obliging a host state to ensure that investors have access to effective means of asserting claims. Arbitral practice also shows that despite its general decline, the expropriation standard can controversially be given a new lease of life in cases where procedural barriers limit the investor's ability to invoke other standards of treatment. As the return of the local remedies requirement in investment arbitration has revealed the ramifications of multiple and overlapping treaty provisions, it will be argued that a unified concept of an investment treaty breach offers a means of eliminating the peril of further fragmentation and inconsistency in interpreting core investment protections.

### **1. Due process as a condition of legality of governmental conduct**

International investment treaties frequently provide that foreign investments shall not be expropriated except where such expropriation is non-discriminatory, carried out under *due*

*process of law* and accompanied by compensation.<sup>1</sup> Due process has therefore been regarded as one of the ‘conduct requirements’ that must be satisfied for an expropriation to be lawful.<sup>2</sup> There is support for the view that a host state’s duty to ensure due process in carrying out expropriation implies the availability of judicial review so that an independent host state tribunal can assess the amount of compensation due to a foreign investor for the expropriated investment.<sup>3</sup> For instance, the 2005 Afghanistan–Germany BIT requires that the legality of expropriation, nationalisation or comparable measure and the amount of compensation ‘shall be subject to review by due process of law.’<sup>4</sup> Early US BITs also provided for an investor’s

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<sup>1</sup> See, for example, Article 6(1)(d) of the Treaty Between the Government of the United States and the Government of the Republic of Rwanda Concerning the Encouragement and Reciprocal Protection of Investment (signed on 19 February 2008); also Article 13 (1) (c) of the Energy Charter Treaty signed 17 December 1994, entered into force 16 April 1998) 2080 UNTS 100. See also the award in *Goetz v Burundi* (2000) 15 ICSID Review–FILJ 457. In this case, in a language somewhat similar to that of due process, the 1989 BIT between the Belgium–Luxembourg Economic Union and Burundi provided that measures expropriating or restricting property could be adopted only if certain conditions were satisfied, including the requirement of measures being adopted according to *legal procedures*. (Ibid, para 124). According to the tribunal, this condition implied that the international legality of the measure depended on its legality under international law (ibid, para 127). See CF Dugan and others, *Investor-State Arbitration* (OUP, Oxford 2008) 447–8. See also Chinese investment treaties which commonly include a requirement that to be a lawful an expropriation must be made in accordance with the ‘domestic legal procedure’ (N Gallagher and W Shan, *Chinese Investment Treaties: Policies and Practice* (OUP, Oxford 2009) 279).

<sup>2</sup> See P Muchlinski, *Multinational Enterprises & the Law* (OUP, Oxford 2007) 596; A Reinisch, ‘Legality of Expropriations’ in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 171; A Sheppard, ‘The Distinction between Lawful and Unlawful Expropriation’ in C Ribeiro, *Investment Arbitration and the Energy Charter Treaty* (JurisNet, Huntington NY 2006) 170; JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 322. The compliance by a host state with due process and the ensuing lawfulness of expropriation may be decisive at the remedial stage, i.e. in determination of amounts payable to a foreign investor. See *ADC Affiliate Ltd and ADC & ADMC Management Ltd v Hungary*, Final Award on Jurisdiction, Merits and Damages, 27 September 2006 (ICSID Case No ARB/03/16) paras 483–499; *Siemens AG v Argentina*, Award and Separate Opinion, 6 February 2007 (ICSID Case No ARB/02/8) paras 273, 349–352 (holding that unlawful expropriation would require restitution comprising of the value of the enterprise at of the date of expropriation plus consequential damages); Reinisch (ibid 199–203).

<sup>3</sup> UNCTAD, *Taking of Property* (United Nations, New York and Geneva 2000) 15–6, 32; A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 366.

<sup>4</sup> See Article 4(2) Afghanistan–Germany BIT (2005), also A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 192–3. See also *ADC v Hungary* (n 2) para 435, holding that ‘due process of law, in the expropriation context, demands an actual and substantive legal procedure for a foreign investor to raise its claims against the depriving actions already taken or about to be taken against it. Some basic legal mechanisms, such as reasonable advance notice, a fair hearing and an unbiased and impartial adjudicator to assess the actions in dispute, are expected to be readily available and accessible to the investor to make such legal procedure meaningful.’ For a similar view, see *Siemens v Argentina* (n 2) para 261.

right to judicial review of an act of expropriation.<sup>5</sup>

It is, however, evident that limiting due process to a *post facto* assessment of an act of expropriation becomes problematic in a situation where the host state interference with foreign investment is indirect and hence not accompanied by a formal expropriation decree. It is a distinctive feature of indirect expropriation that no provision is normally made for compensation.<sup>6</sup> In this context, confining due process to judicial review of the compensation provisions would deprive the rule of any meaningful content. It is not surprising that outside the realm of traditional expropriation the requirement of due process acquires a different meaning. There is an emerging trend whereby due process is regarded as one of the conditions for establishing the existence of an expropriation, as opposed to determining the legality of an expropriation that has already been found. As summarised in *Methanex v United States*, ‘a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process...is not deemed expropriatory and compensable.’<sup>7</sup> The requirement of due process thus becomes a part of the conduct-based determination of whether a governmental regulation amounts to an expropriation.

The reliance on the due process standard in determining the existence of expropriation is not a recent development. In *Middle East Cement Shipping and Handling Co v Egypt*, the

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<sup>5</sup> UNCTAD (n 3) 32. See, for example, Article III (2) of the 1992 United States–Bulgaria BIT:

A national or company of either Party that asserts that all or part of its investment has been expropriated shall have a right to prompt review by the appropriate judicial or administrative authorities of the other Party to determine whether any such expropriation has occurred and, if so, whether such expropriation, and any compensation therefore, conforms to the principles of international law.

<sup>6</sup> ‘The absence of an expropriatory decree, but the presence of an expropriatory consequence, defines a generic indirect expropriation.’ (WM Reisman and RD Sloane, ‘Indirect Expropriation and Its Valuation in the BIT Generation’ (2004) 74 *British Ybk Intl L* 115, 130).

<sup>7</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345, Part IV Chapter D, para7. See also J Paulsson, ‘Indirect Expropriation: Is the Right to Regulate at Risk?’ Symposium co-organised by ICSID, OECD, and UNCTAD, 12 December 2005, Paris, available at <<http://www.oecd.org/dataoecd/5/52/36055332.pdf>> accessed 21 June 2010 (the author noting that to escape liability under international law, a regulatory act must be consistent with due process).

tribunal addressed a claim of expropriation under the Greece-Egypt BIT.<sup>8</sup> The investor's business consisted of importing, storing and dispatching cement. Due to the adoption of a ministerial decree prohibiting the import of all kinds of Portland cement and the subsequent attachment and auctioning of a ship belonging to the investor, the latter was prevented from continuing its business. Along with a claim of 'de facto revocation' of its licence, the investor contended that the seizure and auction of its ship by the port authorities was illegal and constituted an expropriation.<sup>9</sup> The tribunal pointed out that while 'normally a seizure and auction ordered by the national courts do not qualify as a taking, they can be a measure the effects of which would be tantamount to expropriation if they are not taken "under due process of law."'”<sup>10</sup> The tribunal held that a matter as important as the seizure and auctioning of the ship ought to have been directly notified to the investor, and, in the absence of such notification, the procedure applied did not meet the requirements of the applicable provisions of the BIT.<sup>11</sup> It concluded that the ship was 'taken by a measure the effect of which would be tantamount to expropriation' and the investor was entitled to compensation as prescribed under relevant provisions of the BIT.<sup>12</sup>

In *Amco v Republic of Indonesia*, the determination of the state's liability to the investor was almost exclusively based on a violation of due process. The case concerned the seizure of the investor's management and a revocation of the investor's licence to operate. In considering the issue of the lawfulness of the withdrawal of Amco's licence, the tribunal addressed separately the procedural and substantive grounds for justifying the revocation

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<sup>8</sup> *Middle East Cement Shipping and Handling Co Sa v Arab Republic of Egypt*, Award, 12 April 2002 (ICSID Case No ARB/99/6) (2003) 18 ICSID Rev- FILJ 602.

<sup>9</sup> *Ibid*, paras 131-132.

<sup>10</sup> *Ibid*, para 139.

<sup>11</sup> *Ibid* para 143.

<sup>12</sup> *Ibid* para 144.

decision.<sup>13</sup> The tribunal emphasised the need to satisfy procedural prerequisites

...as set by the applicable law and which are to be in accord with the fundamental principle of due process, which are to assure to any person or entity whose rights are affected by a revocation the right to discuss the grievances alleged against him and to defend himself...<sup>14</sup>

After having analysed the applicable investment law, the tribunal concluded that in order to comply with due process, any sanction for an investor's failure to fulfill its investment obligations should have been preceded by a warning.<sup>15</sup> It held that the purpose and function of the warnings was

to give the addressee of the warnings the opportunity to remedy the failures (if any) mentioned therein; and even in cases where such remedy could not be offered or made, in fact or in law ..., to give him the opportunity to discuss the administration's grievances and to defend himself against the same.<sup>16</sup>

The tribunal found that in the case before it such warnings had not been made, thus depriving the investor of due process contrary to Indonesian law as well as general principles of law. Furthermore, the manner in which the revocation was prepared, namely the absence of a proper investigation infringed due process.<sup>17</sup> While the award was subsequently annulled, the second tribunal confirmed the finding of a due process violation in the revocation of the licence. In the tribunal's view, 'the whole approach to the issue of revocation of the licence was tainted by bad faith.'<sup>18</sup> This 'generally tainted background' constituted a denial of justice, effectively depriving Amco of its contractual rights.<sup>19</sup>

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<sup>13</sup> *Amco v Indonesia*, Award, 20 November 1984 (ICSID Case No. ARB/81/1) 1 ICSID Reports, para 192.

<sup>14</sup> *Ibid.*

<sup>15</sup> The tribunal held that such requirement was not only established in Indonesian law, but also formed part of general principles of law (*ibid* para 198).

<sup>16</sup> *Ibid* para 198.

<sup>17</sup> *Ibid* paras 199-201.

<sup>18</sup> *Amco Asia Corporation and others v. Republic of Indonesia*, Resubmitted Case, Award, 31 May 1990 (ICSID Case No. ARB/81/1) para 98.

<sup>19</sup> *Ibid* paras 174-8.

## 2. Due process as part of the fair and equitable treatment standard

With the exception of the arbitral decisions discussed above, the role of due process in the mainstream expropriation analysis remains somewhat marginal. Despite the fact that a departure from due process has featured prominently in well-known expropriation disputes, such as *Metalclad*, *Tecmed* and *Loewen*, scholars have been reluctant to acknowledge that it is not (and should not be) limited to a mere legality condition but rather can operate as a substantive conduct requirement capable of triggering a host state's liability to an investor. Unlike legal scholarship, investment treaty practice has been prompt to recognise the role of due process among substantive standards of treatment. In the 2004 US Model BIT, due process forms the core of an obligation to treat investors fairly and equitably:

“Fair and equitable treatment” includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of *due process* embodied in the principal legal systems of the world.<sup>20</sup>

It is further noteworthy that the content of a duty to ensure due process in investment treaty practice has crystallised primarily through interpretations of FET. For instance, in *Waste Management v Mexico* the tribunal held that a breach of FET could result from ‘a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process.’<sup>21</sup> The award in *Tecmed v Mexico* provides yet another clarification on the forms of conduct that might qualify as a violation of due process as part of the host state's obligation to treat investors fairly and equitably.<sup>22</sup> The investor's

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<sup>20</sup> Article 5 (2) (a) of the 2004 US Model BIT.

<sup>21</sup> *Waste Management Inc v Mexico*, Award, 30 April 2004 (Case No ARB(AF)/00/3) (2004) 43 ILM 967, para 98 (emphasis added).

<sup>22</sup> *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, Award of 29 May 2003 (ICSID Case No.ARB(AF)/00/2) (2003) 23 ILM 133.



claim concerned a refusal to renew its permit to operate a waste landfill which it argued was contrary to FET. The tribunal upheld the investor's allegation of an FET breach. It pointed to the fact that the environmental authority did not enter into any form of dialogue through which the investor would become aware of the possibility of non-renewal of its permit and also could rectify deficiencies that would later be the grounds for the environmental authority's decision to discontinue the operation of the landfill site. The investor had thus been deprived of an opportunity, prior to the resolution, to inform the environmental authority of its position or to provide an explanation with respect to such deficiencies.<sup>23</sup>

In a similar vein, notification and an opportunity to respond were at the heart of the investor's claim in *Rumeli Telekom v Kazakhstan*.<sup>24</sup> The dispute involved the termination of an investment contract, which had subsequently led to the redemption of the investor's shareholding in a telecommunications enterprise. The tribunal found several violations of due process. First, in terminating the contract on the grounds of an alleged failure to file reports, the investment committee violated an obligation to suspend a contract initially and notify the investor of the reasons for such suspension.<sup>25</sup> Second, following the termination of the contract, the Ministry of Industry and Trade appointed a Working Group, which had to examine the fulfilment by the investor of its investment obligations. The tribunal found that the Working Group confirmed the validity of the decision terminating the contract without giving the investor a real possibility to present its position. It held that the whole process leading to the decision of the Working Group lacked transparency and due process and was therefore contrary to FET.<sup>26</sup>

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<sup>23</sup> Ibid para 173.

<sup>24</sup> *Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan*, 29 July 2008 (ICSID Case No.ARB/05/16).

<sup>25</sup> Ibid para 614.

<sup>26</sup> Ibid para 616-618.

The fact that due process has been increasingly regarded as a central tenet of FET is noteworthy for two reasons. First, it highlights a growing recourse to standards other than expropriation in substantiating claims against host states. Second, it indicates a move away from effect-based analyses towards the character-based approach. Under this emerging paradigm, the host state becomes responsible not for any deprivation suffered by the investor but only for that which is caused by governmental measures in violation of conduct requirements as enshrined in substantive standards of treatment. In particular, a host state's compliance with due process becomes decisive in establishing whether its conduct is to be qualified as a permissible exercise of governmental powers or as a compensable wrong. In practical terms, the rise of due process as a yardstick in determining a state's international responsibility means that a host state obligation to pay for any deprivation is being gradually supplanted by an obligation to pay for a deprivation that is caused by conduct in violation of due process. The changing role of due process reinforces the idea that investment treaties are not designed to exempt investors from the risk of regulatory change but rather aim to protect them from measures that violate basic international guarantees.

### 3. Due process, denial of justice and state responsibility under investment treaty standards

Desirable as it is, the emphasis on due process and the shift from expropriation to non-expropriatory standards of treatment is not sufficient to address the existing imbalance between the protection of investment and regulatory freedom. Much controversy and inconsistency flows from the proliferation of various non-expropriatory standards of treatment which an investor can invoke in its case against a host state. Consider, for instance, a classic example of an investor being mistreated in a host state's courts. Here, a host state's obligation

not to deny justice is subsumed in the principle of due process under the FET standard.<sup>27</sup> In addition, a denial of justice may amount to an expropriation.<sup>28</sup> As observed by the Iran-US Claims tribunal in *Oil Field of Texas v Iran*, ‘it is well established in international law that the decision of a court depriving an owner of the use and benefit of its property may amount to an expropriation of such property that is attributable to the state of that court.’<sup>29</sup> Finally, as shown in recent investment treaty practice and arbitral decisions, a denial of justice can be challenged under the heading of arbitrary measures as well as a failure ‘to provide effective means of asserting claims.’<sup>30</sup>

The fact that denial of justice falls within the range of several investment treaty provisions can be explained by the broad scope of denial of justice in international law. Early legal discourse in this area reveals the split between an all-encompassing definition, equating denial of justice with the general notion of an international wrong,<sup>31</sup> and a restrictive definition, limiting denial of justice to incidences of refusal of access to courts.<sup>32</sup> The

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<sup>27</sup> Article 5 (2) (a) of the 2004 US Model BIT, see also Article 11.5 (2) of the 2007 Korea-US FTA, available at <[http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file587\\_12710.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file587_12710.pdf)>.

<sup>28</sup> Early international decisions in *Robert E. Brown* and *Martini* illustrate an overlap between denial of justice and expropriation. See *Robert E. Brown (United States v Great Britain)* (1923) 6 RIAA 120; *Martini Case (Italy v Venezuela)* (1930) 2 RIAA 974.

<sup>29</sup> *Oil Field of Texas Inc v Iran* (1986) 12 Iran-USCTR 308, 318-19 para 42, citing the French-Italian Conciliation Commission decision No 136 of 25 June 1952 (concerning a dispute over Italian property in Tunisia).

<sup>30</sup> See below section 5.2.

<sup>31</sup> C Eagleton, ‘Denial of Justice in International Law’ (1928) 22 AJIL 538, 539; C Hyde, *International Law Chiefly as Interpreted and Applied by the United States* (Little, Brown, & Co, Boston 1922) 491-2; A Adede, ‘A Fresh Look at the Meaning of the Denial of Justice under International Law’ (1976) 73 Canadian Ybk Intl L 73, 82; OJ Lissitzyn, ‘The Meaning of the Term Denial of Justice in International Law’ (1936) 30 AJIL 632, 636-8. See also the opinion of the Commissioner Nielsen in the *Neer Case*, suggesting that it was ‘useful and proper to apply the term denial of justice in a broader sense than that of a designation solely of a wrongful act on the part of the judicial branch of the government.’ (*LFH Neer & Pauline v United Mexican States* (1926) 4 RIAA 60, 64). Also, *Robert E. Brown* (n 28). For criticism, see *The Chattin Claim (United States v Mexico)* (1927) 4 RIAA 282, 286; also G Fitzmaurice, ‘The Meaning of the Term “Denial of Justice”’ (1932) 13 British Ybk Intl L 93, 95 (noting that ‘[t]he main objection to this definition of denial of justice is that it converts the term into a species of synonym for international delinquency, or, more accurately, for injuries to foreigners for which a state is, according to the rules of international law, responsible, and thus renders it largely meaningless and unnecessary; whereas, if used in a more restricted sense, the term has a definite value as describing a particular species of international wrong’).

<sup>32</sup> G Guerrero, Annex to Questionnaire N.4, Committee of Experts for the Progressive Codification of International Law, Report of the Sub-Committee, League of Nations Pub. C 196, M. 70, 1927 V., reproduced in

contemporary view of denial of justice occupies a middle ground: it goes beyond a refusal of access to courts and includes manifestly unjust decisions and governmental interference with the administration of justice through acts of legislature or the executive.<sup>33</sup> For example, in *Petrobart v Kyrgyzstan* an investor was deprived of a chance to enforce a judgement against its debtor, KGM, due to the last minute interference in the court proceedings by the Prime Minister who requested that the court stay the execution of the judgement.<sup>34</sup> Subsequent to the stay of execution, all the oil-related assets of KGM were transferred to another state enterprise. KGM was left with debts and no assets against which the creditors could enforce their claims.<sup>35</sup> The tribunal found that the intervention by the government in the court proceedings and the stay of execution constituted a denial of justice contrary to customary international law and the obligation of fair and equitable treatment under Article 10 (1) of the Energy Charter Treaty.<sup>36</sup> A denial of justice through legislative acts was addressed in *AMTO v Ukraine*.<sup>37</sup> An investor claimed that several legislative acts adopted during the bankruptcy proceedings influenced the court judgment and thus constituted a denial of justice.<sup>38</sup> After having examined the timing, purpose and the substantive content of the disputed legislative acts, the tribunal concluded that no denial of justice had taken place.<sup>39</sup> Although no denial of justice had been found, the decision suggests that denial of justice can occur through acts of legislature and the executive.

Since a denial of justice may result from acts of the judiciary as well as those of the

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A Freeman, *The International Responsibility of States for Denial of Justice* (Longmans & Co., London 1938) 632. The narrow approach to defining denial of justice was espoused by the Spanish Government in the *Barcelona Traction Co Case* (1962-9) 4 ICJ Pleadings 463. See also I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 508-9.

<sup>33</sup> See generally J Paulsson, *Denial of Justice in International Law* (CUP, Cambridge 2005).

<sup>34</sup> *Petrobart Limited v Kyrgyzstan*, Award, 29 March 2005 (SCC Case No 126/2003).

<sup>35</sup> Ibid para 120.

<sup>36</sup> Ibid para 131.

<sup>37</sup> *AMTO LLC v Ukraine*, Final Award, 26 March 2008 (SCC Case No 080/2005).

<sup>38</sup> Ibid para 90.

<sup>39</sup> Ibid para 94.

legislative and executive organs, it is clear that the boundaries of denial of justice as a distinct international wrong are defined not by the manner in which the host state denies justice but by the fact of its misconduct at some stage in the process of administering justice. In other words, as long as the disputed conduct takes place in the course of the administration of justice, it may serve as the basis of a denial of justice claim. It is therefore obvious that the inherent breadth of denial of justice, coupled with the availability of various standards of treatment under investment treaties, gives rise to the possibility of invoking multiple causes of action challenging the same conduct. This multiplicity can, however, be problematic. As will be discussed below, the possibility of presenting a denial of justice claim under different standards of treatment may be exploited in circumventing procedural barriers, such as the consent to arbitration and the local remedies requirement. Thus, a host state may be exposed to liability in a situation where it would otherwise be protected against investor claims by a narrowly worded consent and by subjecting investor claims to the exhaustion requirement. The following sections will critically examine the arbitral decisions involving denial of justice claims successfully disguised as either a judicial expropriation or as a failure to provide an effective means of asserting claims. The discussion will highlight the need for bringing multiple and overlapping standards of treatment under a single standard which would set out generally applicable conditions of state responsibility toward foreign investors.

#### 4. Denial of justice and the local remedies rule

##### 4.1 General

One of the areas where the relationship between denial of justice and investment treaty

standards gives rise to controversy is the application of the local remedies rule. Historically, both a denial of justice and the exhaustion of local remedies rule shared their origins in the ancient practice of private reprisals. While the latter practice gradually evolved into the institution of diplomatic protection of citizens abroad,<sup>40</sup> the exhaustion of local remedies rule developed into a principle of customary international law and a condition precedent to bringing an international claim against a state.<sup>41</sup> In *Interhandel*, which involved an alleged expropriation of foreign-owned assets, the International Court of Justice held:

The rule that local remedies must be exhausted before international proceedings may be instituted is a well-established rule of customary international law; the rule has been generally observed in cases in which a State has adopted the cause of its national whose rights are claimed to have been disregarded in another State in violation of international law. Before resort may be had to an international court in such a situation, it has been considered necessary that the State where the violation occurred should have an opportunity to redress it by its own means, within the framework of its own domestic legal system.<sup>42</sup>

While the exhaustion of local remedies remains a general rule of customary international law, its application can be excluded by the operation of the principles of consent and good faith.<sup>43</sup>

The latter has an exclusionary effect in cases where the circumstances justify the invocation of the doctrine of estoppel. In turn, the principle of consent precludes the application of the local remedies rule in a case where an agreement contains an express waiver.<sup>44</sup> The foremost

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<sup>40</sup> H Spiegel, 'Origin and Development of Denial of Justice' (1938) 3 AJIL 63.

<sup>41</sup> See further CF Amerasinghe, *Local Remedies in International Law* (2<sup>nd</sup> edn CUP, New York 2004). The rule is expressly provided for in Article 35 of the European Convention on Human Rights (Convention for the Protection of Human Rights and Fundamental Freedoms (opened for signature 4 November 1950) 213 UNTS 221).

<sup>42</sup> *Interhandel Case* [1959] ICJ Reports 6, 27. In *Interhandel*, a dispute arose from the confiscation by the US government of shares belonging to the Societe Internationale pour participations Industrielles at Commerciales (Interhandel, a Swiss company) in the General Aniline and Film Corporation. The confiscation was undertaken pursuant to the Trading with the Enemy Act during the Second World War, on the ground that an enemy-controlled company had owned the shares. Subsequently, an agreement (the Washington Accord) was reached between the governments of the United States and Switzerland according to which Swiss assets in the US were to be released.

<sup>43</sup> Amerasinghe (n 41) 247.

<sup>44</sup> *Ibid.* The prospects of precluding the application of the local remedies rule by an implied waiver are distant, though such possibility cannot be ruled out altogether. In *ELSI*, the United States questioned whether the

example is Article 26 of the ICSID Convention which provides that:

Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy. A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention.<sup>45</sup>

The exhaustion of local remedies can be waived by a bilateral or multilateral agreement whereby investors are allowed to bring their grievances directly against a host state.<sup>46</sup> The recent proliferation of BITs has shown that by and large the exhaustion of local remedies has become an exception.<sup>47</sup> Freed from the burden of having to exhaust domestic means of redress, investors have readily seized the opportunity to claim against host states.<sup>48</sup> However, the emerging tide was turned by a decision of the NAFTA tribunal in *Loewen v United States*, which held that notwithstanding a waiver in the applicable treaty, the local remedies rule ought to be satisfied in a case where the investor claimed a denial of justice.<sup>49</sup>

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exhaustion of local remedies should apply at all to a case brought under the FCN Treaty, which provided for the submission of disputes to an international adjudication and contained no reference to the local remedies rule. The ICJ Chamber admitted that the parties to a treaty can either agree that the local remedies rule shall not apply to claims based on alleged breaches of that treaty, or confirm that it shall apply. However, the Chamber was not prepared to acknowledge an implied waiver. It found itself '[u]nable to accept that an important principle of customary international law should be held to have been tacitly dispensed with, in the absence of any words making clear an intention to do so.' (*Elettronica Sicula S.P.A. (ELSI) (United States of America v. Italy)* (1989) ICJ Rep, para 50). The rigidity of the ICJ ruling in *ELSI* may explain a subsequent tendency to dispense with the local remedies requirement in bilateral investment treaties concluded in the post-1980s. See S Subedi, *International Investment Law: Reconciling Policy and Principle* (Hart Publishing, Oxford 2008) 149-50.

<sup>45</sup> The Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (signed 18 March 1965, opened for signature 14 October 1966) 575 UNTS 159.

<sup>46</sup> P Peters, 'Exhaustion of Local Remedies: Ignored in Most Bilateral Investment Treaties' (1997) 44 *Netherlands Intl L Rev* 233. According to this study, among some 200 BITs concluded during the 1980s, only three required exhaustion of local remedies before arbitration of a dispute could be initiated. Other BITs limited the application of local remedies by setting the time limit within which the resolution of a dispute by local means should be undertaken, such period varying from 3 to 24 months. (Ibid 234). An analysis of the 409 BITs signed in the 1990s showed that 20 agreements specifically excluded the rule of local remedies, 345 implicitly renounced it, while the other 145 BITs referred to the possibility, not an obligation, of bringing a dispute before domestic tribunals. For an argument that the recourse to local remedies may not serve the best interests of foreign investors see R Dolzer, C Schreuer, *Principles of International Investment Law* (OUP, Oxford 2008) 214-6, also C Schreuer, 'Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration' (2005) 4 *L & Practice Intl Courts & Tribunals* 1.

<sup>47</sup> Ibid.

<sup>48</sup> Peters' study shows that the application of local remedies has become more of an exception than a rule (ibid).

<sup>49</sup> *Loewen v United States*, Award, 26 June 2003 (ICSID Case No ARB(AF)/98/3) (2003) 42 ILM 811.

#### 4.2. *Loewen v United States*: reinstating the local remedies rule

In *Loewen*, the dispute arose from a private litigation in the Mississippi court instigated against a Canadian investor by its local competitor, the owner of a funeral home business, Jeremy O'Keefe. The trial is noted for the judge's failure to prevent xenophobic and racist comments by O'Keefe's counsel, and the jury verdict against Loewen in the amount of US\$ 500 million.<sup>50</sup> Subsequently, Loewen was prevented from appeal by the state's 'supersedeas bond' requirement according to which a stay of execution on assets pending recourse to higher courts was available only subject to the posting of a bond as security for payment of the judgment, in the amount of 125 percent of the verdict appealed. Since O'Keefe threatened to seize the assets immediately and Loewen could not raise the necessary sum, the claim was settled by the payment of US\$ 170 million. In its claims brought before an investment tribunal, Loewen claimed that the trial amounted to a denial of justice, breach of FET, and expropriation.<sup>51</sup> The United States, for its part, contended that state responsibility for a judicial act would arise only when there was a final action by the state's judicial system as a whole. This argument was predicated on the notion that a judicial decision is a single action and that the state should not be deemed to have spoken until all appeals have been exhausted.<sup>52</sup> According to the United States' submission, the 'substantive requirement of customary international law for a final non-appealable judicial action' was different from the 'procedural' rule of local remedies.<sup>53</sup>

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<sup>50</sup> Ibid para 113. The dispute involved three contracts valued at \$980,000 and an exchange of two funeral homes worth approximately \$2.5 million for the Loewen funeral insurance company valued at approximately \$4 million.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid para 143.

<sup>53</sup> Ibid. As Article 1101 NAFTA refers to measures 'adopted or maintained by a Party,' the respondent argued that 'only those judicial decisions that have been accepted or upheld by the judicial system as a whole, after all available appeals have been exhausted, so the argument runs, can be said to possess that degree of finality that



The tribunal favoured the respondent's position. It held that the purpose of the rule of judicial finality was to 'afford the State the opportunity of redressing through its legal system the inchoate breach of international law occasioned by the lower court decision.'<sup>54</sup> Although Article 1121 NAFTA envisaged a waiver of domestic proceedings as a condition of bringing a claim before an investor-state tribunal, in the tribunal's view the purpose of such provision was not 'altogether clear' and it contained 'nothing expressly about the requirement that, in the context of a judicial violation of international law, the judicial process be continued to the highest level.'<sup>55</sup> The tribunal concluded that the waiver of the duty to exhaust local remedies was not applicable in cases where a breach of international law was allegedly caused by *a judicial act*.<sup>56</sup>

As the reasoning of the *Loewen* tribunal suggests, the application of the local remedies rule as a rule of judicial finality rests on three interrelated assumptions: (1) denial of justice is a breach of the state's obligation to provide a *system* of justice; (2) the rule of local remedies is a substantive element of the delict of denial of justice; and (3) the rule of finality of judicial action is an essential element of the sovereign right of the state to administer justice by its own means. It is submitted below that none of these arguments furnishes a sufficient basis for reinstating the local remedies rule in investment arbitration.

#### 4.3. Denial of justice as a breach of the 'obligations of result'

It has been argued that the *Loewen* tribunal correctly applied international law when it found

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justifies the description "adopted or maintained" (ibid para 144).

<sup>54</sup> Ibid para 156.

<sup>55</sup> Ibid para 161.

<sup>56</sup> Ibid para 164. It has been observed that, in spite of having distinguished between the rule of local remedies and the rule of judicial finality, the tribunal has on several occasions referred to the exhaustion of local remedies in addressing *Loewen's* failure to appeal. BK Gathright, 'A Step in the Wrong Direction: The *Loewen* Finality Requirement and the Local Remedies Rule in NAFTA Chapter Eleven' (2005) 54 Emory L J 1093, 1105.

that a waiver of local remedies in Article 1121 NAFTA was inapplicable to claims arising from judicial misconduct.<sup>57</sup> This view draws support from earlier writings according to which ‘an essential condition of a State being held responsible for a judicial decision in breach of municipal law is that the decision must be a decision of a court of last resort, all remedies having been exhausted.’<sup>58</sup> It also relies on the Second Report on State Responsibility to the International Law Commission holding that ‘an aberrant decision by an official lower in the hierarchy, which is capable of being reconsidered, does not of itself amount to an unlawful act.’<sup>59</sup> The main justification for the application of the local remedies rule in denial of justice cases lies in the *nature* of the delict of denial of justice:

...the obligation which the State owes the foreign national in this context (whether under general international law or under the specific provisions of a treaty like NAFTA or a bilateral investment treaty) is to provide a system of justice which affords fair, equitable and non-discriminatory treatment. So long as the system itself provides a sufficient guarantee of such treatment, the State will not be in violation of its international obligations merely because a trial court gives a defective decision which can be corrected on appeal.<sup>60</sup>

Thus, the distinct nature of a denial of justice, in contrast with other international wrongs, flows from the state’s obligation to create and maintain a *system* of justice.<sup>61</sup> International law, it has been argued, does not require a state to ensure justice at every step of the judicial process.<sup>62</sup> While a waiver of local remedies remains effective in respect of other breaches by a state of its international obligations,

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<sup>57</sup> Paulsson (n 33) 104.

<sup>58</sup> J Arechaga, ‘International law in the past third of a century’ (1978) 159 *Recueil des Cours de l’Académie de Droit International* 1, 282.

<sup>59</sup> ILC, ‘Second Report on State Responsibility’ (3 May–23 July 1999) UN Doc A/CN.4/498, 34. See also Freeman commenting that the ‘responsibility [of a State] is engaged as the result of a definitive judicial decision by a court of last resort which violates an international obligation of the State’ (above (n 47) 311-2); see also R Jennings and A Watts (eds) *Oppenheim’s International Law* (9<sup>th</sup> edn Longman, Harrow 1992) 543-4.

<sup>60</sup> C Greenwood, ‘State Responsibility for the Decisions of National Courts’ in M Fitzmaurice and D Sarooshi (eds) *Issues of State Responsibility before International Judicial Institutions* (Hart Publishing, Oxford 2004) 61.

<sup>61</sup> Paulsson (n 33) 7, 27-30.

<sup>62</sup> *Ibid* 7.

...in the particular case of denial of justice, however, claims will not succeed unless the victim has indeed exhausted municipal remedies, or unless there is an explicit waiver of a type yet to be invented. ... This is neither a paradox nor an aberration, for it is in the very nature of the delict that a state is judged by the final product or at least a sufficiently final product – of its administration of justice. A denial of justice is not consummated by the decision of a court of first instance. Having sought to rely on national justice, the foreigner cannot complain that its operations have been delictual until he has given it scope to operate, including by the agency of its ordinary corrective functions.<sup>63</sup>

The understanding of the local remedies rule as a substantive element of the delict of denial of justice is heavily influenced by a theory that draws a distinction between ‘obligations of conduct’ and ‘obligations of result.’ As explained in an earlier ILC Report on State Responsibility, an obligation of result presupposes some form of finality of action:

When the conduct of the State has created a situation not in conformity with the result required of it by an international obligation, but the obligation allows that this or an equivalent result may nevertheless be achieved by subsequent conduct of the State, there is a breach of the obligation only if the State also fails by its subsequent conduct to achieve the result required of it by that obligation.<sup>64</sup>

In practical terms, looking at a denial of justice through the lens of an obligation of result means that no breach occurs until the state has failed to take any of the opportunities available to it to produce the required result.<sup>65</sup> Where the state is under a duty to provide a fair and efficient system of justice, a wrongful decision by an inferior court would not violate that obligation if redress was available in a higher court.

It is submitted that the distinction between obligations of conduct and obligations of

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<sup>63</sup> Paulsson (n 33) 108.

<sup>64</sup> Article 20 dealt with the obligations of conduct. Under the rubric “Breach of an international obligation requiring the adoption of a particular course of conduct”, it provided that ‘There is a breach by a State of an international obligation requiring it to adopt a particular course of conduct when the conduct of that State is not in conformity with that required of it by that obligation.’ ILC, ‘Report on the work of the twenty-ninth session’ (9 May – 29 July 1977) UN Doc A/32/10, 11-9. See also ILC, Second Report on State Responsibility (n 59) 23-36.

<sup>65</sup> Greenwood (n 60) 67, fn 28. For critical comment, see Arechaga (n 58) discussing the ILC Report 1977. The local remedies rule, argued Arechaga, should be applied ‘in all cases where the original violation affecting an alien may be corrected by a higher national authority, having jurisdiction over the original act, this subsequent action securing, for the alien concerned, a recognition of the right he sought to exercise, even if the international obligation is one of conduct and not one of result’ (ibid 296).

result does not provide a convincing basis for transforming the local remedies rule into the requirement of judicial finality. The distinction fails because under international investment treaties a host state's duties can be readily classified as both obligations of conduct and those of result. For instance, an obligation to provide fair and equitable treatment can be classified as an obligation of conduct because it requires the state to refrain from unfair treatment of foreign investors (i.e. not to withdraw a licence without prior notice, not to cancel a permit on improper grounds etc). In a similar fashion, however, the FET standard can be characterised as an obligation of result, calling for host state conduct that *ultimately* achieves a fair and equitable result. Thus, where an allegedly wrongful act is committed by a host state's administrative authorities, it can plausibly be argued that the FET standard is an obligation of result under which the state is required to ensure a fair and efficient *system of administration* as opposed to ensuring fairness at each stage of the administrative process. If FET were to be construed as an obligation of result, the unjustified cancellation of a permit would not constitute a breach; rather, the investor would need to show that the whole system of administration has failed. Interpreting the host state duty not to deny justice as an obligation of result inevitably raises the question as to whether a rule of administrative or legislative finality exists.<sup>66</sup> Once the rule of finality is extended to administrative and judicial acts, a waiver of local remedies in the applicable treaty instruments becomes ineffective in its entirety. Whilst relying on the notion of an obligation of result, the proponents of the judicial finality rule do not explain why only judicial conduct requires the finality of action.

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<sup>66</sup> In support of the judicial finality rule, reference has been made to the observation by ILC Rapporteur (Professor Crawford) that 'there are also cases where the obligation is to have a system of a certain kind, e.g., the obligation to provide a fair and efficient system of justice. There, systemic considerations enter into the question of breach, and an aberrant decision by an official lower in hierarchy, which is capable of being reconsidered, does not of itself amount to an unlawful act.' See ILC Report (n 59) para 75; also Greenwood (n 60) 67. However, it is worth mentioning that ultimately the Rapporteur suggested that the distinction between obligations of conduct and obligations of result should be abandoned (ibid paras 88-92). Before reaching this conclusion, Professor Crawford noted that not all obligations can be classified as obligations of conduct or of result (ibid para 80).

#### 4.4. Denial of justice arising from a breach of the ‘obligations of conduct’

It is interesting to note that in a different context the distinction between obligations of conduct and obligations of result has been invoked in support of the proposition that the local remedies rule does *not* apply in the case of a denial of justice resulting from a state’s refusal to arbitrate. In contrast with the theory of judicial finality and its reliance on the concept of an obligation of result, it has been argued that denial of justice may result from the breach of an obligation of conduct. According to this argument, the state’s obligation to arbitrate disputes with a foreigner *must* be classified as an obligation of conduct as the state has bound itself to act in a certain way.<sup>67</sup> Therefore, once it has committed itself to submitting disputes to arbitration, the state cannot subsequently contend that justice would be provided in another way.<sup>68</sup> The obligation to arbitrate, construed as an obligation of conduct, would impose on the state a duty to provide for specifically agreed means of adjudication. If a host state refuses or otherwise fails to honour its commitment to arbitrate disputes, a denial of justice occurs.<sup>69</sup> One cannot help noticing the fundamental disparity between this interpretation of a denial of justice and that endorsed in the *Loewen* award. Why should a commitment to arbitrate disputes be enforced as an obligation of conduct and give rise to a denial of justice without the prior exhaustion of local remedies, if a general commitment not to deny justice is construed as an obligation of result and is subject to the exhaustion rule? If a denial of justice can, as a matter of principle, arise from a breach of the obligation of conduct (such as an obligation to arbitrate disputes), one is left to ponder why in all other cases denial of justice is deemed to be classified as being based on the obligation of result and subject to the exhaustion of local

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<sup>67</sup> S Schwebel, *International Arbitration: Three Salient Problems* (Grotius, Cambridge 1987) 116.

<sup>68</sup> *Ibid.*

<sup>69</sup> See above n 67.

remedies.

Notably, it was a proponent of the judicial finality rule (and an advocate of the view that an obligation not to deny justice is an obligation of result) who found Indonesia responsible for a denial of justice resulting from a breach of the agreement to arbitrate. In *Himpurna v Indonesia*,<sup>70</sup> a dispute arose from the government's refusal to acknowledge a guarantee of performance by PLN, a national electricity company, of its obligations under a power supply contract with a foreign investor. Following the initiation of international arbitration by the foreign investor, Indonesian authorities secured an order from the District Court of Jakarta enjoining parties from taking part in any arbitral proceedings in relation to the dispute. After the arbitral tribunal decided to change the place of arbitration and continue the proceedings in the Hague, Indonesia sought an injunction from the District Court of the Hague and intercepted its own appointee in order to prevent him from taking part in the arbitral hearings. The tribunal found that it was 'a denial of justice by the courts of a State to prevent a foreign party from pursuing its remedies before a forum to the authority of which the State consented, and on the availability of which the foreigner relied in making investments explicitly envisaged by that State.'<sup>71</sup> *Himpurna* is a classic example of a refusal to arbitrate disputes, which arguably amounts to a breach of an obligation of conduct and justifies the finding of a denial of justice. The award demonstrates that a denial of justice is not always a breach of the obligation of result, and that the host state duty to refrain from denial of justice can be (and has been) construed flexibly as both an obligation of conduct and also that of result.

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<sup>70</sup> *Himpurna v Indonesia*, Interim award of 26 September 1999 and final award of 16 October 1999 (2000) XXV ICCA Ybk Commercial Arbitration 109. See Paulsson (n 33) 149-54. However, compare *Waste Management* (n 21) paras 120-123. See also Dugan and others (n 1) 528-9 (noting that some authorities also recognise state responsibility for a breach of arbitration agreement, without, however, having recourse to the language of fair and equitable treatment or denial of justice).

<sup>71</sup> *Himpurna* (n 70) para 184.

#### 4.5. Judicial finality and the rules of attribution

The conceptual validity of the judicial finality rule is further undermined by an ultimately unpersuasive deployment of the rules of attribution. Principles of state responsibility in international law draw a distinction between primary and secondary wrongs. For instance, an injury may be caused to a foreigner by a governmental act which is imputable to the state, such as when a foreigner incurs loss as a consequence of a direct and uncompensated confiscation of its property. For state responsibility to arise, the foreigner would customarily need to exhaust local remedies, unless the applicable treaty contains an express waiver. In a similar vein, the local remedies rule should apply in a case where the injury originates from a judicial act, such as where a foreigner is convicted without a trial, or a manifestly wrong judgment is rendered against a foreigner in private litigation.<sup>72</sup> In both examples, the rule of local remedies operates as a procedural prerequisite that must be satisfied before a claim of state responsibility is brought in international law.

However, the original injury to a foreigner can also be the result of the private conduct of a person or legal entity. In this case, in accordance with the rules of attribution, the state cannot be held responsible unless the foreigner, in its attempt to obtain redress for its injury caused by a private actor, has been denied justice in the municipal courts. For example, the investor may suffer an injury caused by its competitor, the owner of a private business. Such an injury cannot be attributed to the state unless state organs become involved. For example, if the national courts fail to redress the injury suffered by the investor, the host state becomes implicated because of acts or omissions of its judiciary. The denial of justice, and

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<sup>72</sup> See Fitzmaurice (n 31) who decades ago persuasively argued that denial of justice was not limited to the failure to redress an original wrong, rather, denial of justice could be found in the original injury caused to a foreigner. (Fitzmaurice (n 46)105-9).

not the original private wrong, is imputable to the host state and can lead to the latter's responsibility in international law. In this context, resort to local avenues of redress is necessitated by the need to satisfy the rules of attribution: since the original private wrong cannot be attributed to the host state, it is the subsequent failure of the domestic courts that would form the basis for state responsibility.<sup>73</sup>

It is important to draw a line between cases where the original injury is caused by a private party and those where the original wrongdoer is a host state court. This confusion lies at the heart of the judicial finality thesis which insists on the exceptional application of the local remedies requirement in denial of justice cases. The proponents of judicial finality argue that where an original wrong is committed by a private actor, and until the foreigner attempts to secure redress in a local court, 'there is nothing which could form the substance of an international claim ...because there is nothing which is imputable to the respondent State.'<sup>74</sup> This argument, however, erroneously equates the actions of a court of first instance with those of a private party. Where a judge has committed a wrong, that wrong is attributable to the state and, therefore, the application of the otherwise waived local remedies requirement cannot be justified by the need to satisfy the rules of attribution. It is well recognised that the courts are instruments of the state for the purposes of international responsibility.<sup>75</sup> The proponents of the judicial finality rule fail to advance a convincing explanation for the refusal

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<sup>73</sup> See ILC, 'Second report on diplomatic protection by Mr. John Dugard, Special Rapporteur' (23 April-1 June and 2 July-18 August 2001) UN Doc A/CN.4/514; U Kriebaum, 'Local Remedies and the Standards For the Protection of Foreign Investment' in C Binder and others (eds) *International Investment Law for the 21<sup>st</sup> Century: Essays in Honour of Christoph Schreuer* (OUP, Oxford 2009) 421.

<sup>74</sup> Greenwood (n 60) 60.

<sup>75</sup> See Article 4 (1) of Draft Articles on Responsibility of States for Internationally Wrongful Acts:

The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organization of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State.

(ILC, 'Report on the work of its fifty-third session' (23 April - 1 June and 2 July - 10 August 2001) UN Doc A/56/10, 40).



to recognise that a denial of justice committed by a lower court constitutes an international wrong imputable to the host state.<sup>76</sup> By equating lower courts with private actors, the rule of judicial finality runs contrary to the principles of state responsibility in international law.<sup>77</sup>

#### 4.6. Denial of justice, local remedies and respect for sovereignty argument

‘Respect for sovereignty’ is often invoked in justifying an exceptional application of the local remedies rule to judicial misconduct. It has been argued that if a foreigner is allowed to bypass local avenues of redress and bring an international claim for denial of justice allegedly caused by a lower court judgment, international law ‘would find itself intruding intolerably into internal affairs of the host state.’<sup>78</sup> The respect for sovereignty argument echoes in the *Loewen* tribunal’s reasoning that the main purpose of the finality requirement is to ‘afford the State the opportunity of redressing through its legal system the inchoate breach of international law occasioned by the lower court decision.’<sup>79</sup>

It is submitted that considerations relating to the respect for sovereignty do not offer a convincing justification for the judicial finality rule. First, respect for sovereignty does not mean that tribunals can render ineffective the arrangements agreed between contracting states under bilateral and multilateral investment treaties. If the states agreed to waive local remedies, the respect for sovereignty would command tribunals to refrain from creating exceptions in a case where arbitrators are reluctant to find against the respondent state (such as in *Loewen*). Second, if finality of action is required out of respect for sovereignty, the

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<sup>76</sup> See Gathright (n 56 ) 1127; D Wallace Jr, ‘State Responsibility for Denial of Substantive and Procedural Justice Under NAFTA Chapter Eleven’ (2000) 23 Hastings Intl & Comp L Rev 393, 397. Among earlier authorities, Freeman acknowledged that a judgment of an inferior court may be in breach of international law. (Freeman (n 32) 445).

<sup>77</sup> See above n 75.

<sup>78</sup> Paulsson (n 33)108.

<sup>79</sup> *Loewen* (n 49) para 156.

question arises as to whether the same degree of deference should be accorded to the acts of administrative or legislative organs of the host state.<sup>80</sup> It has been correctly observed that ‘it is difficult to distinguish the desirability of requiring a decision of the highest body within a court system from requiring a final decision from the highest official in an administrative system.’<sup>81</sup> If respect for sovereignty were to justify the rule of judicial finality, similar considerations would inevitably extend to the conduct of administrative and legislative organs, justifying the adoption of a general rule of ‘finality of action’. Consequently, any waivers of local remedies would be overridden.

The principal problem with the sovereignty rationale is that it fails to explain a distinction between decisions of lower courts, which are subject to the stringent rule of local remedies and exempt from any express waivers thereof, and administrative decisions, which in most cases give rise to state responsibility without any need to exhaust local remedies. For instance, despite acknowledging the tension stemming from the differentiation between judicial and administrative acts, it has been argued that

...the requirement to exhaust remedies within the judicial system is not inconsistent with the fact that investors are not required to exhaust administrative appeal mechanisms to bring an IIA claim. The reason is that there is a fundamental difference in the type of claim being made. The basis for a claim of denial of justice is that the

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<sup>80</sup> According to the *Loewen* tribunal, ‘[i]t would be very strange if a State were to be confronted with liability for a breach of international law committed by its magistrate or low-ranking judicial officer when domestic avenues of appeal are not pursued, let alone exhausted. If Article 1121 were to have that effect, it would encourage resort to NAFTA tribunals rather than resort to the appellate courts and review processes of the host State, an outcome which would seem surprising, having regard to the sophisticated legal systems of the NAFTA Parties.’ (*Loewen* (n 49) para 162). Commenting on this finding, Wallace correctly observed that such “sophisticated legal systems” are also available for non-judicial breaches. (Wallace (n 76) 399). However, compare V Been and J Beauvais, ‘The Global Fifth Amendment? The NAFTA’s Investment Protections and the Misguided Quest for an International “Regulatory Takings” Doctrine’ (2003) 78 NYU L Rev 30, 83; A Afilalo, ‘Towards a Common Law of International Investment: How NAFTA Chapter 11 Panels Should Solve Their Legitimacy Crisis’ (2004) 17 Geo Intl Env’tl L Rev 51 (expressing concerns over the possibility of arbitral review of national court decisions).

<sup>81</sup> A K Bjorklund, ‘Reconciling State Sovereignty and Investor Protection in Denial of Justice Claims’ (2005) 45 Virginia J Intl L 809, 858 (observing that ‘when the *Loewen* tribunal opined that only a final act of a judicial system may give rise to a NAFTA claim, the logical extension of that concept to requiring “appeals” within different hierarchical structures may lead to claims by states party to NAFTA that eviscerate any waiver of the local remedies rule.’)

judicial system has failed to provide justice. Special considerations apply to judicial systems in terms of international minimum standards of procedural due process.<sup>82</sup>

This argument inevitably raises the question about the ‘special considerations’ that allegedly set judicial acts apart from other acts. It is true that ‘a judicial system is specifically designed to allow for review and the correction of due process errors.’<sup>83</sup> But the availability of the judicial system, with its corrective function, also holds true for administrative acts: just as a denial of a licence by a municipality can be corrected through judicial review proceedings, so too can a lower court judgment be overturned through an appeal process. The possibility of rectification usually exists in relation to most categories of decisionmaking. Yet the judicial finality rule tends to insulate only judicial conduct from an international review. Not only does the special treatment of judicial conduct lack the support of investment treaty instruments or principles of state responsibility in international law<sup>84</sup>, but it also cannot plausibly be rationalised: administrative and legislative acts can have consequences that are equally as important as those of as judicial acts. Desirable though it may be from the international policy perspective to erect a barrier preventing international claims against national courts, such considerations should not be read into investment treaty texts, especially where the latter include express waivers.

##### 5. After *Loewen*: the local remedies rule and fragmentation

Significantly, the local remedies requirement, reinstated as a rule of judicial finality, has not been uniformly adopted in investment disputes that have involved allegations of treaty

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<sup>82</sup> Newcombe & Paradell (n 3) 244.

<sup>83</sup> Ibid.

<sup>84</sup> C McLachlan, L Shore and M Weiniger, *International Investment Arbitration: Substantive Principles* (OUP, Oxford 2007)232 (‘since the State has a single legal personality at international law, there would seem to be no reason in principle to distinguish between decisions of inferior courts, and decisions of administrative officials’).

breaches in the exercise of judicial power. While some tribunals<sup>85</sup> have endorsed the *Loewen* approach, others have chosen to allow the investor's case to proceed without insisting on the exhaustion of local remedies, even despite the fact that the relevant cases have concerned an alleged breach of the host state's treaty obligations in the course of administration of justice.<sup>86</sup> In the latter category, particularly prominent are decisions where a dispensation with the exhaustion requirement was the result of bringing a disputed conduct under the rubric of 'a judicial expropriation' and 'a failure to provide effective means of asserting claims.'<sup>87</sup> The discussion below will focus on alternative causes of action, which have so far enabled investors to circumvent the exhaustion requirement in obtaining redress for losses caused in the course of the administration of justice by host state organs. It will be shown that a tactical resurrection of the otherwise declining standard of expropriation and the proliferation of new standards for challenging the judicial acts of national courts is at odds with the objective of creating a balanced, credible and sustainable system of investment protection.

### 5.1. Judicial expropriation

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<sup>85</sup> See for example, *Waste Management* (n 21) para 97 ('where the minimum standards of international law in question in a particular case are raised in respect of a claim of judicial action—that is, a denial of justice—what matters is the *system* of justice'). In more recent practice, the *Loewen* approach was endorsed in *Toto Costruzioni Generali SpA v Lebanon*, Decision on Jurisdiction, 8 September 2009 (ICSID Case No ARB/07/12) paras 156-168 ('a state can only be held liable for denial of justice when it has not remedied this denial domestically'); and in *Pantechniki SA Contractors and Engineers v Albania*, Award, 28 July 2009 (ICSID Case No ARB/07/21) para 94 ('denial of justice does not arise until a reasonable opportunity to correct aberrant judicial conduct has been given to the system as a whole'). It was found to be necessary to resort to domestic courts in a number of non-denial of justice disputes (cases involving expropriation and breach of contract claims). See, for example, *Generation Ukraine*, where the tribunal held that '... the failure to seek redress from national authorities disqualifies the international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable – not necessarily exhaustive – effort by the investor to obtain correction' (*Generation Ukraine, Inc v Ukraine*, Award, 15 September 2003 (ICSID Case No ARB/00/9) (2005) 44 ILM 404, para 20.30). A similar approach was endorsed in *EnCana Corporation v the Republic of Ecuador* (2006) 45 ILM 655, para 184; *Parkerings-Compagniet AS v Lithuania*, Award on Jurisdiction and Merits, 14 August 2007 (ICSID Case No ARB/05/8) para 448; *Helnan International Hotels AS v Egypt*, Award, 7 June 2008 (ICSID Case No ARB/05/19) para 148; *EDF (Services) Ltd v Romania*, Award, 2 October 2009 (ICSID Case No RB/05/13) para 313.

<sup>86</sup> See section 5.1. below.

<sup>87</sup> See section 5.2. below.

In *Saipem v Bangladesh*, the dispute concerned an interference by the Bangladeshi courts with arbitral proceeding that the investor had instituted before an ICC panel in pursuit of its contractual rights.<sup>88</sup> The investor contended that the judicial intervention in the contractual arbitration constituted an uncompensated expropriation. However, Bangladesh objected to the ICSID tribunal's jurisdiction. It invoked the decision in *Loewen* and contended that where a court decision formed the basis of an investor's claim, the local remedies rule ought to be applied as a substantive prerequisite regardless of whether the claim was characterised as a denial of justice or as an expropriation.<sup>89</sup> The tribunal had to decide whether the rule of local remedies, viewed as a substantive condition in cases involving a denial of justice, should also be regarded as a substantive condition in a case of expropriation resulting from actions of the judiciary.<sup>90</sup>

While endorsing the view that denial of justice called for the finality of judicial action,<sup>91</sup> the tribunal held that an expropriation resulting from the actions of the state's judiciary did not necessarily amount to a denial of justice and, therefore, the exhaustion of local remedies was not required.<sup>92</sup> It thus distinguished between a denial of justice and a judicial expropriation. As the tribunal did not dwell on the reasons underlying this distinction, one is left to speculate as to whether labelling a denial of justice as 'a judicial expropriation' served the sole purpose of justifying the inapplicability of the local remedies rule in the case before the tribunal. While affirming the rule of judicial finality, *Saipem* has controversially opened the door to the possibility of avoiding the application of the local remedies rule by presenting a denial of justice claim as one of expropriation. It has undermined the central

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<sup>88</sup> *Saipem v Bangladesh*, Award 20 June 2009 (ICSID Case No ARB/05/7).

<sup>89</sup> Ibid para 178.

<sup>90</sup> Ibid para 176.

<sup>91</sup> Ibid para 176.

<sup>92</sup> Ibid para 181.

tenet of the judicial finality rule: indeed, if the exhaustion of local remedies in denial of justice claims is explained by a special nature of the judicial activity, does the labelling of a judicial act as an expropriation change the nature of the underlying wrong? If the host state is obliged to provide a fair and efficient system of justice, the same principle should arguably be extended to all forms of misconduct by the judiciary.<sup>93</sup> Regrettably, *Saipem* sets an example of the creative use of causes of action in circumventing the local remedies requirement.<sup>94</sup>

## 5.2. Failure to provide effective means of asserting claims and enforcing rights

Expropriation has not been the only investment treaty standard which disgruntled investors have invoked in an attempt to obtain redress for judicial misconduct without having to exhaust local remedies. Another recent contender is an obligation ‘to provide effective means of asserting claims and enforcing rights with respect to investment, investment agreements, and investment authorisations’ (hereinafter, the effective means standard).<sup>95</sup> This standard can be found in a number of the US BITs and the Energy Charter Treaty. The scope of the effective means clause and its relationship with denial of justice was recently addressed in *Chevron v Ecuador*.<sup>96</sup> A dispute broke out following the investor’s failure to obtain redress in seven breach-of-contract cases brought in the Ecuadorian courts against the Ecuadorian government. After failing to obtain redress in all these cases, the investor contended that an

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<sup>93</sup> Newcombe and L Paradell (n 3) 301, 314 (suggesting that the exceptional application of the local remedies rule should extend to *any* breach of treaty by judicial organs, including a violation of the standard of full protection and security and of the arbitrary and non-discriminatory conduct clause. The authors did not, however, elaborate on the distinction between a denial of justice and other wrongs committed by the judiciary).

<sup>94</sup> Besides, as shown in *Saipem* (above n 88) the disguising technique could be used to circumvent other barriers, such as the limited consent to arbitration.

<sup>95</sup> See, e.g. Article II (7) of the Treaty Between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal Protection of Investment (adopted 27 August 1993, entered into force 11 May 1997)S Treaty Doc No 103-15; also Article 10 (12) of the Energy Charter Treaty (see above n 1).

<sup>96</sup> *Chevron Corporation and Texaco Petroleum Corporation v Ecuador*, Partial Award on Merits, 30 March 2010 (Ad hoc—UNCITRAL Arbitration Rules).

unreasonable delay in deciding on the investor's contractual claims and a wrongful dismissal of some of its cases constituted a violation of Ecuador's obligations under the BIT, including the obligation to provide effective means of asserting claims.<sup>97</sup>

In addressing the investor's claim brought under the effective means standard, the tribunal observed that the relevant provision overlaps significantly with the prohibition of denial of justice under customary international law.<sup>98</sup> However, since the wording of the effective means standard in the BIT did not explicitly refer to denial of justice, the tribunal held that the standard ought to be construed not as a mere restatement of a customary guarantee against denial of justice but rather as *lex specialis*.<sup>99</sup> In the tribunal's view, if the effective means standard were to be construed as expressing an obligation not to deny justice, the treaty would need to contain an explicit formulation to that effect.<sup>100</sup> The tribunal referred to a commentary on the US BITs, which explained that the standard was envisaged as an independent treaty provision in order to address the lack of clarity on the right of access to courts in customary international law.<sup>101</sup> It therefore concluded that an obligation to provide effective means for asserting claims represented a distinct and 'potentially less demanding' standard as compared with denial of justice under customary international law.<sup>102</sup>

In determining the substantive content of the standard, the tribunal found that 'effective means of asserting claims' encompassed a guarantee against indefinite or undue delay.<sup>103</sup> So far as the investor's cases in the Ecuadorian courts were concerned, at the time the investment arbitration was initiated, the litigation in all seven claims had been pending for

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<sup>97</sup> Ibid paras 206-207.

<sup>98</sup> Ibid para 242.

<sup>99</sup> Ibid.

<sup>100</sup> Ibid.

<sup>101</sup> Ibid para 243.

<sup>102</sup> Ibid para 244.

<sup>103</sup> Ibid para 250.

more than thirteen years. In the tribunal's view, neither the complexity of the cases (which involved what the tribunal referred to as straightforward contractual disputes), nor the claimant's conduct could justify such a significant delay.<sup>104</sup> In all but one of the claims the evidentiary phase had been closed by mid-1997 and the Ecuadorian courts had had more than nine years before rendering a first instance judgment in each case.<sup>105</sup> The tribunal concluded that the nature of the delay and the apparent unwillingness of the Ecuadorian courts to allow the cases to proceed constituted a failure to provide effective means in accordance with Article II(7) of the BIT.<sup>106</sup>

In relation to the local remedies rule, the investor contended that it had exhausted local remedies and that in any event the exhaustion rule was inapplicable. The *Saipem* award was invoked in support of the argument that a treaty violation other than a denial justice would not require the exhaustion of local remedies.<sup>107</sup> The tribunal agreed with the investor. It held that the exhaustion of local remedies, while being mandatory in denial of justice claims, was not required in establishing a breach of other BIT standards.<sup>108</sup> It is interesting that, having found the claim under the effective means standard to be exempt from the exhaustion requirement, the tribunal then held that establishing a violation of the effective means standard was subject to a "qualified" application of the local remedies rule. In the tribunal's view, the investor was under a duty to 'have adequately utilized the means made available to them to assert claims and enforce rights.'<sup>109</sup> The exhaustion of local remedies was relevant only to the extent that

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<sup>104</sup> Ibid para 254.

<sup>105</sup> Ibid para 256.

<sup>106</sup> Ibid para 275. Since the undue delay rose to the level of a breach of the effective means standard, the tribunal held that it was unnecessary to consider denial of justice claims, including the allegation of manifestly unjust decisions which the Ecuadorian courts rendered against TexPet after the commencement of arbitration.

<sup>107</sup> Ibid para 278, citing *Saipem v Bangladesh*, Award 20 June 2009 (ICSID Case No ARB/05/7). For a critical comment on the *Saipem* award, see M Sattorova, 'Judicial Expropriation or Denial of Justice? *Saipem v Bangladesh*: A Note (2010) 13 International Arbitration Law Review 35.

<sup>108</sup> Ibid para 321.

<sup>109</sup> Ibid para 268.



would enable the tribunal to determine whether the Ecuadorian legal system had provided the investor with effective means to recover the damage caused by the alleged breaches of concession agreements.<sup>110</sup> The tribunal refrained from examining the claimant's futility of remedies argument based on the alleged lack of independence of Ecuador's judiciary, but instead addressed whether the remedies, which Ecuador argued to have been available, were effective. It concluded that the remedies pointed out by Ecuador, including monetary and disciplinary actions and recusals, 'did not rise to the level where their exhaustion would be required under the standard of Article II (7).'<sup>111</sup>

At first glance, the *Chevron* award can be regarded as just another arbitral decision supporting the judicial finality rule. Indeed, as noted earlier, the tribunal did not dispute that local remedies ought to be exhausted as a condition precedent to a denial of justice claim.<sup>112</sup> However, the award begs the question of whether the systemic considerations underlying the finality rule would command the need to exhaust remedies not only in denial of justice claims but also in all cases involving judicial acts. If the state is under a duty to provide a fair and efficient system of justice, then *any* wrong committed in the course of the administration of justice should be subject to correction through recourse to existing avenues of appeal. The *Chevron* tribunal failed to offer a convincing explanation of the differentiation between a failure to provide effective means of asserting claims and a denial of justice. On the contrary, in its analysis of whether an unreasonable delay by the Ecuadorian courts amounted to a violation of the effective means standard, the tribunal expressly referred to the customary law standard of denial of justice.<sup>113</sup> Furthermore, the tribunal's analysis of the availability and

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<sup>110</sup> Ibid para 327.

<sup>111</sup> Ibid para 331.

<sup>112</sup> Ibid para 321 ('the Tribunal is amply satisfied that a requirement of exhaustion of local remedies applies generally to claims for denial of justice').

<sup>113</sup> See for instance para 250: 'As with denial of justice under customary international law, some of the factors

effectiveness of local remedies did not differ from what should have otherwise been analysed as part of the determination of a denial of justice.<sup>114</sup> Despite being construed as a standard distinct from a guarantee against denial of justice, the effective means clause in *Chevron* was applied on the basis of the same principles that usually govern the finding of a denial of justice. If establishing a violation of the effective means standard involves the application of the same principles and norms that govern establishing a denial of justice, both in terms of substance and procedure, doubts arise as to whether the two grounds of state responsibility are materially different. In *Chevron*, the disputed conduct (labelled as a failure to provide effective means of asserting claims) was committed by judicial organs, fell within the definition of denial of justice in international law, and was subject to the same procedural and substantive analysis which is usually carried out in determining the existence of a denial of justice. It is therefore difficult to see how, in the circumstances of the dispute, a breach of the effective means standard was different from a denial of justice.<sup>115</sup> The tribunal's preference for the effective means standard as the basis of Ecuador's liability for the acts of its judiciary is more readily explained as an attempt to avoid the local remedies rule. By accepting the

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that may be considered are the complexity of the case, the behaviour of the litigants involved, the significance of the interests at stake in the case, and the behavior of the courts themselves' (emphasis added).

<sup>114</sup> See *ibid* paras 328-331 (the tribunal resorting to the customary international law principles on effective remedies).

<sup>115</sup> Unlike *Chevron*, the tribunal in *Duke Energy Electroquil Partners and Electroquil SA v Ecuador*, Award, 12 August 2008 (ICSID Case No ARB/04/19) looked at the substance of the dispute and refrained from drawing a superficial distinction between a denial of justice and a breach of the effective means clause. The dispute arose in connection with a power purchase agreement concluded between Electroquil, of which the investor was a shareholder, and INECEL, a state-owned entity responsible for the generation, distribution and transmission of energy. The investor contended that Ecuador failed to provide effective means of asserting claims. According to the investor, a failure by the local arbitral tribunal to exercise jurisdiction over Electroquil's claim and the government's opposition to arbitration contrary to its earlier commitment amounted to a violation of the effective means standard. The tribunal noted that Article II(7) guaranteed the access to courts and the existence of relevant institutional mechanisms. Hence, it 'formed part of the more general guarantee against denial of justice' (*ibid* para 391). In examining whether the fact that the government had objected to the jurisdiction of the local tribunal amounted to a denial of justice, the tribunal highlighted the fact that Electroquil had not challenged the final decision of the local arbitral tribunal before the courts of Ecuador. As a result, the Ecuadorian legal system 'never came into play to rule on the award' (*ibid* para 398). The tribunal dismissed the claim of denial of justice due to the investor's failure to show that no adequate and effective remedies existed.

investor's claim under the effective means standard, the tribunal found the host state liable without having to distinguish the *Loewen* ruling on judicial finality. Just as was the case with *Saipem*, the *Chevron* award encourages the doubtful practice of obtaining redress for denial of justice by disguising the latter as a different cause of action.

### 5.3. The effective means standard: beyond denial of justice

The wording of the effective means standard suggests that it may encompass not only the judicial process but also legislation. The latter dimension was prominent in the interpretation given to the standard by the tribunal in *AMTO v Ukraine*.<sup>116</sup> AMTO's claim was brought before an ECT tribunal by virtue of its shareholding in EYUM-10, an entity which was engaged in supplying services to a nuclear power plant called ZAES. At the time of arbitration, ZAES was a separate division of the National Nuclear Power Generating Company 'Energoatom'. When the investor purchased its shares in EYUM-10, Energoatom was its largest debtor. At the heart of the investor's claims were unsuccessful attempts by EYUM-10 to recover its debts in eleven cases of contractual non-payment and the subsequent bankruptcy proceedings instituted against Energoatom. The investor contended that there was a denial of justice resulting from (1) proceedings in Ukrainian courts, (2) Ukrainian bankruptcy legislation, and (3) state interference in the bankruptcy proceedings. Along with contending that there had been a denial of justice, the investor claimed that Ukraine had failed to 'ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights.'<sup>117</sup>

The tribunal observed that in order to determine the existence of a denial of justice, the

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<sup>116</sup> *AMTO v Ukraine* (n 37).

<sup>117</sup> *Ibid* paras 75, 85.

treatment of an investor by national courts should be examined in its entirety.<sup>118</sup> In addressing the allegations of a denial of justice in connection with judicial proceedings in Ukrainian courts, the tribunal noted that EYUM-10 had been successful in its claims for contractual non-performance and that irregularities in the bankruptcy proceedings were remediable. While noting that EYUM-10's experience of Ukrainian bankruptcy proceedings might have been frustrating, the tribunal concluded that the investor failed to prove 'any legal error, abuse, undue delay or interference in the process by the Ukrainian courts.'<sup>119</sup> No denial of justice by the Ukrainian courts was established as the tribunal observed that the investor's submissions demonstrated 'unrealistic expectations of a simple and rapid result, in a judicial structure where there were many other interests and competing rights to be considered.'<sup>120</sup>

After dismissing the investor's allegation of denial of justice, the tribunal proceeded with an analysis of the claims under the effective means provision in Article 10(12) which the investor invoked in support of its contention that the bankruptcy legislation in the Ukraine was clearly inadequate and 'did not live up to the standard required by international law.'<sup>121</sup> The investor identified various specific shortcomings in the bankruptcy legislation, such as the absence of remedies in the case where a debtor was protected by a moratorium. The tribunal held that the 'effective means' provision in Article 10(12) implied a qualitative standard: legislation ought to be not only constitutional and accessible but also effective.<sup>122</sup> It acknowledged the difficulty of identifying criteria by reference to which the effectiveness of the legislation could be assessed. Taking into consideration the object and purpose of the

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<sup>118</sup> Ibid para 78. See also para 76 ('The investor that fails to exercise his rights within a legal system, or exercises its rights unwisely, cannot pass his own responsibility for the outcome to the administration of justice, and from there to the host State in international law').

<sup>119</sup> Ibid para 84.

<sup>120</sup> Ibid.

<sup>121</sup> Ibid para 85.

<sup>122</sup> Ibid para 87.

ECT, the tribunal suggested that “effectiveness” under Article 10(12) implied a systematic, comparative, progressive and practical standard:

[The standard] is systematic in that the State must provide an effective framework or system for the enforcement of rights, but does not offer guarantees in individual cases. Individual failures might be evidence of systematic inadequacies, but are not themselves a breach of Article 10(12). It is comparative in that compliance with international standards indicates that imperfection in the law might result from the complexities of the subject matter rather than inadequacies of the legislation. It is progressive in the sense that legislation ages and needs to be modernized and adapted from time to time, and results might not be immediate. Where a State is taking the appropriate steps to identify and address deficiencies in its legislation – in other words improvement in progress – then the progress should be recognized in assessing effectiveness. Finally, it is a practical standard in that some areas of law, or the application of legislation in certain circumstances, raise particular difficulties which should not be ignored in assessing effectiveness.<sup>123</sup>

In examining the investor’s allegations against the above criteria, the tribunal observed that the Ukrainian bankruptcy law was modern and introduced new concepts. The tribunal found it unsurprising that the application of the law to an enterprise of strategic importance in the energy sector caused certain problems.<sup>124</sup> Despite the fact that EYUM-10 had encountered difficulties in collecting its debts from Energoatom, the tribunal was not persuaded that the bankruptcy legislation did not provide an effective means to enforce creditors’ rights in the Ukraine.<sup>125</sup> Neither had the investor succeeded in showing that the legislation in issue otherwise constituted a denial of justice.<sup>126</sup>

The *AMTO* award is notable for adding another dimension to the effective means standard of Article 10(12) ECT. As it is evident from the investor’s claim and its analysis by the tribunal, the effective means standard is not limited to the obligation to provide a fair and efficient system of justice. Indeed, the reading of the pertinent provision suggests that the

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<sup>123</sup> Ibid para 88.

<sup>124</sup> Ibid para 89.

<sup>125</sup> Ibid.

<sup>126</sup> Ibid.

state is obligated to ensure effectiveness of not only the judicial system but also of the legislation, which is necessary for the assertion of claims and the enforcement of rights by foreign investors. The question is whether the need to assess the relevant legislation as a part of the legal system, by analogy with the prevailing views on denial of justice, should imply a mandatory application of the local remedies rule as a substantive element of the delict. If denial of justice requires that the whole system be tried (and failed), then a failure to provide an effective means of asserting claims might be construed as necessitating the same measure of remedial finality in respect of legislative conduct. The *AMTO* tribunal highlighted that the effective means standard 'is systematic in that the State must provide an effective framework or system for the enforcement of rights.'<sup>127</sup> Should this mean that in order to challenge the efficacy of a certain regulation or law the whole framework of remedies should be exhausted? If the rationale behind the judicial finality rule is to be extended to the effective means standard, one could argue that a successful claim under Article 10(12) ECT would necessitate the exhaustion of all available remedies, including, where applicable, an attempt to challenge the inefficiency of certain legislative provisions before a constitutional court of the host state. The 'systematic' nature of a host state's obligation under the effective means standard once again brings to the fore problematic aspects of the judicial finality rule which has yet to provide a convincing explanation for exempting administrative and legislative decision-making from the exhaustion of local remedies requirement.

#### 5.4. Labelling as a means of avoiding the local remedies?

The foregoing discussion has exposed the ramifications of multiple and overlapping standards of treatment being included in investment treaty texts. The *Chevron* and *Saipem* awards

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<sup>127</sup> See above n 157.

enable investors to obtain redress for a denial of justice without having to comply with the rule of judicial finality. Investors are simply encouraged to disguise their claims by invoking an investment treaty standard other than the denial of justice guarantee. The effective means standard and judicial expropriation are not the only causes of action which an investor can rely upon in its attempt to avoid the application of the local remedies requirement and other procedural barriers. In accordance with some of the US BITs, claims under the arbitrary and discriminatory measures clause are also exempt from the local remedies requirement.<sup>128</sup> This provision was deployed in the *Chevron* claim but was not discussed by the tribunal. While it is only logical that, in order to avoid the need to satisfy the cumbersome exhaustion rule, investors would prefer to present their cases as anything but a denial of justice, the willingness on the part of tribunals to accept such tactics of cherry-picking is questionable at best. The exercise in a ‘skillful labelling’ undermines the principal justification for the rule of judicial finality, which explains the mandatory exhaustion of local remedies by reference to the special nature of judicial activity and the host state’s duty to provide a fair and efficient system of justice – as opposed to ensuring justice at every stage of the judicial process. As argued earlier, if the exercise of judicial power were to be subject to special treatment in international law, the rule of finality would need to be extended to all forms of judicial action.

Contradictory interpretations of the effective means standard betray the existing indeterminacy about the role of investment arbitration and the relationship between international tribunals and national courts. Indeed, it remains unclear whether investor-state arbitration ought to function as an alternative to national courts or as a subsidiary mechanism

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<sup>128</sup> For example, Article II (3) (b) of the US-Ecuador BIT provides that ‘[a] measure may be arbitrary or discriminatory notwithstanding the fact that a party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party.’

of dispute resolution.<sup>129</sup> The reinstatement by the *Loewen* tribunal of the local remedies rule in relation to claims involving judicial acts was nothing but an attempt to draw the line between investor-state arbitration and adjudication by host state courts. As explained by the NAFTA tribunal in *Loewen*,

Far from fulfilling the purposes of NAFTA, an intervention on our part would compromise them by obscuring the crucial separation between the international obligations of the State under NAFTA, of which the fair treatment of foreign investors in the judicial sphere is but one aspect, and the much broader domestic responsibilities of every nation towards litigants of whatever origin who appear before its national courts.<sup>130</sup>

However, as the rule of judicial finality failed to command uniform acceptance among arbitral tribunals, attempts to circumvent the local remedies requirement have only exacerbated the lack of consistency in arbitral practice. As evidenced by the *Chevron* award, the investor-state dispute settlement system continues to function as an alternative to domestic courts, however at the expense of conceptual clarity, certainty and predictability. The judicial finality exception to the local remedies rule was created in *Loewen* only to be departed from in *Chevron* and *Saipem*. In all three cases, the treatment of the investors by the host state courts indeed justified an international review. However, the fact that the exhaustion of local remedies was found necessary to stop a claim against the US but dispensed with to allow claims against Ecuador and Bangladesh raises the question of whether the rule ought to be so flagrantly moulded to suit the personal convictions of party-appointed arbitrators. Hence, there is a need for redefining, in clear terms, the scope of the local remedies rule and its applicability to various categories of investment disputes. Since arbitral practice exhibits strong disagreement and a varying measure of support for the exhaustion rule, the task of

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<sup>129</sup> Kriebaum (n 73) 426 (distinguishing between the ICSID arbitration as an alternative to domestic adjudication, and the dispute resolution bodies in the international law of human rights which operate as a subsidiary mechanism ). See also McLachlan, Shore and Weiniger (n 84) 128 (stating that ‘one of the purposes of investment arbitration is to provide a neutral forum for dispute resolution of investor-State disputes’).

<sup>130</sup> (n 49) para 242.



redefining the role of local remedies in investment arbitration is better deferred to state parties. For its part, the ICSID Convention allows states to make their consent to arbitration subject to the exhaustion of local remedies.<sup>131</sup> States must decide if claims arising from the administration of justice, legislative acts, and executive conduct should be subject to the local remedies rule. Until such clarification is introduced, tribunals should enforce existing waivers of local remedies and refrain from creating special categories of international wrong for the sole purpose of granting investor claims.

The proliferation of alternative causes of action in recent arbitral practice—which investors have exploited to circumvent various procedural constraints—also raises a question about the redundancy of certain treaty provisions. Indeed, violations of investor rights arising in the course of the administration of justice can be brought under FET (which incorporates a guarantee against denial of justice), the prohibition of arbitrary and discriminatory measures, expropriation, and the effective means standard. Does the availability of the largely overlapping standards benefit the system of investment treaty protection? As evidenced by *Chevron* and *Saipem*, the principal benefit of having multiple and overlapping standards lies in their ability to replace a denial of justice guarantee in order to allow the investor to avoid the local remedies rule and other procedural barriers. While individual investors may gain from labelling the host state’s conduct as a breach of the effective means standard or as a judicial expropriation instead of invoking a denial of justice, such practice will significantly compromise the integrity, credibility and sustainability of investment treaty law in the long

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<sup>131</sup> See Schreuer (n 46) 2 (emphasising that Article 26 ICSID expressly waives local remedies, except when state parties wish to make their consent to arbitration subject to the exhaustion rule. Israel and Guatemala both gave notification to ICSID opting for the mandatory exhaustion of local remedies prior to arbitration, but Israel has subsequently withdrawn its notification). See further GR Delaume, ‘ICSID Arbitration and the Courts’ (1983) 77 AJIL 784, 785 (arguing that by virtue of Article 26 providing for ICSID arbitration as an exclusive remedy, “if a court in a contracting state becomes aware that a claim before it may call for adjudication under ICSID, the court ought to stay the proceedings pending proper determination of the issue by ICSID”). Also, C Schreuer and others, *The ICSID Convention: A Commentary* (2<sup>nd</sup> edn CUP, Cambridge 2009) 386-7.

term. It is therefore submitted that both host states and foreign investors would benefit more from abolishing variously overlapping standards. This would preclude claimants and tribunals from deploying the local remedies rule in a selective manner, and would introduce clarity as to what forms of governmental conduct can give rise to the international responsibility of the host state to affected investors.

The reliance on the standard of expropriation as a distinct cause of action may be of decisive importance if a dispute is brought under the BIT which allows for investor-state arbitration only in the case of expropriation. The award in *Saipem v Bangladesh* highlights the practical implications of invoking expropriation in a case where the factual context more readily supports the finding of a denial of justice. Although the conduct complained of also amounted to denial of justice and a breach of fair and equitable treatment, the primary claim was for expropriation, which under Article 9(1) of the BIT was the sole ground giving rise to the jurisdiction of an ICSID tribunal.<sup>132</sup> Despite the fact that the case was clearly about a denial of justice, the tribunal preferred to characterise the disputed conduct as an expropriation through judicial acts. Had the *Saipem* tribunal described the conduct of the Bangladeshi courts as a denial of justice and not as an expropriation, the investor would have been deprived of the opportunity to have its grievance heard by an investment treaty tribunal. As regards BITs providing for the arbitration of expropriation cases only, the elimination of alternative standards may seem problematic. Such BITs reflect a policy choice that intentionally limits the availability of investment arbitration to only certain types of host state interference with foreign investment.<sup>133</sup> However, it is clear that despite seeking to limit its exposure to investment arbitration by providing consent to only expropriation disputes, a host

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<sup>132</sup> *Saipem* (n 88) para 121.

<sup>133</sup> For example, Chinese investment treaties usually provide for state consent to arbitration of disputes relating to the amount of compensation for expropriation only (For detail, see Gallagher & Shan (n 1) 326). A similar practice was characteristic to the USSR BITs many of which were inherited by Russia.

state may still end up being held liable. Driven by a perceived need to afford the investor an effective remedy, tribunals may prefer to characterise the disputed conduct as an international wrong that they are competent to rule upon. BITs providing for arbitration of expropriation disputes alone fail to limit the exposure of the host state to international responsibility. Host states would gain more from eliminating multiple and overlapping standards. The adoption of a unified standard of treatment with clearly outlined parameters of illegality would introduce clarity as to what forms of governmental conduct can give rise to international responsibility of the host state to affected investors.

**CHAPTER VI: UMBRELLA CLAUSES AND DISPUTE RESOLUTION CLAUSES:  
SPECIFIC COMMITMENTS AS A LEGAL RESTRAINT ON THE EXERCISE OF  
REGULATORY POWERS BY THE HOST STATE**

As contract has long been the key legal instrument in business transactions, including those between foreign businesses and host states, it is unsurprising that many investment treaty instruments contain a special provision aiming to protect the investor's contractual rights. The distinctive feature of an umbrella clause—also known as an observance of undertakings and sanctity of contract provision—is that in contrast with other non-expropriatory standards it is not defined by reference to the manner in which investors and investments must be treated, but simply renders contractual undertakings inviolable. In this respect, umbrella clauses are akin to the traditional expropriation standard as it creates a blanket guarantee against an interference with contractual rights regardless of whether such an interference is non-discriminatory, compliant with due process and/or justified by reference to a rational policy objective. However, unlike the expropriation standard, the investor's ability to claim under umbrella clauses is unencumbered by the need to show a substantial deprivation.

While the rise in the use of umbrella clauses among other non-expropriatory standards points to a gradual decline of expropriation as a core investment protection, the effect of such a development and in particular its potential to further expand the scope of state responsibility in investment treaty law may be a cause for concern. Is there a different role for contract in safeguarding the investor from an interference by the host state? This chapter will critically examine the recent developments concerning the protection of investors' contract rights in investment treaty practice and arbitration. After discussing the role of dispute resolution and umbrella clauses, it will focus on the function of contractual commitments as a legal restraint

on the exercise of regulatory powers by host states.

# 1. Breach of contract as a violation of international law: the minimum standard as a benchmark

Traditionally, a breach of contract *per se* was not sufficient to give rise to an international wrong for which the state could be held responsible. Customary international law has long been characterised by states being reluctant to intervene in cases involving an alleged breach of contract with the state.<sup>1</sup> Despite some schools of thought postulating the internationalisation of contracts, the prevailing view is that a breach by a state of a contract with a foreign investor is not *per se* a breach of international law.<sup>2</sup> Rather, something more than a mere breach of contract (such as an arbitrary termination or confiscation of the contractual rights, or the denial of justice) is required to give rise to a state's international responsibility.<sup>3</sup> So far as customary international law is concerned, state practice is well demonstrated by the positions taken by both the United States and the United Kingdom governments. For example, as summarised by Hackworth in his earlier treatise on international law,

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<sup>1</sup> See E Bochar, *The Diplomatic Protection of Citizens Abroad* (1915) 284; M Whiteman, *Damages in International Law* (1943) 1558; C Eagleton, *The Responsibility of States in International Law* (1928) 47-8; KS Carlston, 'Concession Agreements and Nationalization' (1958) 52 AJIL 260, 267; FA Mann, 'State Contracts and State Responsibility' (1960) 54 AJIL 572, 577; R Jennings, 'State Contracts in International Law' (1961) 37 British Ybk Int L 156, 159.

<sup>2</sup> J Crawford, *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries* (Cambridge, CUP 2002) 96; I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 523-4; CF Amerasinghe, *Local Remedies in International Law* (2<sup>nd</sup> edn CUP, New York 2004) 107-141; S Schwebel, *International Arbitration: Three Salient Problems* (Grotius, Cambridge 1987) 111. For the UK position on a breach of state contracts, see also DW Bowett, 'State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach' (1988) 59 British Ybk Intl L 49, 58. However, compare UK Memorial, *Anglo-Iranian Oil Co. Case* (UK v Iran), Pleadings, 86-93.

<sup>3</sup> See LB Sohn and RR Baxter, 'Responsibility of States for Injuries to the Economic Interests of Aliens' (1961) 55 AJIL 554, 566-7; SM Schwebel, *Justice in International Law: Selected Writings of Stephen M. Schwebel* (CUP, Cambridge 1994) 425-35; CF Amerasinghe, *State Responsibility for Injuries to Aliens* (Clarendon Press, Oxford 1967) 79-84. There are, however, examples where, in contrast to the prevalent position, the state party to a private contract was found internationally responsible for a failure to pay or a refusal to accept goods. (See *Singer Sewing Machine Company Arbitration* (United States v Turkey), *Deutz* (1929) IV RIAA 472).

[t]he Department of State does not intervene in cases involving breaches of contract between a foreign state and a national of the United States in the absence of showing a denial of justice... The practice of declining to intervene formally prior to a showing of denial of justice is based on the proposition that the Government of the United States is not a collection agency and cannot assume the role of endeavouring to enforce contractual undertakings freely entered into by nationals with foreign states.<sup>4</sup>

Similarly, the position of the UK government on this matter was expressed in its memorial in *Ambatielos*:

It is generally accepted that, so long as it affords remedies in its Courts, a State is only directly responsible, on the international plane, for acts involving breaches of contract, where the breach is not a simple breach... but involves an obviously arbitrary or tortuous element, e.g. a confiscatory breach of contract – where the true basis of the international claim is the confiscation, rather than the breach *per se*.<sup>5</sup>

Recent investment arbitration practice in relation to claims involving an alleged breach of contract has largely endorsed the traditional approach. In *Azinian v Mexico*, the tribunal stressed that investors

...may enter into contractual relations with a public authority, and may suffer a breach by that authority, and *still not be in a position to state a claim under NAFTA*. It is a fact of life everywhere that individuals may be disappointed in their dealings with public authorities, and disappointed yet again when national courts reject their complaints. [...] NAFTA was not intended to provide foreign investors with blanket protection from this kind of disappointment, and nothing in its terms so provides.<sup>6</sup> (emphasis original)

The dispute in *Azinian* involved an annulment of a concession contract by a local municipality due to a number of irregularities in the conclusion and performance of the contract by the investors. The investors' claim disputing the validity of the municipality's decision had been dismissed by Mexican courts. The tribunal held that for a termination of the concession

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<sup>4</sup> GH Hackworth, *Digest of International Law* (US Government Printing Office, Washington 1943) vol 5, 611, see also M Sornarajah, *The International Law on Foreign Investment* (2<sup>nd</sup> edn CUP, Cambridge 2004) 405; Jennings (n 1) 159.

<sup>5</sup> See G Fitzmaurice, 'Hersch Lauterpacht – The Scholar as Judge' Part I (1961) British Ybk Intl Law 37, 64-5. By contrast, the Greek Government in *Ambatielos* espoused the position that the breach by a state of its contract with a foreigner is a breach of international law. The same position was endorsed by Switzerland in the *Losinger and Co Case* before the PCIJ. See further Schwebel (n 3) 427.

<sup>6</sup> *Azinian and ors v Mexico*, Award on Jurisdiction and Merits, 18 October 1999 (ICSID Case No ARB (AF)/97/2) (2000) 39 ILM 53, para 83.

contract to give rise to Mexico's international responsibility, the investors ought to point to a violation of substantive obligations contained in Chapter 11 NAFTA.<sup>7</sup> In addressing the claim that Mexico had expropriated the investors' contractual rights, the tribunal held that 'a governmental authority surely cannot be faulted for acting in a manner validated by its courts *unless the courts themselves are disavowed at the international level.*'<sup>8</sup> To hold the state internationally liable, the investors ought 'to show either a denial of justice, or a pretence of form to achieve an internationally unlawful end.'<sup>9</sup> The investors' allegation of a contractual expropriation failed as the tribunal found that no denial of justice had occurred.<sup>10</sup>

Similarly, in *Waste Management* the tribunal held that 'the mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is tantamount to expropriation.'<sup>11</sup> In considering whether a failure to pay under the concession contract would qualify as expropriation under NAFTA, the tribunal found that 'it is not the function of Article 1110 to compensate for failed business ventures, absent arbitrary intervention by the State amounting to a virtual taking or sterilising of the enterprise.'<sup>12</sup> As no arbitrariness, denial of justice or discrimination was found to have occurred, the tribunal rejected both the claim of expropriation and the alleged breach of FET.

In *Vivendi v Argentina*, the dispute concerned the termination of a concession for the provision of water and sewage services.<sup>13</sup> After making substantial investments to improve the

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<sup>7</sup> Ibid para 84.

<sup>8</sup> Ibid para 97 (emphasis original).

<sup>9</sup> Ibid para 99.

<sup>10</sup> Ibid para 124.

<sup>11</sup> *Waste Management Inc v Mexico* (2004) 43 ILM 967, paras 160, 174.

<sup>12</sup> Ibid para 175. In *Biwater Gauff v Tanzania*, the tribunal held that a breach of contract *per se* does not constitute an expropriation. The tribunal noted that while a denial of justice need not be established for a breach of contract to constitute an expropriation, the critical distinction was in the state acting not merely as a contractual partner, but in the exercise of its governmental authority. (*Biwater Gauff v United Republic of Tanzania*, Award 24 July 2008 (ICSID Case No ARB/05/22) paras 457-458). Similarly, see *Consortium RFCC v Morocco*, Award, 22 December 2003 (ICSID Case No ARB/00/6) paras 69, 87.

<sup>13</sup> *Compañía de Aguas del Aconquija SA and Vivendi Universal SA v Argentina*, Award, 20 August 2007 (ICSID

system of water supply and sewage, the investors had encountered strong opposition from the newly elected provincial government. The government's hostility was reflected in a number of actions, including the decision to impose a tariff reduction, calls for non-payment of invoices for the services provided, and forcing the investors to re-negotiate the concession under the threat of rescission. The tribunal characterised the disputed acts as 'a vindictive exercise of sovereign power aimed at punishing CAA [i.e. the investor] and its shareholders for seeking to terminate the Concession Agreement and for exercising their rights to arbitrate under the BIT.'<sup>14</sup>

In *Eureko v Poland*, the claim arose from a governmental failure to conduct an Initial Public Offering, through which the investor was to purchase additional shares as agreed in a contract.<sup>15</sup> The investor contended that its contractual rights had been frustrated by the host state measures.<sup>16</sup> The tribunal found Poland responsible for expropriation and breach of FET.<sup>17</sup> It held that Poland 'by the conduct of organs of the State, acted not for cause but for purely arbitrary reasons linked to the interplay of Polish politics and nationalistic reasons of a discriminatory character.'<sup>18</sup>

The foregoing examples support the view that a mere breach of contract does not amount to an international wrong but requires something more. Among international instruments, the MIGA Convention endorses the idea that an investor is entitled to indemnification in a case where a breach of contract is accompanied by the absence of access

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Case No ARB/97/3).

<sup>14</sup> Ibid para 7.4.45. A similar dispute was brought before the ICSID tribunal in *Azurix v Argentina*. The tribunal found that the local authorities acted arbitrarily and violated the full protection and security standard. See *Azurix Corp v Argentina*, Award, 23 June 2006 (ICSID Case No ARB/01/12) para 314, 393, 406-408; also *Sempra Energy International v Argentina*, Award, 18 September 2007 (ICSID Case No ARB/02/16) para 281.

<sup>15</sup> *Eureko BV v Poland*, Partial Award and Dissenting Opinion, 19 August 2005 (Ad hoc—UNCITRAL Arbitration Rules).

<sup>16</sup> Ibid para 80.

<sup>17</sup> Ibid paras 240-242.

<sup>18</sup> Ibid paras 233.



to a competent forum, unreasonable procedural delays, and lack of enforcement mechanisms.<sup>19</sup> It is the presence of arbitrariness, discrimination and a failure of due process of law that usually transforms a breach of an investor's contractual rights into a violation of international law. This view is underpinned by the idea that investment contracts—as any other forms of legal arrangements underlying the investor's undertaking in the host state—are not exempt from the effects of regulatory acts by host state organs and may come within the purview of an international tribunal in cases involving an arbitrary, discriminatory and procedurally unlawful state interference.

Although largely endorsed by investment tribunals, the traditional 'something more than a mere breach of contract' view is, nevertheless, contrasted by a more expansionist approach to state responsibility for a breach of contract. It was precisely because neither earlier treaties nor customary international law had provided for the state's international responsibility for a mere breach of contract without something more, that the drafters of modern BITs resorted to umbrella clauses and open-ended dispute resolution provisions in BITs.<sup>20</sup> As will be shown below, by enabling an investor to bring its contract claims directly against a host state in a binding arbitration, international investment treaties attempt to bring contract claims within the ambit of international law. Again, this raises the question of not only drawing the boundaries of the state's responsibility to foreign investors but also

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<sup>19</sup> The Convention Establishing the Multilateral Investment Guarantee Agency (1985) 24 ILM 1605, see also JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 61.

<sup>20</sup> See S Alexandrov, 'Breaches of Contract and Breaches of Treaty: The Jurisdiction of Treaty-based Arbitration Tribunals to Decide Breach of Contract Claims in *SGS v Pakistan* and *SGS v Philippines*' (2004) 5 (4) J World Investment & Trade 555, 565-6 (discussing the specific range of situations in which a breach of contract would give rise to state responsibility in customary international law, and noting that 'it should hardly come as a surprise that States may wish to agree in an investment treaty to consider all contractual breaches, or breaches of other obligations undertaken by the State with respect to foreign investors, as treaty breaches. Typically, they do so in the form of an "umbrella clause" or an "observance of undertakings clause."' Also, T Walde, 'The 'Umbrella' (or Sanctity of Contract/Pacta Sunt Servanda) Clause in Investment Arbitration: A Comment on Original Intentions and Recent Cases' (2004) 1 (4) TDM 1, 29-32; R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP, Oxford 2008) 154-55.

identifying the role and scope of standards of treatment which investors can invoke in their claims against the host state. The following sections will focus on contract claims and explore the role of an umbrella clause and its relationship with other standards of treatment in protecting investors against host state interference with their contractual undertakings.

## 2. Internationalisation of foreign investment contracts in investment treaty law

### 2.1. Internationalisation through dispute resolution clauses

Prior to the rise of international arbitration and its institutionalisation under the ICSID Convention, state contracts with foreign investors had been a matter for the domestic law of host states.<sup>21</sup> As evidenced by the ICJ decision in the *Serbian Loans Case*, the ambit of the protection under international law was largely confined to contracts concluded between states.<sup>22</sup> These limitations of customary international law and the institute of diplomatic protection left foreign concession-holders exposed to risks of interference by a host state driven by political and economic motives.<sup>23</sup> Concerns about the lack of international restraints on state powers to unilaterally change or terminate an investor's concession rights culminated in the emergence of a theory of internationalised contract.<sup>24</sup> The internationalisation theory sought to insulate a contract between a foreign investor and a host state from the domestic law by subjecting contractual disputes to international law and thus safeguarding the contract from

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<sup>21</sup> See Amerasinghe (n 3) 66-119, 277-8.

<sup>22</sup> *Serbian Loans Case* (Judgment No 14) PCIJ Rep Series A No 20, 41.

<sup>23</sup> International arbitrations involving nationalisation of petroleum concessions in the Middle East illustrate some of the by now familiar scenarios in which the host state may interfere with investment contracts. See P Muchlinski, *Multinational Enterprises and the Law* (2<sup>nd</sup> edn OUP, Oxford 2007) 580-2.

<sup>24</sup> See M Sornarajah, *The Pursuit of Nationalized Property* (Martinus Nijhoff, The Hague 1986) 81-119; S Asante, 'Stability of Contractual Relations in the Transnational Investment Process' (1979) 28 ICLQ 401; AA Fatouros, 'International Law and the Internationalized Contract' (1980) 74 AJIL 134; N Nassar, 'Internationalization of State Contracts: ICSID, The Last Citadel' (1997) 14 Journal Intl Arbitration 185; Muchlinski (n 23) 579-83.

the perils of host state intervention through the exercise of its power to legislate.<sup>25</sup> In some sources, it was argued that a contract between a foreign investor and a host government was similar to an international treaty concluded between sovereign states and, therefore, such a contract ought to be protected in international law.<sup>26</sup> Other justifications rested on stabilisation, choice of law and international arbitration clauses, entailing the application of international law to the exclusion of domestic law.<sup>27</sup> The internationalisation theory was also rationalised on the ground that concessions between foreign companies and developing states ought to be classified as international development agreements.<sup>28</sup>

Contemporary investment treaty practice and arbitration reveals divergent views on the scope of protection granted to contract claims. Many investment treaties still preclude contract-related investment claims from being litigated in investor-state arbitration. For instance, under Article XIII of the 1996 Canada–Ecuador BIT, investor-state arbitration covers any dispute relating to a claim by an investor that a measure taken or not taken by the

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<sup>25</sup> See Jennings (n 1) 156-7; also *Saudi Arabia v Arabian American Oil Company* (1963) 27 ILR 117 *Aminoil v Kuwait* (1982) 21 ILM 1024; for discussion, see M Hunter and AC Sinclair, 'Aminoil Revisited: Reflections on a Story of Changing Circumstances' in T Weiler (ed), *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (London, Cameron May 2005) 347.

<sup>26</sup> Under Article 26 of the Vienna Convention on the Law of Treaties, *pacta sunt servanda* requires the parties to fulfil obligations and rights created by the treaty. The theory of internationalisation of contracts by assimilation to treaties was at work in the *Anglo-Iranian Oil Company Case* [1952] ICJ Rpts 93. After the Iranian government had terminated the D'Arcy Concession in November 1932, the involvement of the United Kingdom government had led to signing a concession contract on April 29<sup>th</sup> 1933. Subsequently, the concession was nationalised in May 1951. The United Kingdom contended before the ICJ that the concession contract of 29<sup>th</sup> April 1933 had a double character: the character of being at once a concessionary contract between the UK government and the company, and a treaty between the two governments. The Court did not accept these contentions and held that the contract was 'nothing more than a concessionary contract between a government and a foreign corporation.'

<sup>27</sup> See *Lena Goldfields v USSR* (1950-1951) 31 Cornell L Q 42; *Sapphire v NIOC* (1967) 35 ILR 136, *ARAMCO v Saudi Arabia* (1963) 27 ILR 117; *Texaco v Libya* (1979) 53 ILR 389. See also C Greenwood, *State Contracts in International Law – The Libyan Oil Arbitrations* (1982) 33 British Ybk Intl Law 27, 53 (arguing that it was the presence of stabilisation clauses, rather than any other characteristics of the concessions that could justify their internationalisation).

<sup>28</sup> See *Revere Copper and Brass Inc v Overseas Private Investment Corporation* (1978) 56 ILR 258, Lord McNair, 'The General Principles of Law Recognised by Civilised Nations' (1957) 33 British Ybk Intl L 1-4; JN Hyde, 'Economic Development Agreements' (1962-1) 105 *Recueil des Cours* 282-83; CT Curtis, 'The Legal Security of Economic Development Agreements' (1988) 29 *Harvard Intl L J* 317. For criticism, see Sornarajah (n 24) 86-90.

host state is in breach of the treaty, and that the investor has incurred loss or damage by reason of, or arising out of, that breach.<sup>29</sup> In practical terms, dispute settlement provisions of this kind allow the arbitration of contractual claims only if such claims violate substantive provisions of a BIT. This approach reinforces the idea that a mere breach of contract, without something more, will not suffice to give rise to host state liability in international law.

The practice of limiting investor-state arbitration to breaches of substantive treaty provisions is, however, in contrast with a number of BITs which contain broadly worded dispute resolution clauses. A pertinent example is Article 10(1) of the 2001 Japan–Mongolia BIT, which makes investor-state arbitration available to *any* dispute between an investor and the host state with respect to investment in the territory of that state.<sup>30</sup> Provisions of this kind mirror the stance taken in Article 25(1) of the ICSID Convention, which allows the arbitration of *any* legal dispute arising directly out of an investment.<sup>31</sup> A broadly formulated dispute resolution clause can bring contractual claims within the purview of international tribunals even in cases where a breach of contract does not constitute a violation of substantive treaty provisions enshrined in FET, non-discrimination and non-arbitrariness clauses. In contrast with the early efforts to internationalise contracts between host states and investors that were

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<sup>29</sup> See also Articles 22-23 of the 2009 Canada–Jordan BIT, and Article 8(1) of the 2002 UK–Vietnam BIT. It is important to note that a promise to arbitrate investor-state disputes can also be given in individual investment contracts and in foreign investment laws of the host state. For instance, Article 11 of the Law of the Republic of Uzbekistan on Guarantees and Measures of Protection of Foreign Investor Rights provides that any dispute, directly or indirectly relating to investment, can be brought before an international tribunal. (Law No 611-I, 30 April 1998, available at <[http://www.mfer.uz/zakonodatelstvo\\_v\\_sfere\\_ved/zakoni\\_respubliki\\_uzbekistan/o\\_garantiyax\\_i\\_merax\\_prav\\_i\\_nostrannix\\_investorov.mgr](http://www.mfer.uz/zakonodatelstvo_v_sfere_ved/zakoni_respubliki_uzbekistan/o_garantiyax_i_merax_prav_i_nostrannix_investorov.mgr)> accessed 29 June 2010). Similar laws exist in Kazakhstan and Georgia. (S Alexandrov, ‘Breach of Treaty Claims and Breach of Contract Claims: Is It Still Unknown Territory?’ in K Yannaca-Small (ed), *Arbitration under International Investment Agreements: A Guide to the Key Issues* (OUP, Oxford 2010) 332). For arbitral practice see *SPP v Egypt*, Decision on Jurisdiction (1995) 3 ICSID Reports 112 November 27 1985 paras 64-87; *Tradex v Albania*, Decision on Jurisdiction (2002) 5 ICSID Reports 47; *Autopista v Venezuela*, Award 23 September 2003, 10 ICSID Rep 309. See also Alexandrov (n 20) 575.

<sup>30</sup> See Article 7(1) of the 2000 Switzerland–Lebanon BIT, and Article 8(1) of the 1997 Switzerland–Philippines BIT.

<sup>31</sup> Article 25(1), the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (1965) 4 ILM 524.

primarily aimed at the *ex post* protection of individual agreements, broadly worded dispute resolution clauses provide for the wholesale internationalisation of prospective investor-state contracts.

Unsurprisingly, some arbitral tribunals have been reluctant to embrace the expansion of investment arbitration to encompass an indefinite range of investment contracts. Thus, in *SGS v Pakistan*, the tribunal held that Article 9 of the Pakistan–Switzerland BIT providing for ICSID arbitration of disputes ‘with respect to investment’ was not purported to cover all contractual claims.<sup>32</sup> In the tribunal’s view, while the claim arising from violations of a contract for pre-shipment inspection services could be described as a ‘dispute with respect to investments’, such a description alone did not necessarily imply that purely contractual claims were intended to be covered by Article 9.<sup>33</sup> The tribunal was generally unwilling to allow contractual claims in investor-state arbitration.<sup>34</sup> The *Salini v Morocco* tribunal was similarly reluctant to allow any contractual claims in investor-state arbitration. It preferred to limit the scope of an otherwise open-ended dispute resolution clause in Article 8 of the Italy–Morocco BIT to contracts concluded with the host state only.<sup>35</sup> Despite acknowledging the breadth of the relevant clause, the tribunal chose to construe the relevant clause restrictively to exclude breaches of contract concluded with an entity other than the host state.<sup>36</sup> In the tribunal’s view,

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<sup>32</sup> *SGS Société Générale de Surveillance SA v Pakistan*, Decision on Objections to Jurisdiction, 6 August 2003 (ICSID Case No ARB/01/13) (2003) 42 ILM 1290.

<sup>33</sup> *Ibid* para 161. For critical discussion, see E Gaillard, ‘Investment Treaty Arbitration and Jurisdiction Over Contract Claims – the SGS Cases Considered’ in T Weiler (ed) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, London 2005) 325-336.

<sup>34</sup> In addressing the scope of an umbrella clause, the tribunal held that ‘[t]he “commitments” subject matter of Article 11 may, without imposing excessive violence on the text itself, be commitments of the State itself as a legal person, or of any office, entity or subdivision (local government units) or legal representative thereof whose acts are, under the law on state responsibility, attributable to the State itself’ (*ibid* para 166).

<sup>35</sup> *Salini Construttori S.p.A. and Italstrade S.p.A. v Kingdom of Morocco*, Decision on Jurisdiction, 23 July 2001 (ICSID Case No. ARB/00/4) (2003) 42 ILM 609, para 59.

<sup>36</sup> *Ibid* para 61.

In the case where the state has organised a sector of activity through a distinct legal entity, be it a State entity, it does not necessarily follow that the State has accepted *a priori* that the jurisdiction offer contained in Article 8 should bind it with respect to contractual breaches committed by this party.<sup>37</sup>

A somewhat similar stance was adopted in *Impregilo v Pakistan*, where a claim was brought under the Italy–Pakistan BIT.<sup>38</sup> The reasoning behind such an interpretation is not entirely convincing. It is submitted that principles of treaty interpretation, including the principle of *effet utile*,<sup>39</sup> would justify the application of the relevant dispute settlement clauses to disputes involving a violation of substantive treaty provisions as well as purely contractual claims, irrespective of whether a contract is entered into with the host state or its entities. Since the applicable BITs did not draw a distinction between a contract concluded with the host state and those concluded with various state entities, the correct approach would be to give effect to the host state’s consent to arbitration without reading limitations into the relevant provision. If the state parties to a BIT were to limit the scope of their consent to arbitration they would have done so expressly by excluding contracts entered into between investors and entities other than the host state or by excluding pure contract claims altogether.<sup>40</sup>

Indeed, a number of BITs allow for investor-state arbitration of only a narrow category of investment contracts. For instance, the state consent to investor-state arbitration under Article VI(1) of the US–Ukraine BIT covers disputes relating to ‘an investment authorisation granted by that party’s foreign investment authority to such national or

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<sup>37</sup> Ibid para 60.

<sup>38</sup> *Impregilo SpA v Pakistan*, Decision on Jurisdiction (ICSID Case No ARB/03/3) para 214 (the tribunal holding that Article 9 covered only contracts concluded with the host state as opposed to its entities).

<sup>39</sup> See A Orakhelashvili, *The Interpretation of Acts and Rules in Public International Law* (OUP, Oxford 2008) 393, explaining that the principle of effective treaty interpretation does not imply the expansion of treaty obligations to other objects or aspects of life. Rather, it concerns the effectiveness of treaty obligations embodied in the text, in light of the object and purpose of the treaty (ibid 393-4).

<sup>40</sup> See Z Douglas, *The International Law of Investment Claims* (CUP, Cambridge 2009) 238 (criticising the restrictive view adopted by the *SGS v Pakistan* tribunal, and noting that ‘the general language of Article 9 does not expressly carve out contractual claims from its purview; to the contrary, the natural meaning of the words ‘disputes with respect to investments’ is broad enough to encompass any disputes that are factually related to investments’).

company.’ The scope of this provision was at issue in *Generation Ukraine*, where the tribunal examined whether it was competent to hear the investor’s claims based on lease agreements and a foundation agreement with a municipal authority of Ukraine.<sup>41</sup> The tribunal noted that Ukraine had not been a party to the agreements at issue.<sup>42</sup> The lease and foundation agreements did not constitute ‘an investment authorisation granted by the state’s foreign investment authority’ for the purpose of Article VI(1) because they had been entered into between the claimant and the local municipality. The tribunal was therefore correct in excluding the lease and foundation agreements from the scope of investment agreements covered by the state consent in the BIT.<sup>43</sup> Unlike *Salini* and *Impregilo*, the *Generation Ukraine* tribunal did not read a dispute settlement clause restrictively but rather gave effect to the express wording of the applicable BIT specifying a type of contract that would fall within the purview of investor-state arbitration.

The *SGS v Philippines* award also exemplifies the correct approach to construing a broadly formulated dispute resolution clause.<sup>44</sup> A claim was brought under the Swiss–Philippines BIT, Article VIII of which provided for settlement of ‘disputes with respect to investments between a Contracting Party and an investor of the other Contracting Party.’<sup>45</sup> In its interpretation of this provision, the tribunal correctly acknowledged the absence of restrictions on the type of claims covered therein:

The term “disputes with respect to investments” (“different relatifs à des investissements” in the French text) is not limited by reference to the legal classification of the claim that is made. A dispute about an alleged expropriation contrary to Article VI of the BIT would be a “dispute with respect to investments”; so

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<sup>41</sup> *Generation Ukraine, Inc v Ukraine*, Award, 15 September 2003 (ICSID Case No ARB/00/9) (2005) 44 ILM 404, para 8.12.

<sup>42</sup> *Ibid* para 8.12.

<sup>43</sup> See also Douglas (n 40) 238-9.

<sup>44</sup> *SGS Société Générale de Surveillance SA v Philippines*, Decision on Objections to Jurisdiction and Separate Declaration, 29 January 2004 (ICSID Case No ARB/02/6).

<sup>45</sup> *Ibid* para 130.

too would a dispute arising from an investment contract such as the CISS Agreement.<sup>46</sup>

The *SGS v Philippines* tribunal gave effect to the state parties' agreement as enshrined in the dispute resolution clause of the BIT. Where an investment treaty provides for investor-state arbitration of all or any disputes with respect to investment, perceived concerns over the expansion of the scope of investor-state arbitration does not justify inferring restrictions unsupported by the treaty text or its context. It is true that by allowing any contract claims in investor-state arbitration, a broadly formulated dispute resolution clause increases the host state's exposure to liability and raises various concerns over the design of the investment protection mechanism and its long-term sustainability. Nonetheless, leaving the task of redefining the contours of state responsibility in investment treaty law to party-appointed arbitrators is likely to exacerbate the existing problems and aggravate the current growing discontent. Instead of placing reliance on tribunals which may (or may not) favour a restrictive interpretation of open-ended dispute resolution clauses, the conceptually well-founded and practically more effective solution would be for state parties to redesign their approaches to resolving contract-related investment disputes.

## 2.2. Umbrella clauses

### A. General

Umbrella clauses—also known as the observance of undertakings, sanctity of contract, and *pacta sunt servanda* standard—represent another method of internationalising contract claims.<sup>47</sup> While the wording of the standard may significantly vary, a typical umbrella clause

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<sup>46</sup> Ibid para 131.

<sup>47</sup> According to an OECD report, of the 2500 or more BITs in force approximately 40 per cent contain an umbrella clause. (OECD Working Papers on International Investment, Interpretation of the Umbrella Clause in



requires that each contracting party observes any obligation it may have entered into with regard to an investment of an investor of another contracting party.<sup>48</sup> Prior to its adoption in investment treaty texts, the idea of umbrella protection was deployed in the settlement of disputes between states. The earliest known example of an umbrella treaty is the 1921 Agreement between the United Kingdom and Peru concluded as part of a settlement reached by the parties in respect of a disputed mineral concession.<sup>49</sup> The idea of an umbrella treaty was later deployed in the settlement of the Iranian oil nationalisation dispute.<sup>50</sup> The 1959 Abs-Shawcross Draft Convention on Investments Abroad became the first multilateral investment treaty instrument to include a clause providing for the state's obligation to observe undertakings assumed towards foreign investors.<sup>51</sup> The incorporation of the umbrella clause in the Draft was criticised as being 'a far-reaching departure from the law as it stands',<sup>52</sup> having 'too high a degree of sacrosanctity of foreign investment', and for its failure to 'allow for the dynamic of events.'<sup>53</sup> Similar criticisms were later raised in relation to the umbrella

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Investment Agreements, No 2006/3, available at <<http://www.oecd.org/dataoecd/3/20/37579220.pdf>>

<sup>48</sup> See Article 2(2) of the 2005 UK Model BIT, Article (3)4 of the 1997 Netherlands Model BIT, and Article 7(2) of the 2005 Germany Model BIT.

<sup>49</sup> The treaty was an *ad hoc* arrangement resolving certain issues over the application of Peruvian laws to the concession. The purpose was to elevate the status of the resulting award to an international obligation which could be enforced as a matter of international law. (AC Sinclair, 'The Origins of the Umbrella Clause in the International Law of Investment Protection' (2004) 20 *Arbitration Intl* 411, 413-4).

<sup>50</sup> Sinclair (n 49) 416. The proposed settlement included (a) a contractual consortium agreement between Iran and NIOC on the one hand, and on the other hand, a consortium of oil companies; and (b) an umbrella treaty that would incorporate the consortium agreement and would contain a provision by which the Iranian government guaranteed observance of all contractual commitments. The effect of the umbrella would be (1) to give the terms of the consortium agreement a stability guaranteed by treaty between the states concerned; and (2) to combine an inter-state remedy for breach of the settlement agreement, and the choice of governing law and arbitration clause so as to complete the process of internationalisation of the whole arrangement. (Ibid).

<sup>51</sup> See HJ Abs, 'Proposals for Improving the Protection of Private Foreign Investments' (Rotterdam, 1958) 35, cited in Sinclair (n 49) 419. For a general discussion of the Draft, see G Schwarzenberger, *Foreign Investments and International Law* (Steven & Sons, London 1969) 109-134. The Abs-Shawcross Draft can be found in UNCTAD, *International Investment Instruments: A Compendium* (United Nations, New York & Geneva 2000) vol. V, 395).

<sup>52</sup> See Schwarzenberger (n 51) 117; also G Schwarzenberger, 'The Abs-Shawcross Draft Convention on Investments Abroad: A Critical Commentary' (1960) 9 *J Public Law* 147, 155.

<sup>53</sup> Sinclair (n 49) 426. See also criticism by CN Brower, 'The Future for Foreign Investment – Recent Developments in the International Law of Expropriation and Compensation' in VS Cameron (ed), *Private Investors Abroad – Problems and Solutions in International Business in 1975* (1976) 93-105.

clause in the 1962 OECD Draft Convention on the Protection of Foreign Property.<sup>54</sup> In particular, the US Department of State opposed the inclusion of a sanctity of contract provision in the Draft Convention, seeing it as ‘an undesirable attempt through international law to fetter the US Government’s sovereign right of eminent domain and to bargain away its police powers.’<sup>55</sup>

## B. Umbrella clauses in investment arbitration

In its original design, the main objective of an umbrella clause was to protect against expropriation of contractual rights and to ensure that the same remedy as in the case of expropriation—full compensation—was available to foreign investors in the event of state interference with their contracts.<sup>56</sup> Thus, umbrella provisions offer an additional layer of protection by enabling an investor to claim a remedy for breach of contract which may not readily be characterised as an expropriation or other international delict. In other words, umbrella clauses can entitle investors to redress if there is no violation of substantive treaty provisions. Just like a broad dispute resolution clause, an umbrella provision can bring pure contract claims within the purview of an international tribunal.

Concerned about its potential to alter radically the scope of state responsibility under international law, some investment tribunals have construed an umbrella clause restrictively. The first tribunal to have emphatically rejected the idea of internationalisation behind

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<sup>54</sup> OECD Draft Convention on the Protection of Foreign Property (1968) 7 ILM 117.

<sup>55</sup> Sinclair (n 49) 431. Interestingly, the recent generation of the US BITs do not contain an umbrella clause. Opposition to the idea of sanctity of state contracts has long been a feature of English law. DW Bowett, ‘State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach’ (1988) 59 British Ybk Intl L 49, 58 (noting that where a contract is concluded by the UK Government and governed by English law, such a contract is always subject to future legislation the operation of which cannot be precluded by acts of the local authority or the central government).

<sup>56</sup> See Walde (n 20) 15-6 (noting that an umbrella clause was a reaction to nationalisations and expropriations of concession rights and was devised to counter unilateral breaches of concession contracts). Also Sinclair (n 49) 424.

umbrella clauses was the arbitral panel in *SGS v Pakistan*.<sup>57</sup> The dispute concerned the termination of a contract for pre-shipment inspection services. The investor contended that such a termination was contrary to the commitments undertaken by Pakistan under the BIT. It invoked an umbrella clause in Article 11 of the BIT which required each contracting party to ‘constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party.’<sup>58</sup> The tribunal was not prepared to accept the investor’s argument and held that:

[t]he scope of Article 11 of the BIT, while consisting in its entirety of only one sentence, appears susceptible of almost indefinite expansion. The text itself of Article 11 does not purport to state that breaches of contract alleged by an investor in relation to a contract it has concluded with a State (widely considered to be a matter of municipal rather than international law) are automatically “elevated” to breaches of international treaty law.<sup>59</sup>

In refusing to give effect to the umbrella provision at issue, the tribunal invoked the public international law position on contract claims and pointed to the consequences that a different interpretation of the umbrella clause would entail:

Considering the widely accepted principle with which we started, namely, that under general international law, a violation of a contract entered into by a state with an investor of another state, is not, by itself, a violation of international law, and considering further that the legal consequences that the Claimant would have us attribute to Article 11 of the BIT are so far-reaching in scope, and so automatic and unqualified and sweeping in their operation, so burdensome in their potential impact upon a Contracting Party, we believe that clear and convincing evidence that such was indeed the shared intent of the Contracting Parties to the Swiss-Pakistan Investment Protection Treaty in incorporating Article 11 in the BIT.<sup>60</sup>

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<sup>57</sup> *SGS v Pakistan* (n 32). Prior to the *SGS* arbitration, an arbitral tribunal in *Fedax v Venezuela* had dealt with an umbrella provision without discussing its meaning and scope. The dispute concerned the respondent’s failure to honour promissory notes. The applicable BIT contained an umbrella clause providing that ‘[e]ach Contracting Party shall observe any obligation it may have entered into with regard to the treatment of investments of nationals of the other Contracting Party.’ The tribunal found that a non-payment of the contractual obligation to pay amounted to a violation of the BIT. However, it did not address the umbrella clause (*Fedax v Venezuela*, Award, 9 March 1998 (ICSID Case No ARB/96/3) (1998) 37 ILM 1391, para 29).

<sup>58</sup> *SGS v Pakistan* (n 32) para 163.

<sup>59</sup> *Ibid* para 166.

<sup>60</sup> *Ibid* para 167.

The tribunal warned that, if interpreted otherwise, the umbrella clause would cover ‘an unlimited number of State contracts, as well as other municipal law instruments setting out State commitments including unilateral commitments to an investor of the other Contracting Party.’<sup>61</sup> It rejected the argument that by virtue of an umbrella clause any alleged breach of contract would be treated as a breach of the BIT.<sup>62</sup>

By contrast, an arbitral tribunal in *SGS v Philippines*, addressing an analogous claim, reached an outcome entirely different to that in *SGS v Pakistan*. In the claim it brought against the Philippines, SGS contended that the failure by the government to honour payment obligations under a contract of pre-shipment inspection services resulted in a violation of substantive provisions of the BIT, including an umbrella clause contained in Article X(2).<sup>63</sup> The tribunal observed that the investor’s claim, being in substance a claim for monies unpaid under the contract, fell within the protective scope of the BIT due to the definition of investment in Article I(2) which included claims to money or to any performance having an economic value.<sup>64</sup> Furthermore, the jurisdiction over the essentially contractual claims was also based on an umbrella clause contained in Article X(2) of the BIT. The tribunal disagreed with the restrictive interpretation of an umbrella clause earlier adopted in *SGS v Pakistan*.<sup>65</sup> It held that, although the umbrella clause did not convert questions of contract law into questions of treaty law, its function was to provide an assurance of the performance of

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<sup>61</sup> Ibid para 168.

<sup>62</sup> Ibid. The tribunal also pointed out that the acceptance of the view that an umbrella clause transforms simple contract breaches into breaches of a treaty would render other standards of treatment stipulated in the BIT substantially superfluous. ‘There would be no real need to demonstrate a violation of those substantive treaty standards if a simple breach of contract, or of municipal statute or regulation, by itself, would suffice to constitute a treaty violation on the part of a Contracting Party and engage the international responsibility of the Party’ (ibid).

<sup>63</sup> Article X (2) provided that ‘Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party.’ See *SGS v Philippines* (n 44) para 115.

<sup>64</sup> Ibid para 33.

<sup>65</sup> Ibid paras 121-125.

obligations assumed by the host state with regard to specific investments.<sup>66</sup> The effect of the umbrella clause, in the tribunal's view, was to make it a breach of the BIT for the host state to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments.<sup>67</sup> Hence, it was not necessary for a breach of contract to constitute also a violation of substantive treaty provisions; the umbrella clause could effectively bring contractual breaches under the tribunal's jurisdiction.<sup>68</sup>

Following the *SGS* cases, a number of tribunals dealt with claims invoking umbrella provisions.<sup>69</sup> Nevertheless, the debate over the effective meaning and scope of umbrella clauses in investment treaty practice remains unsettled. One view postulates that the purpose of umbrella clauses is to allow the enforcement of contractual rights without transforming the character and content of a contract claim.<sup>70</sup> There is also a view that the language of, and the rationale behind, an umbrella clause both warrant its effective interpretation whereby it can transform breaches of obligations (undertaken by a host state in a contract with a foreign investor) into treaty breaches.<sup>71</sup> Others, while criticising the restrictive approach adopted by the *SGS v Pakistan* tribunal, endorse the view that umbrella clauses should extend investment

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<sup>66</sup> Ibid para 126.

<sup>67</sup> Ibid para 128.

<sup>68</sup> The tribunal, however, did not consider the merits of this point as the dispute was remitted to municipal courts on the ground of admissibility (ibid paras 174-176).

<sup>69</sup> For an overview of arbitral practice, see K Yannaca-Small, 'What About This "Umbrella Clause"?' in K Yannaca-Small (ed), *Arbitration under International Investment Agreements: A Guide to the Key Issues* (OUP, Oxford 2010) 479; A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 438.

<sup>70</sup> See J Crawford, 'Treaty and Contract in Investment Arbitration' (2008) 24 *Arbitration Intl* 351, 368-70. This view was supported in *SGS v Philippines* (n 44) para 126; *Toto Costruzioni Generali SpA v Lebanon*, Decision on Jurisdiction, 8 September 2009 (ICSID Case No ARB/07/12) paras 201-202.

<sup>71</sup> See Alexandrov (n 20) 566-72; J Wong, 'Umbrella Clauses in Bilateral Investment Treaties: Of Breaches of Contract, Treaty Violations, and the Divide Between Developing and Developed Countries in Foreign Investment Disputes' (2006) 14 *Geo Mason L Rev* 135; JP Gaffney and JL Loftis, 'The "Effective Ordinary Meaning" of BITs and the Jurisdiction of Treaty-Based Tribunals to Hear Contract Claims' (2007) 8(1) *J World Investment & Trade* 5, 15. Also, see *Noble Ventures Inc v Romania*, Award, 5 October 2005 (ICSID Case No ARB/01/11) paras 51-61; *Eureko* (n 15) paras 246-250; *LG&E Energy Corp and ors v Argentina*, Decision on Liability, 3 October 2006 (ICSID Case No ARB 02/1) (2007) 46 *ILM* 36, para 170; *Continental Casualty Company v Argentina*, Award, 5 September 2008 (ICSID Case No ARB/03/9) para 299.

treaty protection to contract claims, with the exception of disputes relating to purely commercial aspects of contract and trivial disputes.<sup>72</sup>

It is submitted that the stance taken by the tribunal in *SGS v Philippines*—undesirable though it may be from the perspective of the host state and balanced investment protection policy—is legally well-founded and consistent with the principles of treaty interpretation as codified in the Vienna Convention.<sup>73</sup> The ordinary meaning of the requisite provision in the Switzerland-Philippines BIT, established in light of the object, purpose and context of the BIT,<sup>74</sup> supports its effective interpretation whereby any breach of contract between the state and a foreign investor automatically violates the BIT.<sup>75</sup> Furthermore, such interpretation of an umbrella clause is in line with Article 25(1) of the ICSID, which does not exclude breaches of contract from the protective scope of investor-state arbitration. Even the advocates of a restrictive view of umbrella clauses have admitted that, as a matter of principle, states might

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<sup>72</sup> See C Schreuer, 'Travelling the BIT Route: Of Waiting Periods, Umbrella Clauses and Forks in the Road' (2005) 5 J World Investment & Trade 231, 250-5; Walde (n 20) 41-55. See, however, S Subedi, *International Investment Law: Reconciling Policy and Principle* (Oxford, Hart Publishing 2008) 161. For arbitral decisions restricting the effect of umbrella clauses to governmental breaches, as opposed to breaches of contract not involving the exercise of governmental powers, see *Joy Mining Machinery Ltd v Egypt*, Award on Jurisdiction, 30 July 2004 (ICSID Case No ARB/03/11) (2004) 19 ICSID Rev 486, paras 79-81; *Sempra* (n 14) para 310; *El Paso Energy International Co v Argentina*, Decision on Jurisdiction, 27 April 2006 (ICSID Case No ARB/03/15) paras 68-82; *Pan American Energy LLC and BP Argentina Exploration Co v Argentina*, and joined case, Decision, Preliminary Objections, 27 July 2006 (ICSID Case Nos ARB/03/13, ARB/04/8) paras 113-114. The award in *CMS*, while pointing to the distinction between governmental and commercial conduct, placed emphasis on the intensity of the governmental interference with the contract. (*CMS Gas Transmission Company v Argentina*, Award, 12 May 2005 (ICSID Case No ARB/01/8) (2005) 44 ILM 1205, para 299). The emphasis on the 'intensity' (*CMS*) or 'magnitude' (*Joy Mining*) of the governmental interference with the contract renders an umbrella clause superfluous because a breach of contract caused by governmental conduct due to its intensity or considerable magnitude can readily be characterised as a breach of substantive treaty standards such as FET. For a critique, see Crawford (n 70) 368.

<sup>73</sup> The Vienna Convention on the Law of Treaties (entered into force on 27 January 1980) 1155 UNTS 331 (1969). See also Crawford (n 70) 355 (pointing to the principle of *effet utile*: the words of a substantive treaty provision should be given some rather than no effect).

<sup>74</sup> See further RK Gardiner, *Treaty Interpretation* (OUP, Oxford 2007) 142; Orakdelashvili (n 39) 393. For a criticism of interpretive approaches emphasising the ordinary and effective meaning, see J Kammerhofer, *Alexander Orakdelashvili. The Interpretation of Acts and Rules in Public International Law* (2009) 20 EJIL 1282, 1284.

<sup>75</sup> *SGS v Philippines* (n 44) para 128. See also R Dolzer and M Stevens, *Bilateral Investment Treaties* (Martinus Nijhoff Publishers, The Hague 1995) 81-2, J Karl, 'The Promotion and Protection of German Investment Abroad' (1996) 11 ICSID Rev-FILJ 1, 23; Alexandrov (n 20) 566-72; UNCTAD, *Bilateral Investment Treaties in the mid-1990s* (United Nations, New York 1998) 54-6; Gaffney & Loftis (n 71) 15; Schreuer (n 72) 249-255; Crawford (n 70) 168-70.

agree in a BIT that all breaches of the state's contracts with investors of the other state shall be treated as breaches of the BIT.<sup>76</sup>

The restrictive interpretation of umbrella clauses not only lacks support in the treaty terms and context but also appears to be counterproductive. By refusing to give effect to umbrella clauses, the restrictive approach fails to achieve the goal of curbing the expansion of investor-state arbitration. It is obvious that a narrow reading of umbrella clauses is often driven by concerns over the drastic impact that the ordinary and effective interpretation of the clause may have on the contours of state responsibility in international law.<sup>77</sup> By insisting that clear and convincing evidence must be produced to confirm the shared intent of the contracting states in including an umbrella clause among substantive BIT provisions, tribunals highlight the fact that not all contracting states fully realise the potential reach of investment protection standards and, in particular, that of umbrella clauses.<sup>78</sup> Nevertheless, an interpretation contrary to the ordinary and effective meaning of the term is not likely to succeed in the task of preventing an unprecedented expansion of investor-state arbitration and state responsibility in international law. Concerned as they may be about the lack of evidence showing the shared understanding by the parties of the scope and function of an umbrella clause,<sup>79</sup> tribunals should nonetheless interpret the clause in accordance with its ordinary

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<sup>76</sup> *SGS v Pakistan* (n 32) para 161: 'We are not suggesting that the parties cannot, by special agreement, lodge in this Tribunal jurisdiction to pass upon and decide claims sounding solely in the contract. Obviously the parties can. But we do not believe that they have done so in this case.'

<sup>77</sup> See *Pan American* (n 72) para 110 (characterising the effect of the textual interpretation of umbrella clauses as being 'quite destructive of the distinction between the national legal orders and the international legal order', and concluding that 'it would be strange indeed if the acceptance of a BIT entailed an international liability of the State going far beyond the obligation to respect the standards of protection of foreign investments embodied in the Treaty and rendered it liable for any violation of any commitment in national or international law "with regard to investments"').

<sup>78</sup> See, for example, an observation on a BIT negotiation process made by JE Alvarez at the ASIL annual meeting in 1992: 'A BIT negotiation is not a discussion between sovereign equals. It is more like an intense training seminar conducted by the United States, on U.S. terms, on what it would take to comply with the U.S. draft' (referred to in Subedi (n 72) 85).

<sup>79</sup> See Subedi (n 72) 106, criticising the *SGS v Philippines* award and endorsing the shared intent argument against the textual interpretation of the umbrella clause.

meaning established against the background of the treaty object, purpose and context. It seems that a more effective and principled approach would be to abide by the canons of treaty interpretation, and, at the same time, to highlight the actual and potential reach of umbrella clauses. The unbiased and legally valid interpretation of umbrella provisions, along with a clear exposition of their intended and unintended effects, may invite states to revise existing treaties and may also influence their approaches to the drafting of new treaties.

### C. The scope of umbrella clauses: the state as a merchant and as a sovereign

If construed in line with the principles of treaty interpretation, umbrella clauses will cover *any* breaches of foreign investment contracts, as opposed to only breaches committed by host governments acting in their sovereign capacity.<sup>80</sup> The extension of investment treaty protection, by virtue of umbrella provisions, to ordinary breaches of contract stems from the practical impossibility and irrelevance of distinguishing between the state acting as a sovereign or simply as a merchant.<sup>81</sup> Indeed, according to the principles of state responsibility, as codified in the ILC Draft Articles, it is immaterial for the purposes of attribution whether the conduct of a state organ may be classified as commercial or as *acta iure gestionis*.<sup>82</sup> In both cases, the state may unilaterally use its sovereign prerogative to change, terminate or fail to perform a foreign investor's contract. From the investor's

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<sup>80</sup> See, for instance, *Siemens v Argentina*, Award, 6 February 2007, para 206 (holding that an umbrella clause would be applicable to *any* binding commitment entered into by Argentina with respect to the investor's investment).

<sup>81</sup> J Gill, M Gearing, and G Birt, 'Contractual Claims and Bilateral Investment Treaties: A Comparative Review of the SGS Cases' (2004) 21 J Intl Arbitration 397, 406 (noting the practical difficulty of distinguishing between governmental and commercial acts). See also *Noble Ventures* (n 71) para 82 (noting that for the purpose of attribution, the distinction between a governmental and commercial conduct was irrelevant); similarly, *Salacuse* (n 19) 283.

<sup>82</sup> See Crawford, *ILC Articles* (n 2) 96; also Crawford (n 70) 356 ('In general, a finding of a breach of international law does not depend on the characterisation of the conduct in question as 'governmental' or involving the exercise of sovereign authority. There are only two questions: what is the state obliged to do or refrain from doing, and has it complied with that obligation?').



perspective, too, it is of little significance whether its contract was breached due to the state acting in its sovereign capacity or as a merchant.<sup>83</sup>

Furthermore, one can argue that if contracting states intended to limit investment treaty protection to a certain category of contracts, they would have done so expressly, as indeed is the case in a number of BITs.<sup>84</sup> In the absence of specific treaty provisions, umbrella clauses—just as with broadly formulated dispute settlement provisions—should not be read restrictively merely for the purpose of creating filters to counter an unprecedented shift towards the open-ended protection of investment contracts.<sup>85</sup> Such a ‘wholesale’ internationalisation of foreign investment contracts may cause concern among host states and trigger the process of revision of existing treaty instruments.<sup>86</sup> However, until such revision or interpretation is undertaken, umbrella clauses may bring almost *any* breach of an investment contract before an international tribunal.<sup>87</sup>

#### D. Transforming a breach of contract into an international cause of action

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<sup>83</sup>See S Schill, ‘Enabling Private Ordering: Function, Scope and Effect of Umbrella Clauses in International Investment Treaties’ (2009) 18 Minn J Intl L 1, 39-43 (arguing that, apart from the practical difficulties involved in distinguishing between the state as a sovereign and the state as a merchant, the extension of investment treaty protection to all breaches of foreign investment contracts is justified by the need to protect investors from opportunistic behaviour by the host state due to the latter’s ability to control the way the law is applied in domestic courts).

<sup>84</sup>See above nn 41-42 and accompanying text (discussing the US BIT provisions on the types of protected contracts).

<sup>85</sup>In fact, various ‘filters’ were in place at the time that umbrella protection was conceived. Sinclair (n 49) 417 (noting that, at the time an umbrella treaty was proposed as a part of the dispute settlement arrangement between the UK and Iran, Anglo-Iranian Oil Company did not have the right of direct access to international remedies and the governments of the UK and Iran were unlikely to get involved in disputes arising from minor controversies).

<sup>86</sup>It has been argued that umbrella clauses, even where given effective interpretation, do not lead to internationalisation of contract claims; contract issues thus do not transform into treaty issues (see n 70). However, it seems that an ordinary and effective meaning of an umbrella clause does result in internationalisation of contracts. While it might be important, in theory, to maintain a conceptual difference between treaty claims and contract claims, it has been admitted that umbrella clauses may entitle a foreign investor to an internationally enforceable remedy for a breach of contract. Thus, even accepting that contract claims are not transformed into treaty claims, it would appear that the availability of an international remedy is the result of ‘internationalisation’ which is brought about by an umbrella clause.

<sup>87</sup>Subject to limitations a treaty may impose in relation to types of contracts covered.

Although umbrella clauses were devised as a safeguard against an uncompensated expropriation of contractual rights, modern investment treaty practice exhibits that, in many cases, the idea of umbrella protection has outgrown the original intentions of its creators. While the 1959 German–Pakistan BIT contained a ‘sanctity of contract’ clause binding the contracting state parties to observe obligations in contracts concluded with foreign investors,<sup>88</sup> some of the more recent investment treaties tend to ascribe a wider meaning to umbrella clauses by imposing an obligation to observe undertakings entered into by third parties.<sup>89</sup> There are also treaties where an umbrella provision transmutes into a state obligation to ‘create and maintain in its territory a legal framework apt to guarantee to investors the continuity of legal treatment, including the compliance, in good faith, of all undertakings assumed with regard to each specific investor.’<sup>90</sup> As tribunals have stressed the importance of textual formulations in interpreting umbrella clauses,<sup>91</sup> the possibility of a further expansion of state responsibility to cover a state’s failure to ‘create and maintain a legal framework’ to ensure the observation of contractual undertakings cannot be completely ruled out.<sup>92</sup> Given the diversity of formulations and their breadth, umbrella clauses indeed go

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<sup>88</sup> An umbrella clause in the 1959 German–Pakistan BIT read as follows: ‘Each Contracting Party shall observe any obligation it has assumed with regard to investments in its territory by nationals or companies of the other Contracting Party.’

<sup>89</sup> For instance, the Czech Republic–Singapore BIT provides that ‘[e]ach Contracting Party shall not interfere with any commitments, additional to those specified in this Agreement, entered into by nationals or companies with the nationals or companies of the other Contracting Party as regards their investment.’

<sup>90</sup> See Article 2 (4) of the Italy–Jordan BIT, discussed in *Salini Costruttori SpA and Italstrade SpA v Jordan*, Decision on Jurisdiction, 15 November 2004 (ICSID Case No ARB/02/13) (2005) 44 ILM 563, para 126.

<sup>91</sup> Ibid; also *Noble Ventures* (n 71) para 50. Similarly, Crawford (n 70) 355 (emphasising that each umbrella clause must be interpreted in its own right); A Sinclair, ‘The Umbrella Clause Debate’ in AK Bjorklund, IA Laird and S Ripinsky (eds), *Investment Treaty Law: Current Issues III* (BIICL, London 2009) 283, 286 (commenting on *SGS v Pakistan* and noting that the disputed clause in the Switzerland–Pakistan BIT might not even be an umbrella clause as such). However, compare *El Paso* (n 83) para 70.

<sup>92</sup> There is also an unresolved tension about whether an umbrella clause protects contracts concluded with sub-entities, as opposed to contracts concluded with host states, and whether the protection extends to contracts entered into with investors’ subsidiaries. See *CMS Gas Transmission Company v Argentine Republic* (Annulment Proceeding) (2007) 46 ILM 1136, paras 95–97 (the ad hoc committee holding that an umbrella clause could not be relied upon by the investor who was not a party to the disputed contract); *Impregilo v Pakistan* (n 48) para 223 (concluding that the contract entered into between the investor and the Pakistan Water and Power Development Authority was not covered by the BIT). For a recent analysis of the problem, see N

beyond the traditional minimum standard<sup>93</sup> and may protect the investor ‘against any interference with his contractual rights, whether it results from a mere breach of contract or a legislative or administrative act, and independently of whether or not such interference amounts to expropriation.’<sup>94</sup>

Even in the cases where the wording of an umbrella clause follows the original model contained in the 1959 German–Pakistan BIT, it opens the door to investment claims going beyond the traditional remit of international law on the protection of foreign interests abroad. By enabling investors to bring contractual claims against host states in the absence of a breach of international law, umbrella clauses go further than non-expropriatory standards of treatment. The FET, non-discrimination, and non-arbitrariness standards entitle the investor to a remedy for state interference with contractual rights without the investor having to show a substantial deprivation. Just like non-expropriatory standards, umbrella clauses do not require the existence of a substantial deprivation. However, unlike non-expropriatory standards, the scope of umbrella clauses is not limited to discriminatory, arbitrary or otherwise patently wrongful conduct; rather, a mere failure to observe contractual commitments will usually amount to a treaty breach.

The decision in *SGS v Philippines* illustrates the potential of umbrella provisions to alter the scope of state responsibility in investment treaty law. While the tribunal was prepared to give effect to the umbrella clause in the applicable BIT, it found the claim inadmissible due to the existence of a domestic forum clause in the contract.<sup>95</sup> However, it is

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Gallus, ‘An Umbrella just for Two? BIT Obligations Observance Clauses and the Parties to a Contract’ (2008) 24 *Arbitration Intl* 157. See also Newcombe & Paradell (n 69) 457-9 (concluding that promises contained in a regulatory framework would frequently fall within the protective scope of umbrella clauses, providing that there is a legally significant connection between an investment and a unilateral undertaking by the host state).

<sup>93</sup> Schreuer (n 72) 250.

<sup>94</sup> FA Mann, ‘British Treaties for the Promotion and Protection of Investments’ (1981) *British Ybk Intl L* 241, 246.

<sup>95</sup> *SGS v Philippines* (n 44) paras 155, 162.

possible to conceive of a scenario where a contract either contains no domestic forum clause or provides for international arbitration. In other words, had the pre-shipment inspection contract in *SGS v Philippines* not referred disputes to municipal courts, the tribunal would have had to examine a claim based on a simple breach of contract. If successful, the investor would have been entitled to a contractual remedy enforceable in international law. An umbrella clause may not transform a breach of contract into an international wrong in the traditional sense, but it nonetheless internationalises contractual claims by giving rise to a state's responsibility for a breach which would not otherwise fall within the ambit of international law.

This far-reaching effect of umbrella clauses is unprecedented. International law contains examples of individual investor-state contracts that provided for binding arbitration of disputes.<sup>96</sup> However, the distinctive feature of umbrella clauses (as well as that of broadly formulated dispute resolution clauses) is that a promise to arbitrate *any* disputes is extended prospectively to an indefinite number of contracts in various economic contexts. As the unrivalled potential of umbrella clauses cannot be curbed by means of interpreting umbrella clauses restrictively, the inclusion of domestic forum clauses in a contract may offer a partial solution, providing that future tribunals follow the approach taken by the *SGS v Philippines* tribunal on the issue of the validity of a contractual clause referring disputes to domestic courts. As will be shown below, where a contract claim is brought under an umbrella clause, the presence of a domestic forum clause in such a contract gives rise to the problem of competing or parallel jurisdictions.

### 3. Umbrella clauses and competing jurisdictions

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<sup>96</sup> See, for example *Sapphire v NIOC* (1967) 35 ILR 136; *Lena Goldfields* (n 27).

As illustrated in *SGS v Philippines*, investment contracts may contain a domestic forum clause, referring contractual matters to the host state courts. Since umbrella clauses function as a means of bringing contract claims within the purview of investment tribunals, the question is whether the jurisdiction of domestic courts should prevail over that of international tribunals. The same question holds true in relation to investment treaties providing for investor-state arbitration of *any* or *all* disputes with respect to investment. A foreign investor can avoid the contractual forum selection clause by bringing the dispute directly before an international tribunal through the invocation of an umbrella clause or a broadly worded dispute resolution clause. This multiplicity of choices available to foreign investors leads to overlaps and jurisdictional conflicts.<sup>97</sup>

Where an investment treaty limits investor-state arbitration to treaty breaches only, the existence of a domestic forum clause in the contract would not preclude a tribunal from exercising its jurisdiction over alleged treaty violations. In the practice of investment arbitration, a distinction between treaty claims and contract claims was drawn in *Vivendi v Argentina*.<sup>98</sup> The case involved a concession contract referring disputes to the exclusive jurisdiction of the administrative tribunals of Tucuman. The ICSID tribunal distinguished between claims based on the BIT and claims based on the concession contract, and concluded that the forum selection clause in the concession contract did not preclude the investor's recourse to international arbitration in respect of violations of the BIT.<sup>99</sup> In addressing the merits of the case, however, the tribunal concluded that without going into detailed

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<sup>97</sup> See Y Shany, 'Contract Claims vs. Treaty Claims: Mapping Conflicts Between ICSID Decisions on Multisourced Investment Claims' (2005) 99AJIL835 (arguing that the multiplicity of forums available to foreign investors encourages forum shopping, multiple proceedings and conflicting decisions, and ultimately detracts from the predictability of investment law).

<sup>98</sup> *Compañía de Aguas del Aconquija SA and Compagnie Générale des Eaux v Argentina*, Award, 21 November 2001 (ICSID Case No ARB/09/3) (2001) 40 ILM 426 (hereinafter *Vivendi I*).

<sup>99</sup> *Vivendi I* paras 53-54.

considerations of the concession contract, it could not decide which actions of the province violated the BIT. In the tribunal's view,

[b]ecause of the crucial connection in this case between the terms of the Concession Contract and these alleged violations of the BIT, the Argentine Republic cannot be held liable unless and until Claimants have, as Article 16.4 of the Concession Contract requires, asserted their rights in proceedings before the contentious administrative courts of Tucuman and have been denied their rights, either procedurally or substantively.<sup>100</sup>

Subsequently, the tribunal decision was partially annulled on the ground that, by failing to examine the merits of some claims before it, the tribunal had manifestly exceeded its powers.<sup>101</sup> The annulment committee identified independent standards applicable in determining breaches of contract and breaches of a BIT respectively:

(1) a state may breach a treaty without breaching a contract, and *vice versa*;<sup>102</sup>

(2) where the fundamental basis of the claim is a treaty, the existence of an exclusive jurisdiction clause in a contract between the claimant and the respondent state or one of its subdivisions cannot operate as a bar to the application of the treaty standard;<sup>103</sup>

(3) it is one thing to exercise contractual jurisdiction vested in the administrative tribunals of Tucuman by virtue of the Concession Contract and another to take into account the terms of contract in determining whether there has been a breach of a distinct standard of

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<sup>100</sup> Ibid para 78. The tribunal concluded that 'the nature of the facts supporting most of the claims presented in this case make it impossible for the tribunal to distinguish or separate violations of the BIT from breaches of the Concession Contract without first interpreting and applying the detailed provisions of that agreement' (ibid para 79).

<sup>101</sup> *Compañía de Aguas del Aconquija SA & Vivendi Universal (formerly Compagnie Générale des Eaux) v Argentina*, Decision on Annulment (2002) 41 ILM 1135, paras 111-115. For a critical evaluation, see C Schreuer, 'Investment Treaty Arbitration and Jurisdiction over Contract Claims – the Vivendi I Case Considered' in T Weiler (ed) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, London 2005) 281.

<sup>102</sup> *Vivendi*, annulment, para 96. See also Alexandrov (n 20) 564 (commenting approvingly on the annulment decision and arguing that when treaty claims are asserted, treaty-based tribunals are bound to decide on those claims).

<sup>103</sup> Ibid para 101.

international law, such as that reflected in Article 3 of the BIT.<sup>104</sup>

According to the *Vivendi I* annulment decision, only where *the essential basis of a claim* is a breach of contract should a tribunal give effect to a choice of forum clause in the contract.<sup>105</sup> Where an alleged breach of contract also results in a violation of substantive treaty provisions, the choice of forum clause providing for domestic adjudication of contractual claims will not prevent a tribunal from establishing its jurisdiction and considering the merits of what would otherwise be a purely contractual matter. Thus, if a breach of a concession contract involves discriminatory and arbitrary measures, the fact that the concession contract contains a domestic forum clause will not preclude an investment tribunal from establishing its jurisdiction over the alleged treaty violations.

In practice, the distinction between treaty claims and contract claims is not straightforward, particularly in the cases where a treaty contains an umbrella clause. If the *Vivendi* test is applied to a claim brought under a BIT containing an umbrella clause, the latter would arguably transform a pure contract claim into a treaty claim and thus would enable the tribunal to examine the merits of the case regardless of a contractual forum choice. In other words, once an umbrella clause transforms a breach of contract into a treaty violation, a tribunal becomes competent to hear the merits of the claim despite a domestic forum clause. This gives rise to the problem of competing jurisdictions.<sup>106</sup> Which choice of forum should

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<sup>104</sup> Ibid para 105.

<sup>105</sup> Ibid para 98 (emphasis added). See Z Douglas, 'Nothing if Not Critical for Investment Treaty Arbitration: *Occidental*, *Eureko*, and *Methanex*' (2006) 22 *Arbitration Intl* 27, 40 (observing that the 'essential basis of a claim' test requires a tribunal to undertake an objective analysis of whether an alleged breach falls within the tribunal's jurisdiction *ratione materiae*, regardless of how a claimant presents its contention). The fundamental basis of a claim test was earlier applied in the *Woodruff Case (USA v Venezuela)* (1903-1905) 9 *RIAA* 213, and in *Oil Platforms Case* [1996] *ICJ Rep* 810. Some investment tribunals have adopted the test instead of simply accepting the characterisation of claims by the claimant. See *Joy Mining v Egypt* (n 72) paras 64-78; *Salini v Jordan* (n 90) paras 160-163; *Pantechniki SA Contractors and Engineers v Albania*, Award 28 July 2009, ICSID Case No ARB/07/21, para 67.

<sup>106</sup> See also B Cremades and DJ Cairns, 'Contract and Treaty Claims and Choice of Forum in Foreign Investment Disputes' in N Horn (ed) *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The

prevail: the one agreed in the contract or that provided for under an investment treaty containing an umbrella clause? It has been argued that a contractual forum selection clause made in favour of domestic courts should not be binding on an international tribunal. One rationale is that a breach of contract in violation of an umbrella clause already amounts to a breach of a treaty thus falling squarely under the tribunal's jurisdiction.<sup>107</sup> Where competing jurisdictions exist, it would be preferable for the entire dispute to be heard by the forum with the most comprehensive jurisdiction, namely, an investor-state tribunal.<sup>108</sup> Lest an investor-state tribunal's jurisdiction over the dispute becomes an empty shell, the arbitration choice in a BIT should prevail over the domestic forum choice in an investment contract.<sup>109</sup>

It is difficult to agree with this line of reasoning. Where the essential basis of a claim is that of a breach of contract, an umbrella clause should not override an express and exclusive forum selection clause.<sup>110</sup> In evaluating the umbrella clause's effect on a contractual forum selection choice, it is important to focus on the contract as the basis of the investor's claim. In the words of the *SGS v Philippines* decision, a party to a contract should not be allowed to approbate and reprobate with regard to the same contract.<sup>111</sup> If the contract is relied upon as a ground for the invocation of an umbrella clause of the applicable BIT, the

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Hague 2004) 327.

<sup>107</sup> See Schill (n 83) 66-7.

<sup>108</sup> C Schreuer, 'Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration' (2005) 4 L & Practice Intl Courts & Tribunals 1, 11-2 (suggesting that where competing jurisdictions exist it is preferable that the entire dispute is heard by the forum with the most comprehensive jurisdiction, namely, an investor-state tribunal).

<sup>109</sup> Gaillard (n 33) 334. However, compare Gaffney & Loftis (n 71) 29-30.

<sup>110</sup> In order to prevail over the reference to the jurisdiction of the international tribunal, a choice of forum should be exclusive. (Douglas (n 41) 375-7). See *Lanco International Inc v Argentina*, Preliminary Decision on Jurisdiction, 8 December 1998 (ICSID Case No ARB/97/6) (2001) 40 ILM 457, paras 25-26, and *Salini* (n 90) para 27 (holding that a reference to the jurisdiction of administrative tribunals cannot be opted for and hence does not qualify as a true contractual forum choice).

<sup>111</sup> See *North American Dredging Company of Texas (United States) v United Mexican States* (1926) 4 RIAA 26, 31 (criticising the claimant for reneging on its obligation to abide by a contractual choice of forum by instituting an international claim); Douglas (n 49) 372-5 (criticising the awards in *Eureko* and *Nykomb* where the respective tribunals have allowed claimant-investors to rely on the contract in establishing their disputed rights and ignoring the same contract's forum selection clause referring contentious matters to the jurisdiction of local courts). For more detail, see also Douglas (n 105) 38-46.



investor should abide by the terms of that contract before claiming a violation of a treaty. A breach of an investment treaty through a violation of an umbrella clause contained therein should not be deemed consummated until the investor abides by all terms of the contract, including its forum selection clause. Only where the investor has fulfilled the contractual terms should a breach of the contract by a state party trigger an umbrella clause.

Furthermore, an umbrella provision, as a general promise extended to all investors of the contracting state, cannot prevail over a forum selection clause because the latter operates as *lex specialis*, specifically agreed in a contract between the host state and an individual foreign investor.<sup>112</sup> There appears to be general agreement in the domestic law of the major developed countries that an express forum selection clause should be enforced as an inalienable part of the contractual bargain.<sup>113</sup>

Since it is largely undisputed that a forum selection clause constitutes part of the contractual bargain, scholars have invoked the doctrine of severability of arbitration agreements in an attempt to negate the validity of contractual forum selection clauses.<sup>114</sup> It has been argued that certain provisions of a contract can be relied upon in establishing a breach of an umbrella clause, whereas the domestic forum clause of the same contract can be severed and rendered ineffective.<sup>115</sup> This proposition is, however, seriously flawed. The very notion of severability was devised to ensure that a clause containing an agreement to arbitrate disputes, being viewed independently from the contract of which it was an integral part, remained enforceable and binding upon the parties even in the event that the contract had

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<sup>112</sup> C Schreuer, *The ICSID Convention: A Commentary* (Cambridge, CUP 2001) 362; *SGS v Philippines* (n 44) para 141.

<sup>113</sup> See R Doak Bishop, J Crawford and W Reisman, *Foreign Investment Disputes* (Kluwer Law International, The Hague 2005) 243-6 (pointing to the decision in *M/S Bremen v Zapata Off-Shore Company* [1972] 407 US 1 as an authority on the validity of forum selection clauses).

<sup>114</sup> Schill (n 83) 67-8.

<sup>115</sup> *Ibid.*

been terminated by the host state.<sup>116</sup> An arbitration clause, severed from the rest of the contract, would thus survive the termination of that contract and provide the basis for the concessionaire's right to bring its claim before an international tribunal.<sup>117</sup> If the doctrine of severability is applied in a contractual dispute under an umbrella clause, it does not detract from the binding force of a domestic forum clause. On the contrary, it reinforces the idea that certain contractual terms will remain effective regardless of a contracting party's willingness to abide by them. In other words, the notion of severability militates against a party ignoring the contractual forum choice where it relies on the contract as a basis of its claim. Just as with an arbitration clause in international oil concessions,<sup>118</sup> a dispute resolution clause can be regarded as a standalone agreement, enforceable despite the contract-holder's preference for a different means of dispute resolution.

In a similar vein, the idea of sanctity of contract, as a central tenet of umbrella protection, covers a contract in its entirety and protects the contractual choice of forum. If a failure to honour contractual obligations entered into by the host state with regard to an investment of the investor is seen as a breach of the umbrella clause, a failure to abide by the contractual choice of forum should similarly fall under the protective scope of the umbrella clause.<sup>119</sup> Recent arbitral practice contains examples where a state was found in breach of contract due to its failure to abide by a contractual clause referring disputes to ICSID

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<sup>116</sup> See Schwebel (n 2) 11.

<sup>117</sup> Ibid 24-59. The severability of an agreement draws support from *Delagoa Bay v Portugal* (1875), summarised in M Whiteman, *Damages in International Law* (United States Government Printing Office, Washington 1943) vol III, 1695-1703; *Lena* (n 27) para 14; *BP v Libya* (1977) 53 ILR 296, 354. See in particular *Texaco* (n 27) 410 (the arbitrator holding that the arbitration clause has a separate life in relation to the contract to which it refers).

<sup>118</sup> Schwebel's discussion of the severability of arbitration agreements draws much support from the international decisions in Middle East concession disputes.

<sup>119</sup> See Z Douglas, 'The Hybrid Foundations of Investment Treaty Arbitration' (2003) 74 British Ybk Intl L 151, 248 (noting that the parties' consent to investment treaty arbitration is no more solemn than their consent to the submission of their contractual disputes to a different forum).

arbitration.<sup>120</sup> From the point of view of legal policy and principle, the investor should equally be bound by its commitment to submit disputes to a forum designated in the contract. Investment tribunals, for their part, should refrain from asserting jurisdiction over contract claims which the parties had agreed to refer to domestic courts. It has been pointed out that by accepting jurisdiction over contractual disputes subject to a different forum, a tribunal may subvert the contractual certainty to the detriment of one of the parties and may undermine the sanctity of commercial undertakings.<sup>121</sup> In this context, it is interesting to recall the theory according to which a host state's reneging on an agreement to arbitrate amounts to a denial of justice.<sup>122</sup> Would there be a denial of justice if an international tribunal asserts its jurisdiction over a breach of contract and effectively abrogates a valid domestic choice clause of the same contract?

In different circumstances, a domestic forum clause in a contract acquires importance as part of the general framework which the host state is under a duty to provide. As noted above, in some treaties the original idea of sanctity of contract has transmuted into a more general obligation to 'create and maintain in its territory a legal framework apt to guarantee to investors the continuity of legal treatment, including the compliance, in good faith, of all undertakings assumed with regard to each specific investor.'<sup>123</sup> This standard was discussed in *Salini v Jordan*.<sup>124</sup> The tribunal refused to construe it as an observance of undertakings clause due to its distinctive formulation.<sup>125</sup> Indeed, the wording of the standard is more readily understood as an obligation to ensure the existence of a legal framework and not an

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<sup>120</sup> *Autopista* (n 30) paras 204-208.

<sup>121</sup> See Douglas (n 41) 364-6 (outlining policy considerations in favour of enforcing contractual jurisdiction clauses).

<sup>122</sup> Schwebel (n 2) 115-18.

<sup>123</sup> Article 2 (4) Italy-Jordan BIT, see above nn 101-102 and accompanying text.

<sup>124</sup> *Ibid.*

<sup>125</sup> *Ibid* para 126.

obligation to observe certain contractual commitments. The creation of a legal framework presupposes the availability of domestic courts and contractual remedies. Although the relevant provision in the Italy–Jordan BIT may not exactly qualify as an umbrella clause,<sup>126</sup> it would support giving effect to a domestic forum clause in a contract brought before an investment tribunal.

#### 4. Contract claims in investment arbitration: an umbrella clause as a super-protection standard

The focus of early critiques of investment arbitration was on the breadth of expropriation clauses and their effect on the contours of state responsibility in international law. Taking a closer look, however, it is clear that treaty provisions on dispute resolution as well as umbrella clauses have a greater capacity to expand the range of investor claims entitled to international protection and the corresponding change in the scope of state responsibility. In particular, umbrella clauses exhibit a hitherto unprecedented level of protection afforded to a variety of arrangements which investors may enter into with a host state. Under an umbrella clause, an investor need not establish a certain degree of deprivation or show the presence of discrimination, arbitrariness, and a breach of due process; the existence of a contract and carefully crafted umbrella provisions would entitle the investor to an internationally enforceable remedy.

It is interesting to observe that international investment instruments supporting the customary view of the international minimum standard and the fair and equitable treatment standard do not contain umbrella provisions. There is no umbrella clause in the NAFTA, or the US and Canada Model BITs. As Mexico has recently followed the suit of NAFTA in

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<sup>126</sup> See Crawford (n 70) 367 (noting that in *Salini v Jordan* it was not an umbrella clause at all).

adopting the customary view of FET, the 2006 UK–Mexico BIT contains no umbrella provision. This is in stark contrast with most UK BITs, which have invariably included an umbrella clause since the launch of the British bilateral treaty programme in the 1970s.<sup>127</sup> The recent practice of the US, Canada, and Mexico in concluding investment treaties with other states indicates that an umbrella clause does not fit well in the paradigm of investment protection, the contours of which are defined by the customary international minimum standard. In other words, while the customary view of FET is compatible with the view that a mere breach of contract would not amount to an international wrong, such an understanding is clearly at odds with the idea that umbrella protection can transform any breach of contract into a treaty breach. By entitling investors to an internationally enforceable remedy in pure contract claims, an umbrella clause provides for treatment that goes far beyond the limits of the international minimum standard. Interpretation alone cannot mitigate the far-reaching effects of an umbrella clause because the formulation of such a clause in investment treaty texts frequently leaves no room for doubt as to its precise import.

For host governments which desire to pre-empt the operation of umbrella provisions under the existing BITs one possible solution would be to include, in investment contracts, a clause expressly and unequivocally providing for adjudication of disputes in domestic courts. This solution is, however, not a panacea because it is difficult to predict whether tribunals will apply an umbrella clause to override the domestic forum clause or whether they will choose to give effect to the latter. Until a great number of existing BITs are revised, umbrella clauses will continue to equip investors with an unrivalled instrument of protection, thus entailing a

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<sup>127</sup> On the launch of the UK bilateral investment programme, see E Denza and S Brooks, 'Investment Protection Treaties: United Kingdom Experience' (1987) 36 ICLQ 908.

host of criticisms against the whole system of investment protection.<sup>128</sup>

## 5. Beyond umbrella clauses: the role of investment contracts in protecting investors against host state interference

### 5.1. Specific commitments as a relevant factor in determining host state responsibility toward a foreign investor

Umbrella clauses and open-ended dispute settlement provisions of BITs are not the only means by which an investor can bring its contract claims in arbitral proceedings against a host state. The practice of investment arbitration shows that a liberal interpretation of the FET standard may also enable an investor to present a breach of contract as a violation of the applicable BIT. For example, in *Noble Ventures v Romania* the tribunal construed FET as a general standard providing for full protection and security, the prohibition of arbitrary and discriminatory measures and the obligation to observe contractual obligations towards the investor.<sup>129</sup> According to this interpretation, a breach of contract alone would amount to a

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<sup>128</sup> At present, it remains hardly conceivable that a construction business from Pakistan would claim against the Swiss government for a violation of an umbrella clause due to a breach of a contract. One of the reasons is that major capital exporting economies remain largely out of the reach of investment initiatives from small and medium sized enterprises from traditional capital importing states. It has been observed that recently EU economies have become difficult to enter due to the complex regulatory limitations on the capacity of non-EU investors to enter the markets of such countries as Germany and the UK. See, for instance, C Rumberg, 'New restrictions for investment into Germany by non-EU and EFTA investors', In-House Lawyer, 10 October 2009 (discussing how recent amendments to the AWG, as well as to the German Foreign Trade and Payments Regulations (Aussenwirtschaftsverordnung (AWV)) that came into force on 24 April 2009, have given the German authorities wider rights to review and restrict investments by investors from outside the EU or the European Free Trade Association (EFTA)). See also UNCTAD, Foreign Direct Investment database, <[http://www.unctad.org/sections/dite\\_dir/docs/wir09\\_fs\\_ch\\_en.pdf](http://www.unctad.org/sections/dite_dir/docs/wir09_fs_ch_en.pdf)> and <[http://www.unctad.org/sections/dite\\_dir/docs/wir09\\_fs\\_ch\\_en.pdf](http://www.unctad.org/sections/dite_dir/docs/wir09_fs_ch_en.pdf)> (showing a negligible proportion of investment from developing countries to the United Kingdom and Switzerland). See also S Hindelang, *The Free Movement of Capital and Foreign Direct Investment: The Scope of Protection in EU Law* (OUP, Oxford 2009) 4-5 (noting that direct investment from developing countries leads to considerable scepticism and sometimes irrational hostility among some EU Member States).

<sup>129</sup> *Noble Ventures v Romania* (n 71) para 182.

breach of FET even in the absence of discrimination, due process and arbitrariness. Once a breach of contract is included within the protective scope of FET, an investment contract becomes internationalised, at least so far as the investor's entitlement to an international remedy is concerned. Unlike internationalisation through umbrella clauses and dispute settlement provisions, using the FET standard to bring a contract claim before an international tribunal is not supported by the wording of investment treaty texts. Neither does it have a basis in customary international law. Since there are treaties which allow the arbitration of contract claims through the express incorporation of the relevant provisions, such as umbrella clauses, it seems that the correct approach would be for tribunals to refrain from deploying FET in an attempt to extend the treaty protection to a contract claim. In other words, where a BIT does not explicitly provide for arbitration of pure contract claims, it would be inappropriate for a tribunal to deploy a liberal interpretation of FET and thus modify the state parties' agreement on the settlement of contract-related disputes.

Troublesome as it is, the fact that FET can be used in internationalising contract claims alludes to an overlap between various standards of treatment. Among these standards, an umbrella clause may be regarded as a specialist provision aiming exclusively at the protection of the contractual undertakings of an investor. As noted earlier, umbrella clauses have a wider reach than the expropriation standard that was traditionally invoked in cases involving a breach of an investment contract. For the umbrella protection to be triggered, a breach of contract need not be confiscatory or even involve the taking of something of a value. Nor does it require establishing the existence of an international illegality in the form of discrimination, abuse of process, or arbitrariness. If existing treaties are to be revised and the sanctity of contract guarantees to be disciplined against a coherent theory of state responsibility by means of adopting an overarching standard of treatment, should such a

standard include the protection of an investor's contractual rights?

It has been suggested that a host state should be held responsible for an interference with a foreign investment if such an interference violates specific commitments made to the investor. In other words, a regulatory act should be compensable in a case where the host state reneges on contractual and other commitments.<sup>130</sup> Indeed, there is a growing support for the view that the existence of specific commitments operates as another legal restraint on the exercise by a state of its power to regulate foreign investment. For instance, in *Methanex v United States* the investor contended that a governmental decision to phase out methanol-based additives from gasoline constituted expropriation of its business interests in methanol production.<sup>131</sup> The tribunal disagreed. It held that

[a] foreign 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.<sup>132</sup>

Although *Methanex* did not involve a termination of contractual rights, the tribunal's statement indicates that the presence of specific commitments assumed by the host state towards the foreign investor can play an important role in establishing whether a particular regulatory act constitutes expropriation.

The significance of specific commitments was also highlighted in *Continental Casualty v Argentina*.<sup>133</sup> In this case, the investor owned and controlled one of Argentina's leading providers of workers compensation insurance services. Its investment was mainly

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<sup>130</sup> See A Newcombe, 'The Boundaries of Regulatory Expropriation in International Law' (2005) 20 ICSID Rev – Foreign Investment L J 1, 46.

<sup>131</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345.

<sup>132</sup> Ibid, Part IV Ch. D, para7. Prior to *Methanex*, the existence of specific commitments as a factor to be taken into account in the expropriation analysis was mentioned in *Metalclad Corporation v Mexico*, Award, 25 August 2000 (ICSID Case No ARB (AF)/97/1) (2001) 40 ILM 36 and *Feldman v Mexico*, Award, 16 December 2002 (2003) 18 ICSID Review-FILJ 488.

<sup>133</sup> *Continental Casualty v Argentina* (n 71).



comprised of a portfolio of low risk assets, such as cash deposits, treasury bills and government bonds. The dispute was brought before a BIT tribunal following the economic, political and social crisis that hit Argentina in 2001 leading to a number of drastic measures, including the abolition of the convertibility regime, the introduction of bank deposit freezes and foreign exchange controls. The investor contended that a compulsory conversion of existing dollar-denominated assets into peso ought to be measured against the floating market value of the peso against the dollar, with the resulting difference between the two rates constituting expropriation. The tribunal disagreed. It held that the issue was rather ‘whether Argentina had given a commitment to the foreign investor that those assets would be linked to the U.S. dollar, thereby meaning the convertible currency of the U.S. under U.S. law, and would be immune from any evolution of the currency regime within Argentina.’<sup>134</sup> As no evidence of such specific commitments was presented before the tribunal, a claim of expropriation was rejected.<sup>135</sup>

The role of specific commitments was also stressed by the tribunal in *Parkerings v Lithuania*.<sup>136</sup> In addressing the investor’s claim alleging state interference with its project through the modification of the legal regime, the tribunal pointed out that

[s]ave for the existence of an agreement, in the form of a *stabilisation* clause or otherwise, there is nothing objectionable about the amendment brought to the

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<sup>134</sup> Ibid para 279.

<sup>135</sup> See also *National Grid v Argentina*, Award, 3 November 2008, paras 151-152, referring to R Higgins, ‘The Taking of Property by the State: Recent Developments in International Law’ (1982) 176 *Recueil des Cours* 259, 338-39 (commenting on the *Martini Case* and observing that ‘governments may indeed need to be able to act qua government and in the public interest, but that is not to liberate them from the obligation to compensate those with whom it has entered into specific arrangements’). See also Z Douglas and J Paulsson, ‘Indirect Expropriation in Investment Treaty Arbitrations’ in N Horn and S Kröll, *Arbitrating Foreign Investment Disputes* (2004) 157. Despite acknowledging the importance of specific commitments as a prerequisite for state liability in a regulatory expropriation claim, the *National Grid* tribunal placed greater emphasis on the criterion of state interference.

<sup>136</sup> *Parkerings-Compagniet AS v Lithuania*, Award on Jurisdiction and Merits, 14 August 2007 (ICSID Case No ARB/05/8).

regulatory framework existing at the time an investor made its investment.<sup>137</sup>

Investment treaty texts also show a growing emphasis on specific commitments as a prerequisite for host state liability in regulatory expropriation claims. The recent generation of BITs and FTAs, including those of the US, Canada and Mexico stipulate that the determination of whether a government's conduct constitutes expropriation should take into account 'the extent to which the government action interferes with distinct, reasonable investment-backed expectations.'<sup>138</sup> The provision on expropriation in the ASEAN-Australia-New Zealand FTA is even more nuanced. Among the key criteria for establishing an indirect expropriation, the pertinent clause requires examining 'whether the government action breaches the government's prior binding written commitment to the investor whether by contract, licence or other legal document.'<sup>139</sup>

While the foregoing examples indicate that the existence of specific commitments play a significant role in establishing a host state's liability for an interference with an investment, it is submitted that the requirement for specific commitments does not operate as a standalone condition for establishing a host state's responsibility. That is, the fact that a host state has acted contrary to its contractual commitments assumed towards an investor does not change the basis of state responsibility. Regardless of the existence of a contract, a host state should be held responsible for a conduct which is discriminatory, arbitrary and contrary to due process. In the case where a host state has committed itself under a contract with an investor, that fact alone does not necessitate modifying the proposed test of state responsibility or adopting an alternative test. The existence of specific commitments does not totally preclude a

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<sup>137</sup> Ibid para 332.

<sup>138</sup> See for instance Article 4 (b) (ii) of the Annex on Expropriation in the US – Uruguay BIT (2005), and Annex A 'Clarification on Indirect Expropriation' in the Canada – Czech Republic BIT (2009).

<sup>139</sup> See Article 3 (b) of the Annex on Expropriation and Compensation of the ASEAN-Australia-New Zealand FTA <<http://www.dfat.gov.au/trade/fta/asean/aanzfta/chapters/chapter11.html>> accessed 2 July 2010.

state from interfering with an investor's business but it does impose upon the state a duty to *take into account* its commitments and the effect of its subsequent regulatory conduct upon an investor. In other words, contractual commitments prescribe the extent of a host state's obligation to treat an investor in a non-discriminatory, non-arbitrary manner and in compliance with due process of law.

Consider, for example, a governmental ban prohibiting the use of a certain fuel additive due to its harmful environmental impact. If an investor's right to engage in producing and distributing a fuel additive has been guaranteed in a contractual or a quasi-contractual form, the investor becomes entitled to an additional layer of protection not available to an analogous business that has not been given any specific commitments. The environmental ban may be generally non-arbitrary and compliant with due process of law. If viewed against the fact that a state committed itself to a certain course of action, however, the same measure would warrant a different assessment. It would be arbitrary for the state to adopt a regulation without providing a redress mechanism for expenses incurred by an investor whom the state has induced into investing, based upon a belief that the business will continue unaffected by regulation. Similarly, a generally due-process compliant measure may not be so compliant if examined against a host state commitment undertaken towards an investor; the latter's case would require specific due process requirements in accordance with the applicable law of contract and procedural law. In other words, an assessment of arbitrariness, discrimination and due process may be more nuanced in a case where the investor has secured contractual or similar undertakings from the host state. In practical terms, in the absence of specific commitments, an environmental regulation requires the availability of judicial review to affected businesses. However, in the case where a host state assumed specific commitments toward an investor, due process may also necessitate a notice, a special remedial regime, and

possibly a duty to renegotiate in a good faith as well as other specific rights to which the investor may be entitled by virtue of its contractual or quasi-contractual arrangement with the host state. By committing itself to act in a certain way a host state does not abdicate its regulatory powers but instead assumes an obligation to regulate without neglecting its other obligations. Thus, the fact that a host state's act was contrary to specific commitments does not transform such an act into a compensable international wrong; rather, it creates an entitlement to a non-discriminatory, non-arbitrary and procedurally fair treatment *informed* by the commitments the host state had assumed towards the investor under a contractual or quasi-contractual instrument.<sup>140</sup>

## 5.2. Contract and establishing the existence of a 'covenanted benefit'

Investment contracts are also instrumental in establishing the existence of a right or benefit that an investor has allegedly lost due to host state interference. It has long been recognised a mere deprivation of an 'uncovenanted benefit' does not give rise to a state's responsibility in international law.<sup>141</sup> Again, the fact that a contract entered into between a host state and an investor was subsequently changed, terminated or otherwise reneged upon does not transform the relevant governmental conduct into a compensable international breach. Rather, a contract may evidence the existence of a certain benefit which the investor claims to have lost. Here, a right accruing to the investor by virtue of a contract is akin to an acquired right. The doctrine of acquired rights featured prominently in the early writings on expropriation but has not

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<sup>140</sup> Commitments must be specific. See generally Crawford (n 70).

<sup>141</sup> BA Wortley, *Expropriation in Public International Law* (University Press, Cambridge 1959) 51, distinguishing between the loss suffered by the owner of a gasoline station due to the road having been moved to a different location and the loss suffered by the taking of the land on which the gasoline station is based. A loss caused by the relocation of the road does not furnish a basis for the obligation to compensate because unlike the use of land, the use of a public road represents an uncovenanted benefit.

enjoyed widespread support.<sup>142</sup> However, the recent emphasis on ‘specific commitments’ shows that the ‘acquired right’ approach is not devoid of meaning and can be deployed as a useful conceptual framework when analysing investor claims challenging the measures of a host state. Two important elements of acquired rights are the possibility of assessing the value of the interest at issue and the fact that the entitlement has been properly acquired.<sup>143</sup> ‘To receive protection of international law an interest must have been properly vested, bona fide acquired and duly evidenced.’<sup>144</sup> If viewed through the lens of the acquired rights doctrine, a contractual entitlement to a certain benefit would arise only if properly acquired and evidenced. The mere fact of committing capital and resources would not furnish the basis of an acquired right; rather, something in the form of an individual and concretised promise granting a benefit upon the investor would be necessary.

The PCIJ decision in *Oscar Chinn* highlights the relevance of the acquired rights doctrine in addressing investor claims challenging regulatory measures. In this case, along with claiming discriminatory treatment, the UK Government contended that by ordering a national transportation company to lower its carriage charges the Belgian Government indirectly deprived Mr. Chinn of ‘any prospect of carrying on his business profitably’ and violated ‘the general principles of international law, and in particular of respect for vested rights.’<sup>145</sup> The court held that despite the change in Mr. Chinn’s financial position it was

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<sup>142</sup> See *Rudloff Case*, US-Venezuelan Claims Commission, Interlocutory Decision (1903) 9 RIAA 244, 250 (‘The taking away or destruction of rights acquired, transmitted, and defined by a contract is as much a wrong, entitling the sufferer to redress, as the taking away or destruction of tangible property’) and *Oscar Chinn Case (UK v Belgium)* (Judgment) [1934] PCIJ Ser A/B No 63. The acquired rights doctrine was at the heart of the discussion of the ILC, ‘Fourth Report on Responsibility of the State for Injuries Caused in its Territory to the Person or Property of Aliens—Measures Affecting Acquired Rights’ (26 February 1959) UN Doc A/CN.4/119. More recently, A Reinisch, ‘Expropriation’ in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 411; M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 419-20.

<sup>143</sup> DP O’Connell, *State Succession in Municipal Law and International Law* (CUP, Cambridge 1967) vol I, 247.

<sup>144</sup> *Ibid.*

<sup>145</sup> (n 142) 87.

‘unable to see in his original position—which was characterized by the possession of customers and the possibility of making a profit—anything in the nature of a genuine vested right.’<sup>146</sup> Revisiting the existing investment arbitration awards in light of the acquired rights doctrine produces interesting findings. It appears that although the buildings and patents in *Methanex* might have qualified as acquired property, its right to produce and sell methanol products could not be characterised as a vested right unless documented in a contract or quasi-contractual arrangement. Similarly, the shareholding in *Saluka* was an acquired property but its entitlement to receive state aid would have been protected as an acquired right only if the host state had made commitments to that effect.

The award in *Eureko v Poland* illustrates the practical importance of the acquired rights approach in determining the host state’s responsibility for regulatory measures.<sup>147</sup> At the heart of the dispute was the investor’s allegation that its right to acquire additional shares through an Initial Public Offering (IPO) had been expropriated because the State Treasury failed to comply with the terms of an addendum to the contract providing for the conduct of the IPO. The tribunal held that under the contract, the Treasury was bound to conduct an IPO and that the failure to perform this obligation amounted to an expropriation of the claimant’s right ‘to acquire additional shares.’<sup>148</sup> In accordance with the Polish law of contract, an obligation to conduct an IPO was simply an obligation of due care and diligence and not an obligation of result.<sup>149</sup> Accordingly, the right to acquire additional shares—which the investor claimed to have been expropriated—was contingent and could not qualify as an acquired right

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<sup>146</sup> Ibid 88.

<sup>147</sup> (n 15).

<sup>148</sup> Ibid para 240.

<sup>149</sup> *Eureko v Poland*, Professor Jerzy Rajski’s Dissenting Opinion, para 4 (noting that, by signing an addendum to the contract, the parties agreed that in case the IPO was not completed by the end of 2001, they would unconditionally undertake to adopt a new timetable for the IPO. However, the agreement did not specify the time limit for the performance of the undertaking which, therefore, was a duty of due care and diligence and did not bind the parties to achieve the envisaged result. See also Douglas (n 105) 44.

duly vested and having an assessable monetary value. However, the tribunal failed to scrutinise the contract against the applicable law in order to establish the existence of a valid contractual right entitling the investor to a material benefit.<sup>150</sup> It is unsurprising that the award was accompanied by a dissenting opinion by a member of the arbitral panel and vigorous criticism in academic writings.<sup>151</sup> So far as the role of contract in protecting foreign investment is concerned, the *Eureko* award highlights two important aspects. First, the acquired rights doctrine may play a useful role by discerning between the rights having an assessable monetary value and duly acquired by the investor, and other contingent rights. Second, the award illustrates the importance of identifying and applying the proper law to a claim arising from a contract.<sup>152</sup> While it is undisputed that international treaties may contain an obligation to honour contractual promises given by a state to a private party, this does not mean that the existence of a certain contractual right, such as a right to payment, right to performance or a right to acquire additional shares, can be established as a matter of international law, *i.e.* without interpreting and analysing the contract itself.<sup>153</sup> It is true that the performance of contractual commitments can be guaranteed by international law and thus viewed as a matter subject to the principles and rules of international law. However, the existence of a contractual right remains a matter of contract interpretation and should be

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<sup>150</sup> Ibid.

<sup>151</sup> Ibid.

<sup>152</sup> See Douglas noting that ‘international law does not apply to the question of what entitlements the investor actually has deriving from a contract subject to municipal law and the municipal courts’ (Douglas (n 105) 45). See also J W Yackee, ‘Toward a Minimalist System of International Investment Law?’ (2009) 32 *Suffolk Transnatl L Rev* 303, 324 (arguing for a minimalist investment law and observing that a major role should be allocated to the municipal law of the host state because when making their decision to invest, foreign investors analyse (or should do so) domestic laws and regulations that govern various aspects of investment activity in the territory of the host state).

<sup>153</sup> See *EnCana Corporation v the Republic of Ecuador* (2006) 45 ILM 655, para 184 (for there to have been an expropriation of an investment or return (in a situation involving legal rights or claims as distinct from the seizure of physical assets) the right affected must exist under the law which creates them, in this case, the law of Ecuador). See also Schreuer (n 108) 3 (noting that domestic courts may play a useful part in the process of determining if and to what extent the property or contract rights in question existed in the first place). Also, Newcombe & Paradell (n 69) 92-3.

decided in accordance with the proper law of contract.<sup>154</sup> Having found the state responsible for divesting the investor of the management rights it might have enjoyed after the IPO, the *Eureko* tribunal failed to duly examine whether the investor's right to acquire additional shares had a proper legal basis in the contract and the applicable national laws.

A failure to look into the existence of an entitlement is not exclusive to contractual claims. Neither has it been a problem plaguing the application of the expropriation standard only. For instance, in *Feldman v Mexico*,<sup>155</sup> a dispute arose from Mexico's refusal to rebate excise taxes applied to exported cigarettes. To qualify for tax rebates, cigarette exporters were required to provide itemised invoices stating the tax amounts separately. While both producers and resellers were formally allowed rebates, only the producers had access to the itemised invoices. A claim of *de facto* discrimination was brought by an investor which had been denied tax rebates, while some resellers and exporters in like circumstances had been granted them, despite their inability to comply with the invoice requirements. The tribunal found that the claimant had established a presumption and a *prima facie* case of discrimination, and Mexico failed to introduce any credible evidence to rebut that presumption thus allowing the tribunal to draw an adverse inference. The tribunal held that it was irrelevant for the purposes of NAFTA Article 1102 that Mexican law had not authorised rebates in the absence of invoices setting out the tax amounts separately. Although Mexico was entitled to strictly enforce its laws, the fact that rebates had been provided to domestically owned cigarette exporters while being denied to the foreign investor, was sufficient to establish discrimination under Article 1102.<sup>156</sup> The major problem with the arbitral award in

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<sup>154</sup> See also K Hober, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation* (Juris Publishing, New York 2007) 170 (observing that, in the general context of expropriation, municipal law is often decisive in determining whether expropriation has occurred).

<sup>155</sup> *Feldman v Mexico*, Award, 16 December 2002 (2003) 18 ICSID Review-FILJ 488.

<sup>156</sup> *Ibid* para 169.



*Feldman* is the fact that the investor was awarded compensation for damages calculated by reference to the tax rebates to which it had never been entitled.<sup>157</sup> The finding of discrimination under the national treatment standard served as the basis for conferring on the investor a benefit which it never possessed. The award illustrates the ramifications of a failure to analyse whether an investor owned an asset of which it has allegedly been deprived by a governmental act or omission. Under a critical assessment, it is clear that in both *Feldman* and *Eureko*, the discussion of a breach of the applicable BIT dominated the analysis. Instead of scrutinising whether the disputed governmental conduct deprived the investor of a duly acquired right, both tribunals largely confined themselves to discussing the existence of a treaty breach. In the given context, embracing the doctrine of acquired rights might have alleviated the insufficient analyses. Insisting on the need to show the existence of a properly acquired and duly evidenced right would mitigate against the current preoccupation with showing a breach of investment protection standards, and also against the unbridled potential of the inadequately defined notion of investment which seems to be partially responsible for the failings discussed above.<sup>158</sup>

It is important to note that establishing the existence of a bona fide acquired and duly evidenced right (a covenanted benefit) is different from establishing the existence of an eligible investment. For example, in *Chemtura v Canada*, the tribunal held that in order for an expropriation to be found it was necessary to establish whether there was an investment capable of being expropriated and whether that investment has in fact been expropriated.<sup>159</sup> The difficulty with this analysis is not its focus on expropriation but rather the fact that by

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<sup>157</sup> Ibid paras 199-205.

<sup>158</sup> See Douglas (n 41) 165, criticising *Feldman* for the tribunal's failure to analyse the existence of the investment that had allegedly been harmed by the conduct of the Mexican authorities.

<sup>159</sup> *Chemtura Corporation v Canada*, Award, 2 August 2010 (Ad hoc—UNCITRAL Arbitration Rules) para 242.

focusing on the existence of an investment a tribunal may fail to scrutinise whether an investor possessed a particular right or asset which it claims to have lost. As exemplified in *Feldman* and *Eureko*, although the investor may have committed resources qualifying as an investment, the investor's entitlement to something it has allegedly been deprived may not be certain. For instance, in *Eureko* the investor's shareholding was undoubtedly a qualifying investment but as the tribunal focused on the the existence of such an investment it failed to properly examine whether a disputed entitlement to additional shares had been *bona fide* acquired and duly evidenced. While establishing the existence of an investment is essential, the validity of an investor's claim alleging the loss should be evaluated separately. The 'acquired right' approach seems to be a way forward.

## 6. Outlining the policy options

In conclusion, it seems only fair to acknowledge that an investment contract may play a role in protecting investors against host state interference. Having analysed existing investment treaty practice and various arbitration awards, it is possible to identify two different policy approaches which host states may adopt. First, host states may incorporate umbrella clauses and open-ended dispute resolution provisions that would bring pure contract claims within the jurisdiction of investor-state tribunals, including ICSID tribunals. Particularly in the context of ICSID arbitration, this would entitle an investor to the privilege of obtaining an international remedy that can be enforced directly against a host state. The degree of sacrosanctity thus far afforded to an investor's contract is largely unprecedented, as it goes beyond the advantages of international commercial arbitration and domestic adjudication in most sophisticated national legal systems. In adopting this option, contracting states should carefully consider the impact on their regulatory freedom and the fact that domestic investors

are not entitled to the same protection of their contracts vis-à-vis governments. It is also crucial to take into account the potential ramifications of this pro-investor model which may undermine the long-term credibility and sustainability of investor-state arbitration by causing host states to withdraw from their international investment instruments.

Another alternative would be to re-model the protection of investor-state contracts in accordance with a more balanced paradigm of state responsibility. This option is underpinned by the idea that a host state should be held responsible only for an interference which is arbitrary, discriminatory, and in violation of due process of law. The fact that the host state has acted contrary to its commitments undertaken under a contract or a similar instrument would not alone suffice for holding the state responsible. Under this model of state responsibility in investment treaty law, an investor's rights under a contract are protected by a general guarantee of non-discriminatory, non-arbitrary and procedurally fair and non-abusive treatment. An investment contract does not totally shield an investor from the effects of governmental activities but rather adds an extra layer of protection by prescribing the extent of these general guarantees and, where agreed in the contract, entitling the investor to specific rights (i.e. renegotiation and adaptation) and specific remedies.<sup>160</sup> Here, the host state remains bound by internationally recognised norms of investment treatment and retains its freedom to intervene in the marketplace in pursuit of its economic and social policies. Some investment treaty instruments already support this model of investment protection by omitting umbrella clauses, narrowing the scope of the state consent to arbitration, and referring to customary international law as the basis of the international minimum and FET standards.

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<sup>160</sup> For a discussion of renegotiation and adaptation of investment contracts, see S Kroll, 'The Renegotiation and Adaptation of Investment Contracts' in N Horn and S Kröll, *Arbitrating Foreign Investment Disputes* (Kluwer Law International, The Hague 2000) 425.

## **CHAPTER VII:**

### **FAIR AND EQUITABLE TREATMENT: AN OVERARCHING STANDARD?**

It has been argued throughout this thesis that the traditional expropriation standard should be abandoned in favour of an overarching standard of treatment which would clearly outline parameters of an internationally impermissible treatment of investments and investors. By focusing on the manner in which a government interferes with foreign investment in the exercise of its regulatory powers, the proposed standard should replace the effect-based analyses. It can thus draw a uniform basis under the institution of state responsibility in investment treaty law and facilitate the development of a balanced, credible and conceptually consistent mechanism of investment protection. While aiming to eliminate the overlap and redundancy of investment treaty provisions, the overarching standard should reinforce the guarantees of non-discrimination, non-arbitrariness and due process of law.

Can the fair and equitable treatment standard be designated as an overarching standard of investment protection and the heir to the guarantee of uncompensated expropriation? This chapter will critically examine the emergence and evolution of FET in investment treaty practice and arbitration. It will argue that as a matter of principle the FET standard can provide a platform for a unified concept of an investment treaty breach. The chapter intends to demonstrate that from the perspective of developing a sustainable investment protection regime, the FET standard ought to be construed as a conglomerate of basic international guarantees against discrimination, arbitrary treatment and violations of due process.

#### **1. FET as an overarching standard**

The emergence of the fair and equitable treatment (FET) standard and its rise to prominence

has been a defining feature of the international law of foreign investment during the past two decades.<sup>1</sup> While the protection of investment under traditional international law was virtually synonymous with the protection against uncompensated expropriation<sup>2</sup>, FET has become the leading non-expropriatory standard of treatment dominating the law as it stands today. It has been observed that ‘not to invoke FET where it is available under an applicable treaty would probably have to be considered as amounting to malpractice.’<sup>3</sup> Arbitral awards amply illustrate the expanding role of FET in the protection of foreign investment under BITs. A prominent example is *CMS v Argentina*, where the dispute concerned the investor’s investment in TGN, a privatised gas transportation company.<sup>4</sup> The key feature of the regime agreed between the parties was that tariffs were to be calculated in dollars and converted into pesos at the prevailing exchange rate and adjusted every six months according to the US Producer Price Index to reflect changes in inflation. Following the severe economic crisis in Argentina, the government adopted emergency measures, abolishing the adjustment of tariffs and reforming the foreign exchange law. The investor argued that the governmental measures led to a 92 percent drop in the value of its shares in TGN, amounting to an expropriation, as well as a violation of FET, the arbitrary or discriminatory measures standard, and the umbrella clause. The tribunal was not prepared to grant the investor’s claim of expropriation. It noted that the investor retained full control, management and ownership of its investment

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<sup>1</sup> Even in the 1990s, of some 335 BITs only 28 did not contain an FET clause. UNCTAD, *Fair and Equitable Treatment* (United Nations, New York & Geneva 1999) 22, referring to M Khalil, ‘Treatment of Foreign Investment in Bilateral Investment Treaties’ (1992) 7 ICSID Review – Foreign Investment L J 339, 355.

<sup>2</sup> C Schreuer, ‘Interrelationships of Standards’ in A Reinisch, *Standards of Investment Protection* (OUP, Oxford 2008) 1.

<sup>3</sup> Ibid 2. See also S Fietta, ‘Expropriation and the “Fair and Equitable” Standard’: The Developing Role of Investors’ “Expectations” in International Investment Arbitrations (2006) 23 J Intl Arbitration 375, 399 (noting that where doubts exist as to whether the expropriation threshold can be satisfied ‘the investor would be advised to construct its investment treaty complaint around a self-standing claim of violation of the fair and equitable standard’).

<sup>4</sup> *CMS Gas Transmission Company v Argentina*, Award, 12 May 2005 (ICSID Case No ARB/01/8) (2005) 44 ILM 1205.

and, therefore, the challenged measures fell short of the level of substantial deprivation necessary for establishing an indirect expropriation.<sup>5</sup> Likewise, the tribunal found no discrimination or arbitrariness in the disputed measures.<sup>6</sup> However, Argentina was found responsible for a breach of FET. In the tribunal's view, the government failed to treat the investment fairly and equitably as the emergency legislation entirely transformed and altered the legal and business environment under which the decision to invest had been made and executed.<sup>7</sup> Despite the fact that no expropriation was found to have occurred, the tribunal awarded the investor compensation in the amount corresponding to the fair market value of its shares (following which the shares were to be transferred to the Argentine Republic).<sup>8</sup> In explaining its decision on liability, the tribunal stated that while the award of the fair market value would be appropriate in the case of expropriation, it could also be applied in redressing breaches that result in 'important long-term losses.'<sup>9</sup>

In *Azurix v Argentina*, the dispute arose from a concession for the provision of potable water and sewerage services concluded with the Province of Buenos Aires.<sup>10</sup> The investor claimed that Argentina was responsible for the actions and omissions of the Province that frustrated its rights under the concession contract. The conduct complained of included the non-application of the tariff regime of the concession for political reasons, the Province's failure to complete certain works to remedy historical problems, and the lack of support for the concession regime preventing the investor from obtaining further financing. The tribunal found the disputed conduct to be in breach of FET.<sup>11</sup> It criticised the government for its

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<sup>5</sup> Ibid paras 263-264.

<sup>6</sup> Ibid para 295.

<sup>7</sup> Ibid para 275.

<sup>8</sup> Ibid para 469.

<sup>9</sup> Ibid para 410.

<sup>10</sup> *Azurix Corp v Argentina*, Award, 23 June 2006 (ICSID Case No ARB/01/12).

<sup>11</sup> Ibid para 377.

refusal to accept Azurix's notice of termination and its insistence on terminating the concession agreement unilaterally, the politicisation of the tariff regime, and for its interference with the contract by urging customers not to pay their bills.<sup>12</sup> The tribunal also held the government responsible for arbitrary measures and a failure to provide full security and protection.<sup>13</sup> After declining the investor's claim of expropriation because ownership and control had remained unaffected, the tribunal nevertheless awarded compensation in the amount corresponding to the fair market value of the investment.<sup>14</sup>

*CMS* and *Azurix* illustrate two important and interrelated aspects of contemporary international investment law: the shift from expropriation to non-expropriatory treaty standards and the emergence of FET as an overriding provision encompassing the otherwise free-standing guarantees of non-arbitrariness, non-discrimination, and due process of law. A similar pattern can be discerned in other investment treaty awards.<sup>15</sup>

It is the flexibility of FET enabling investors to obtain a remedy in a wider range of circumstances that has altered the landscape of international investment law. Indeed, in *Sempra v Argentina*, the tribunal explained the growing role of FET with reference to its remedial scope. The tribunal drew attention to the fact that FET

...ensures that even where there is no clear justification for making a finding of expropriation, as in the present case, there is still a standard which serves the purpose of justice and can of itself redress damage that is unlawful and that would otherwise pass unattended.<sup>16</sup>

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<sup>12</sup> Ibid paras 374-376.

<sup>13</sup> Ibid paras 393, 406-408.

<sup>14</sup> Ibid para 424

<sup>15</sup> See *Mafezzini v Spain*, Award, 13 November 2000 (ICSID Case No ARB/97/7) (2002) 5 ICSID Rep 419; *Occidental Exploration and Production Company v Ecuador*, Award, 1 July 2004 (LCIA Case No UN 3467); *Sempra Energy International v Argentina*, Award, 18 September 2007 (ICSID Case No ARB/02/16); *Enron Corporation and Ponderosa Assets, LP v Argentina*, Award, 22 May 2007 (ICSID Case No ARB/01/3); *BG Group plc v Argentina*, Final Award, 24 December 2008 (Ad hoc—UNCITRAL Arbitration Rules), *National Grid Plc v Argentina*, Award, 3 November 2008 (Ad Hoc – UNCITRAL Arbitration Rules); *Nykomb Synergetics Technology Holding AB v Latvia*, Award, 16 December 2003 (SCC Case No 118/2001).

<sup>16</sup> *Sempra* (n 15) para 300. See also K Yannaca-Small, 'Fair and Equitable Treatment' in K Yannaca-Small (ed),

Even in cases where the existence of a substantial deprivation was evident, tribunals have found no expropriation and have held the host states responsible for a breach of FET. For instance, despite the fact that *CMS* involved a near-total loss in the investment value, the finding of liability was made not under an expropriation standard but on the basis of FET.<sup>17</sup> Since FET entitles investors to a remedy for any degree of interference by the host state and, at the same time, can potentially be invoked against various types of misconduct perpetrated either through a single act or a composition of acts,<sup>18</sup> its rise to prominence is unsurprising. FET is ‘functionally supplanting the prohibition on takings’.<sup>19</sup> However, the move away from the ‘all or nothing’ rigidity of expropriation towards the flexibility of FET comes at the price of inconsistency and uncertainty, which presently characterises the growing body of arbitral awards. As mentioned in the previous chapters, it is exceedingly difficult to define the contours of the responsibility of the host state in international investment law. Indeterminacy appears to stem from (1) the existence of multiple and overlapping standards of treatment,<sup>20</sup> (2) inconsistent interpretations of the meaning and scope of the investment treaty standards, including FET.<sup>21</sup> With these concerns in mind, the following sections will examine the role of

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*Arbitration under International Investment Agreements: A Guide to the Key Issues* (OUP, Oxford 2010) 385-6 (referring to FET as ‘expropriation light’ and noting that it has been increasingly used ‘as an alternative and more flexible way to provide protection to investors in cases where the test for indirect expropriation is too difficult to achieve’).

<sup>17</sup> While the *CMS* tribunal determined the amount of compensation in its ruling on the merits, the investor in *Saluka v Czech Republic* was compensated through the settlement reached after the tribunal issued a partial award that did not determine the measure of damages. It has been reported that the Czech Finance Ministry announced in June 2008 that it would pay compensation of US\$263 million, including interest. See S Alexandrov, M Moroney and A Porges, ‘FDI Growth in Asia: The Potential for Treaty-Based Investment Protection’, available at <<http://www.globalarbitrationreview.com/reviews/12/sections/47/chapters/488/fdi-growth-asia-potential-treaty-based-investment-protection/>> accessed 31 October 2010.

<sup>18</sup> See *Walter Bau AG v Thailand*, Award, 1 July 2009 (Ad Hoc—UNCITRAL Arbitration Rules) paras 12.43-12.44, the tribunal finding that a breach of FET can also be creeping. While this finding is not surprising given that it has been generally recognised that an international wrong may be committed through composite acts, the tribunal’s decision on a creeping breach of FET demonstrates that FET has grown into a fully-fledged substitute of the expropriation standard.

<sup>19</sup> D Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (CUP, Cambridge 2008) 33.

<sup>20</sup> See Chapters IV and V.

<sup>21</sup> See Chapter IV (discussing arbitral interpretations of non-discrimination, non-arbitrariness and FET).



FET in the corpus of investment treaty provisions. It will be argued that FET, as a reflection of the international minimum standard, can be an overarching investment treaty standard. However, in order to facilitate a balanced and sustainable application of investment treaty law in practice, FET should be redefined and emerge as a clearly formulated standard prohibiting the types of host state conduct that are impermissible in international law, as informed by customary norms, treaty obligations, and general principles of law.

## 2. Eliminating overlap and multiplicity

Arbitral tribunals have construed FET to encompass the requirements of due process<sup>22</sup>, non-discrimination<sup>23</sup>, reasonableness, non-arbitrariness,<sup>24</sup> and compliance with contractual undertakings.<sup>25</sup> There are also awards which have construed FET to encompass an obligation to provide full protection and security. While according to the traditional view full protection and security implies physical security, some tribunals have construed the standard as including legal security of investment.<sup>26</sup> For instance, the latter approach was adopted in *Azurix v Argentina*, where the tribunal held that full protection and security ought to be understood as going beyond the protection and security ensured by the police.<sup>27</sup> In the

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<sup>22</sup> See Chapter V.

<sup>23</sup> See Chapter IV.

<sup>24</sup> See *Waste Management Inc v Mexico*, Award, 30 April 2004 (Case No ARB(AF)/00/3) (2004) 43 ILM 967, para 98; *International Thunderbird Gaming Corporation v Mexico*, Award, 26 January 2006 (Ad hoc—UNCITRAL Arbitration Rules) para 194; *Saluka Investments BV v Czech Republic*, Partial Award, 17 March 2006 (PCA—UNCITRAL Arbitration Rules) para 309, *Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan*, 29 July 2008 (ICSID Case No.ARB/05/16) para 681. However, compare *CMS* (n 4).

<sup>25</sup> *SGS Société Générale de Surveillance SA v Philippines*, Decision on Objections to Jurisdiction and Separate Declaration, 29 January 2004 (ICSID Case No ARB/02/6) (2005) 8 ICSID Rep 518, para 162; *Noble Ventures Inc v Romania*, Award, 5 October 2005 (ICSID Case No ARB/01/11) para 182; R Dolzer and C Schreuer, *Principles of International Investment Law* (OUP, Oxford 2008) 140-1. However, compare *Consortium RFCC v Morocco*, Award, 22 December 2003 (ICSID Case No ARB/00/6) paras 33-34, *Waste Management* (n 24) 115.

<sup>26</sup> *Azurix* (n 10) para 408.

<sup>27</sup> *Ibid.*

tribunal's view, the stability afforded by a secure investment environment was as important from an investor's point of view as physical security.<sup>28</sup> Here, an obligation to provide full protection and security becomes entirely subsumed within the FET standard.<sup>29</sup>

Owing to its wide remit, FET can be understood as 'a short-hand formula for the combined legal effects of all other standards of treatment prescribed by an investment treaty.'<sup>30</sup> Indeed, it is clearly unfair and inequitable to subject foreign investment to treatment which is discriminatory, arbitrary, and contrary to due process.<sup>31</sup> Nonetheless, some arbitral tribunals have chosen to draw a line between FET and other standards of treatment.<sup>32</sup> It is possible that relying on some of the existing awards and contrary to an emerging tendency for convergence, future tribunals may interpret FET provisions as covering only certain forms of governmental conduct, to the exclusion of other forms of international illegality. Consequently, one may expect further fragmentation of investment treaty law, exacerbating the lack of certainty and predictability regarding the forms of conduct that may constitute a

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<sup>28</sup> Ibid.

<sup>29</sup> See also Dissenting Opinion of Samuel K.B. Asante in *Asian Agricultural Products Limited v Sri Lanka*, Final Award on Merits and Damages, 21 June 1990 (ICSID Case No ARB/87/3) (1991) 30 ILM 577, para 14 (suggesting that 'requirements as to fair and equitable treatment, full protection and security and non-discriminatory treatment all underscore the general obligation of the host state to exercise due diligence in protecting foreign investment in its territories, an obligation that derives from customary international law'). Also, *Occidental* (n 15) para 187; however, compare *Pantechniki SA Contractors and Engineers v Albania*, Award, 28 July 2009 (ICSID Case No ARB/07/21) para 77; *BG v Argentina* (n 15) paras 326-327 (distinguishing full protection and security (FPS) as a standard of physical security). See also JC Thomas, 'Reflections on Article 1105 of NAFTA: History, State Practice and the Influence of Commentators' (2001) 17 ICSID Review – FILJ 21, 92 (suggesting that the FPS standard is as capable of being given an autonomous and independent interpretation as FET).

<sup>30</sup> R Dolzer, 'Fair and Equitable Treatment: A Key Standard in Investment Treaties' (2005) 39 Intl Law 87, 91; see also FA Mann, 'British Treaties for the Promotion and Protection of Investments' (1981) 52 British Ybk Intl L 241, 243 (suggesting that 'the right to fair and equitable treatment goes much further than the right to most-favored-nation and to national treatment... so general a provision is likely to be almost sufficient to cover all conceivable cases, and it may well be that provisions of the Agreements affording substantive protection are not more than examples of the specific instances of this overriding duty'). Similarly, S Vasciannie, 'The Fair and Equitable Treatment Standard in International Investment Law and Practice' (1999) 70 British Ybk Intl L 99, 130 (indicating that there is support for the view that FET encompasses an array of other standards); UNCTAD, *Fair and Equitable Treatment* (n1) 34-7.

<sup>31</sup> See Vasciannie (n 30) 131 (suggesting that it accords with the plain meaning of fairness and equity to include non-discrimination, reasonableness and respect for contractual obligations). See also JW Salacuse, *The Law of Investment Treaties* (OUP, Oxford 2010) 238-43.

<sup>32</sup> It remains unclear whether FET embraces certain forms of discrimination, and also whether FET and full protection and security provisions involve different thresholds.

breach of FET.

It is submitted that, in keeping with the approaches that consider FET as a standard applicable to a variety of types of host state conduct, the duplication in investment treaty texts should be addressed through abandoning separate provisions on non-arbitrariness, unreasonableness, non-discrimination, and due process of law. Instead, a single standard of treatment under the rubric of FET should be adopted. An investor should be entitled to redress for any loss inflicted upon its investment through a governmental action in violation of non-discrimination, non-arbitrariness, and due process obligations. Eliminating any overlap through the adoption of a unified standard is likely to enhance the conceptual clarity of the resulting body of decisions and to prevent tribunals from expressing often-unfounded preferences for labelling disputed conduct as arbitrary, unfair, or unreasonable.<sup>33</sup> It would also be in line with the demands of judicial economy.

### 3. FET: defining the parameters of an internationally impermissible conduct

The proposal to adopt a unified and overarching standard of treatment inevitably prompts the question as to the scope and meaning of such a standard. An overview of international investment treaties reveals a basic agreement that foreign investment should be protected against treatment that is discriminatory, arbitrary, and in violation of due process of law.<sup>34</sup> These guarantees are commonly contained in most BITs, including the so-called South-South BITs.<sup>35</sup> Investment treaty practice aside, it is possible to discern a line of arbitral decisions in

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<sup>33</sup> See Chapter IV.

<sup>34</sup> See Chapters IV and V.

<sup>35</sup> See, e.g. Agreement between the United Mexican States and the Government of the Republic of India on the Promotion and Reciprocal Protection of Investments (adopted 21 May 2007, entered into force 23 February 2008), which includes a comprehensive minimum standard provision in addition to the traditional expropriation standard and national treatment standard. See also Articles 3-4 of the Agreement between the Government of the People's Republic of China and the Mongolian People's Republic concerning the Encouragement and Reciprocal Protection of Investments (adopted 25 August 1991, entered into force 1 November 1993); Article 3 of the

which FET was interpreted as encompassing the minimum guarantee against discrimination, arbitrariness, and breach of due process of law.<sup>36</sup> It is therefore proposed that as a key investment treaty standard, FET should embody the minimum standard below which host state conduct must not fall. Along with being focused on the basic guarantees of non-discrimination, non-arbitrariness and due process, FET as a single standard of treatment should have a built-in measure of deference, allowing for the international review of a host state's action only where the disputed governmental measure represents a serious departure from the parameters of an internationally permissible conduct.

This proposition invites a number of further questions. It can be asked whether reviving the international minimum standard, which lies below the proposed model of FET, is valid in light of the historical opposition mounted against it by developing states.<sup>37</sup> One can object that FET in modern investment treaty law goes beyond the requirements of non-discrimination, non-arbitrary conduct and due process, and provides additional guarantees of transparency, stability, predictability, and consistency.<sup>38</sup> Another related question concerns the justifications for a high threshold in establishing a breach by a host state, which the proposed model of FET is built upon. The following sections will examine arbitral practice and scholarship on FET and its relationship with customary international law. After outlining the distinctive features of two dominant theories of FET, it will be argued that regardless of whether FET is construed as a codification of customary international law or an autonomous and more demanding treaty standard, there exists a basic agreement that investments are

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Agreement between the Government of the Republic of Argentina and the Government of the People's Democratic Republic of Algeria for the Promotion and the Reciprocal Protection of Investments (adopted 4 October 2000, entered into force 28 January 2002).

<sup>36</sup> See *Waste Management* (n 24) para 98 and *Saluka* (n 24) para 307.

<sup>37</sup> See Vasciannie (n 30) 105; see generally I Brownlie, *Principles of Public International Law* (6<sup>th</sup> edn OUP, Oxford 2003) 501-2; AH Roth, *The Minimum Standard of International Law Applied to Aliens* (A. W. Sijthoff's Uitgeversmaatschappij, Leiden 1949).

<sup>38</sup> See below section 6.

entitled to protection against discrimination, arbitrary action, and violation of due process of law. Focusing on a recent tendency to interpret FET as a good governance guarantee, this chapter will analyse legal and policy considerations supporting a more sound and credible approach to the determination of state responsibility towards foreign investors. It will conclude by outlining proposals for the interpretation of FET as an overarching standard balancing the protection of foreign investors with state responsibility.

#### 4. FET as customary international law

The view that FET is nothing but a codification of customary international law has largely been rooted in arbitral practice under NAFTA Article 1105(1). The relevant clause requires that ‘each party accord to foreign investments treatment in accordance with international law, including fair and equitable treatment and full protection and security.’<sup>39</sup> Despite the express reference to customary international law and to the minimum standard in the wording of Article 1105(1), early NAFTA tribunals construed FET as an autonomous standard not restricted by any existing standards and going beyond the requirements of the international minimum standard.<sup>40</sup> The NAFTA Free Trade Commission<sup>41</sup> responded by issuing a Note of

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<sup>39</sup> An identical provision is contained in Article 5(1) of the 2004 US Model BIT.

<sup>40</sup> See e.g. *Pope & Talbot Inc v Canada*, Award on the Merits of Phase 2, 10 April 2001 (Ad hoc—UNCITRAL Arbitration Rules) paras 110-111. The *Pope & Talbot* tribunal construed the requirement of fair and equitable treatment as being additional to the minimum standard, and concluded that investors under NAFTA were entitled to the international law minimum, “plus the fairness elements.” The tribunal concluded that ‘compliance with fairness elements must be ascertained free of any threshold that might be applicable to the evaluation of measures under the minimum standard of international law’ (ibid para 111). See further R Dolzer and A Von Walter, ‘Fair and Equitable Treatment—Lines of Jurisprudence on Customary Law’ in F Ortino and L Liberti (eds) *Investment Treaty Law: Current Issues II* (BIICL, London 2007) 100-3.

<sup>41</sup> The Note explicitly confined the requirement of fair and equitable treatment of NAFTA Article 1105 to the customary minimum standard and ruled out the relevance of other provisions of NAFTA in determining a violation of the standard prescribed by Article 1105. It held:

Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.

The concepts of “fair and equitable treatment” and “full protection and security” do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens.

Interpretation which clarified that fair and equitable treatment did not require any treatment in addition to or beyond that which was required by the customary international standard of treatment of aliens.<sup>42</sup> Further light on the meaning of the standard and its relationship with customary international law in *Waste Management*. After an extensive discussion of the early NAFTA tribunal decisions, and placing them into the context of early customary international law as reflected in the well-known *Neer* case of 1926<sup>43</sup>, the *Waste Management* tribunal defined the emerging standard in the following terms:

[t]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the state and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process.<sup>44</sup>

The characteristic feature of FET as construed in *Waste Management* is its high threshold. Not only is the standard confined to a prohibition of arbitrariness, discrimination, and due process of law but it also incorporates a measure of deference by limiting the scope of an international

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A determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of Article 1105(1).

<sup>42</sup> Some authors criticised the Note of Interpretation and a subsequent inclusion of similar provisions in the 2004 U.S. Model BIT as a regressive development. See S Schwebel, 'The United States Model Bilateral Investment Treaty: An Exercise in the Regressive Development of International Law' in G Aksen and RG Briner (eds), *Global Reflections on International Law, Commerce and Dispute Resolution: Liber Amicorum in honour of Robert Briner* (ICC Publishing, Paris 2005). Sornarajah explains such a dramatic change by pointing to the fact that '[w]ith the United States increasingly becoming a target of litigation, it sees the need to withdraw from the expansive standard it had supported earlier and desires to ensure that they are construed narrowly' (M Sornarajah, 'The Fair and Equitable Standard of Treatment: Whose Fairness? Whose Equity?' in F Ortino and L Liberti (eds) *Investment Treaty Law: Current Issues II* (BIICL, London 2007)169). See also C McLachlan, L Shore and M Weiniger, *International Investment Arbitration: Substantive Principles* (OUP, Oxford 2007) 210 (commenting that the revised formula in the US Model BIT was a 'response to a perception in and by the United States that a definition of 'fair and equitable treatment' unbounded by custom had left the door open to adventurist arbitrators to exercise an unfettered discretion as to the appropriateness of State policy').

<sup>43</sup> *LFH Neer & Pauline v United Mexican States* (1926) AJIL555. This decision of the US-Mexican Claims Commission, although dealing with a matter of international criminal law, is regarded as an early authority providing the definition of the international minimum standard of treatment of aliens. The *Neer* tribunal held that '[the] treatment of aliens, in order to constitute an international delinquency, should amount to an outrage, to bad faith, to willful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.'

<sup>44</sup> *Waste Management* (n 24) para 98.

review of a host state's conduct to cases showing a serious departure from internationally accepted standards. The interpretation of FET as a high threshold standard is in line with customary international law as reflected in early international decisions.<sup>45</sup> As observed by the tribunal in the recent NAFTA case of *Glamis Gold*, the inclusion of modifiers “manifest”, “gross” and “shocking” aims at safeguarding deferential review of host state conduct.<sup>46</sup>

It is important to stress the difference between the view of FET as customary international law and other theories that have emerged. The latter includes those theories which postulate that FET is a demanding standard of protection and that it has become part of customary international law because of a widespread inclusion of FET clauses in more than 2500 BITs.<sup>47</sup> Likewise, it is crucial to distinguish between construing the FET standard by reference to the international minimum on the one hand and labelling FET as a customary norm with the single purpose of drawing a legal foundation for otherwise unjustified privileges, on the other.<sup>48</sup> The principal objective behind linking FET with customary

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<sup>45</sup> It echoes the views expressed in the *Salem* case, affirming the principle that an international tribunal can ‘[p]roperly award damages *only on the basis of convincing evidence of a pronounced degree of improper governmental action.*’ (*The Salem Claim between the United States of America and Egypt under the Agreement of January 20, 1931* (1932) 2 RIAA 1163). See also Thomas (n 29) 28. See also the ICJ decision in *ELSI*, which highlighted the importance of limiting international judicial review of state action to cases exhibiting arbitrariness – ‘something opposed to the rule of law’, ‘a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of judicial propriety’ (*Elettronica Sicula S.P.A. (ELSI) (United States of America v. Italy)* [1989] ICJ Reports, para 128).

<sup>46</sup> *Glamis Gold Ltd v United States*, Award, 14 May 2009 (Ad Hoc – UNCITRAL Arbitration Rules) para 617; for a similarly restrictive view see *International Thunderbird* (n 24) para 194; *Genin and ors v Estonia*, Award, 25 June 2001 (ICSID Case No ARB/99/2) para 367.

<sup>47</sup> See, for example, S Hindelang, ‘Bilateral Investment Treaties, Custom and a Healthy Investment Climate’ (2004) 5 J World Investment & Trade 767; AF Lowenfeld, ‘Investment Agreements and International Law’ (2003-2004) 42 Colum J Transnatl L 123; SM Schwebel, ‘The Reshaping of the International Law of Foreign Investment by Concordant Bilateral Investment Treaties’ in S Charnovitz, DP Steger and P Van Den Bossche (eds) *Law in the Service of Human Dignity: Essays in Honour of Florentino Feliciano* (CUP, Cambridge 2005) 241. For a critical assessment of this view, see B Kishoiyian, ‘The Utility of Bilateral Investment Treaties in the Formulation of Customary International Law’ (1994) 14 Northwest J Intl L & Bus 327.

<sup>48</sup> See T Kill, ‘Don’t Cross the Streams: Past and Present Overstatement of Customary International Law in Connection with Conventional Fair and Equitable Treatment Obligations’ (2008) 106 Michigan Law Review 853 (highlighting the problems with interpretive approaches adopted by the tribunals in *CMS v Argentina* and *Occidental v Ecuador*. In these awards, while describing the FET as a reflection of customary international law, the tribunals construed the standard expansively to include additional guarantees of stability and predictability. In doing so, they failed to point to evidence that such guarantees became part of customary international law.

international law is to scale back the interpretation of the standard to a level where it would command general acceptance without undermining the system of investment protection.

While the customary international law character of FET has not been uniformly recognised in investment treaty law and doctrine,<sup>49</sup> states have increasingly expressed their preference for the interpretation of FET as a standard rooted in customary international law. Along with the FTC Note of Interpretation of Article 1105 NAFTA, the recent generation of international investment agreements reveals a tendency for defining FET as a codification of customary international law. Beyond the foremost example of the US Model BIT<sup>50</sup>, this approach can be found in the 2004 Canada Model BIT<sup>51</sup>, the 2004 Japan-Mexico FTA,<sup>52</sup> the 2007 India–Mexico BIT,<sup>53</sup> the ASEAN-Australia-New Zealand FTA<sup>54</sup> and the 2007 Korea-US FTA.<sup>55</sup> This trend in the formulation of FET can be regarded as evidence of state practice opposing the autonomous and expansive interpretation.<sup>56</sup>

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Thus, FET was labelled as a customary rule but interpreted as a maximum protection standard).

<sup>49</sup> See section 5 below. For a recent award supporting an expansionist view of FET, see *Merrill & Ring Forestry LP v Canada*, Award, 31 March 2010 (Ad hoc—UNCITRAL Arbitration Rules) paras 193-213 (holding that although FET was bound by customary international law, the latter has evolved and could no longer be defined by reference to the *Neer* standard).

<sup>50</sup> The 2005 US–Uruguay BIT and the 2008 US–Rwanda BIT replicate the formulation of the minimum standard as provided in the model treaty clause:

1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security.
2. For greater certainty, paragraph 1 prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments. The concepts of “fair and equitable treatment” and “full protection and security” do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights.

<sup>51</sup> Article 5(2), the full text of the model FIPA is available at <[http://www.naftaclaims.com/files/Canada\\_Model\\_BIT.pdf](http://www.naftaclaims.com/files/Canada_Model_BIT.pdf)> accessed 31 October 2010.

<sup>52</sup> Article 60, the full text is available at <<http://www.mofa.go.jp/policy/economy/fta/mexico.html>> accessed 31 October 2010.

<sup>53</sup> Article 5 (3), the full text is available at <<http://www.investmentclaims.com>>

<sup>54</sup> Article 6(c) the full text is available at <<http://www.dfat.gov.au/trade/fta/asean/aanzfta/chapters/chapter11.html>> accessed 31 October 2010.

<sup>55</sup> Article 11.5(2), the full text is available at <[http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset\\_upload\\_file587\\_12710.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file587_12710.pdf)> accessed 31 October 2010.

<sup>56</sup> See A Falsafi, ‘The International Minimum Standard of Treatment of Foreign Investors’ Property: A Contingent Standard’ (2006-2007) 30 *Suffolk Transnational L Rev* 318, 351 (arguing that customary



## 5. FET as an autonomous standard: a critique

### 5.1. General

A number of arbitral awards and scholarly writings support the view that FET should not be limited to the customary international minimum.<sup>57</sup> It has been suggested that FET should be regarded as an autonomous and overriding standard, unless an international investment agreement contains explicit provisions to the contrary.<sup>58</sup> In addition to drawing support from existing variations in the drafting,<sup>59</sup> the autonomous interpretation of FET rests on the argument that, in light of the controversy surrounding the customary notion of the international minimum, states signing international investment agreements are unlikely to equate the latter with the fair and equitable treatment standard.<sup>60</sup>

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international law may not emerge or evolve in the face of adverse state practice; NAFTA party practice presents strong evidence against the evolution of the minimum standard of treatment through the adoption of FET); A Alvarez-Jimenez, 'Minimum Standard of Treatment of Aliens, Fair and Equitable Treatment of Foreign Investors, Customary International Law and the *Diallo* case before the International Court of Justice' (2008) 9 J World Investment & Trade 51, 64 (suggesting that to declare the standard of FET as a customary rule of international law would belie the recent attitude evinced by states moving away from providing for higher protection of foreign investment).

<sup>57</sup> For example, it is not clear how the decisions reached in the context of NAFTA arbitrations can represent the customary international law. Even when construed restrictively, the standard of fair and equitable treatment under the NAFTA can be considered as an example of *lex specialis* agreed between contracting parties (see S Subedi, 'The Challenge of Reconciling the Competing Principles within the Law of Foreign Investment with Special Reference to the Recent Trend in the Interpretation of the Term "Expropriation"' (2006) 40 Intl Law 121,127).

<sup>58</sup> C Schreuer, 'Fair and Equitable Treatment in Arbitral Practice' (2005) 6 J World Investment & Trade 357, 363-34 (noting that the result reached in the NAFTA context should not necessarily be applied to other treaties); R Dolzer and M Stevens, *Bilateral Investment Treaties* (Brill, Leiden 1995), 60 ('the fact that the parties to BITs have considered it necessary to stipulate this standard as an express obligation rather than relied on a reference to international law and thereby invoked a relatively vague concept such as the minimum standard, is probably evidence of a self-contained standard'); B Choudhury, 'Evolution or Devolution: Defining Fair and Equitable Treatment in International Investment Law' (2005) 6 J World Investment & Trade 297, 300-1 (noting that the use of the expression "no less than that required by international law" implies a higher standard of protection); see also UNCTAD (n 1) 13.

<sup>59</sup> A Newcombe and L Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, Alphen aan den Rijn 2009) 264 (expressing the view that the interpretation of a specific FET provision depends on the actual text of the treaty in question under principles of treaty interpretation).

<sup>60</sup> Vasciannie (n 30) 144 (noting that 'bearing in mind that the international minimum standard has itself been an issue of controversy between developed and developing States for a considerable period, it is unlikely that a

The award in *Vivendi* illustrates the reasoning behind the autonomous interpretation of FET.<sup>61</sup> Since Article 3 of the France-Argentina BIT referred to fair and equitable treatment in *conformity* with the principles of international law and did not refer to the minimum standard of treatment, the tribunal refused to equate FET with the minimum standard of treatment:

[T]he reference to principles of international law supports a broader reading that invites consideration of a wider range of international law principles than the minimum standard alone... The wording of Article 3 requires that the fair and equitable treatment conform to the principles of international law, but the requirement for conformity can just as readily set a floor as a ceiling on the Treaty's fair and equitable treatment standard.<sup>62</sup>

As the tribunal's reasoning reveals, an autonomous interpretation of FET allows the minimalist protection accorded under the customary standard to be bypassed. Investment tribunals have also harnessed the autonomous theory of FET to lower the bar in establishing a breach. In addressing the relationship between FET and the international minimum, the *Saluka v Czech Republic* tribunal observed that the customary minimum would in any event be binding upon a host state, providing for a minimal protection even where the state was opposed to foreign investment.<sup>63</sup> However, as the object and purpose of investment treaties often refers to stimulation of investment flows and intensification of parties' economic relations, FET ought to be construed as a guarantee protecting investors against state conduct that displays 'a relatively lower degree of inappropriateness' in comparison with the higher threshold required in establishing a violation of customary international law.<sup>64</sup> The absence of any reference to the customary minimum standard in the FET clause of the Czech-

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majority of States would have accepted the idea that this standard is fully reflected in the fair and equitable standard without clear discussion').

<sup>61</sup> *Compañía de Aguas del Aconquija SA and Vivendi Universal SA v Argentina*, Award, 20 August 2007 (ICSID Case No ARB/97/3).

<sup>62</sup> *Ibid* para 7.4.7. A similar stance was adopted in *Azurix* (n 10) para 361 and *Duke Energy Electroquil Partners and Electroquil SA v Ecuador*, Award, 12 August 2008 (ICSID Case No ARB/04/19) para 336.

<sup>63</sup> *Saluka* (n 24) para 292.

<sup>64</sup> *Ibid* para 293

Netherlands BIT enabled the tribunal to uphold an autonomous interpretation of the standard.<sup>65</sup> Despite adding a caveat that the protection of investment ought not to be considered as a sole aim of the treaty,<sup>66</sup> the tribunal construed FET as ‘treatment which if not proactively stimulating the inflow of foreign investment capital, does not at least deter foreign capital by providing disincentives to foreign investors.’<sup>67</sup> Thus, FET included the host state’s duty to ensure transparency, stability and predictability, a duty to negotiate in good faith and to provide state aid without differentiating between potential recipients.<sup>68</sup>

Before turning to criticism of this interpretive position, it is important to note that regardless of whether FET is seen as adding to the international minimum standard or replicating customary international law, as a common denominator investment treaties prohibit arbitrariness, discrimination and breach of due process.<sup>69</sup> These basic investor guarantees are undisputed.<sup>70</sup> The point of disagreement is the scope of protection that foreign investors can enjoy under investment agreements. It is evident that the major thrust of the argument postulating an autonomous nature of FET is that investors should be afforded a higher protection than that provided by customary international law. This implies (1) a low threshold for establishing the existence of a breach by a host government,<sup>71</sup> and (2) additional guarantees of transparency, predictability, consistency, and even-handedness.<sup>72</sup>

Where investment treaties contain a FET clause that omits a reference to international

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<sup>65</sup> Ibid para 294.

<sup>66</sup> Ibid para 300.

<sup>67</sup> Ibid para 301.

<sup>68</sup> See ibid paras 307, 329.

<sup>69</sup> These elements are included in the more restrictive definition of FET in *Waste Management* and the autonomous version in *Saluka* (see above n 24).

<sup>70</sup> While most treaties include at least some kind of prohibition of these types of conduct, so do early international decisions as well as the recent awards adhering to a more restrictive interpretation of FET. See, for example, *Waste Management* (n 24); *ELSI* (n 45). Also, Salacuse (n 31) 227 (‘it must be admitted that the international minimum standard and the fair and equitable treatment standard overlap significantly with respect to issues like arbitrary treatment, discrimination, and unreasonableness’).

<sup>71</sup> See above n 64.

<sup>72</sup> See section 6 below.

law, the rules of treaty interpretation might indeed justify the interpretation of the standard independently from customary international law.<sup>73</sup> In practice, however, the inherent vagueness and subjectivity of the terms “fair and equitable” and references to the promotion and fostering of investment flows as primary treaty objectives have resulted in broadening the remit of investment treaty protection. The breadth of the autonomously construed standard is such that investors may succeed where their claims under a more specific standard might have failed.<sup>74</sup> FET has been construed as a standard entitling an investor to a remedy for a host state’s conduct even in the absence of a breach of traditional international law.<sup>75</sup> The consequence of such interpretation is that a host state can be held liable even for irregularities which do not amount to discrimination, arbitrariness, and breach of due process. Arbitral practice contains examples of FET used as a basis for the host state’s liability for inconsistency, lack of even-handedness, and a failure to handle negotiations in a competent and efficient fashion.<sup>76</sup>

It is evident that under such an expansive interpretation of FET, ‘anything that adversely affects investments and is economically unfavourable to their owners can constitute

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<sup>73</sup> See Newcombe & Paradell (n 59) 265, noting that ‘principles of treaty interpretation provide the primary argument in favour of fair and equitable treatment as an independent treaty standard.’ As acknowledged in *Glamis Gold* (n 46) para 20, ‘a tribunal confronted with a question of treaty interpretation can, with little input from the parties, provide a legal answer. It has the two necessary elements to do so, namely the language at issue and rules of interpretation.’

<sup>74</sup> See Newcombe & Paradell (n 59) 255.

<sup>75</sup> *PSEG Global Inc and Konya Ilgin Elektrik Üretimve Ticaret Ltd Şirketi v Turkey*, Award and Annex, 19 January 2007 (Case No ARB/02/5) para 239.

<sup>76</sup> See *Saluka* (n 24) para 363 (the tribunal finding that in the context of negotiating a proposal relating to the rescue of a failing bank, an investor was entitled to expect that the host state takes seriously a proposal that has sufficient potential to solve the problem and deal with it in an objective, transparent, unbiased and even-handed way. Similarly, see *PSEG* (n 75) para 246 (the tribunal found a breach of FET due to the fact that in the context of the renegotiation of a build-won-transfer contract, ‘key points of disagreement went unanswered and were not disclosed in a timely manner, that silence was kept when there was evidence of such persisting and aggravating disagreement, that important communications were never looked at, and that there was a systematic attitude not to address the need to put an end to negotiations that were leading nowhere, are all manifestations of serious administrative negligence and inconsistency’).

the breach of the relevant provisions of the bilateral investment treaties.’<sup>77</sup> It is submitted that the theory that an ordinary and effective interpretation of FET can be used to create new heads of host state liability in international law is ill founded. FET does not create an entitlement to a higher protection. First, there is evidence that by preferring the label of FET to that of the international minimum standard, treaty drafters merely avoided political sensitivities, without intending to go beyond the international minimum. Second, if interpreted autonomously from treaty texts and customary rules, the terms fair and equitable appear to be not only devoid of substantive content but also precariously open to individual preferences. Third, the notions of “fairness” and “equity” militate against creating new grounds of state responsibility and insulating investors from business risks. Each of these arguments will be explored below.

## 5.2. FET was not intended to add new elements to the international minimum standard

It has been argued that since Latin American states had been strongly opposed to the international minimum standard, it would be incorrect to assume that they opted to include that standard under the rubric of FET.<sup>78</sup> However, the historical opposition to the international minimum standard would in fact militate against an assumption that FET was designed as an independent standard going beyond the requirements of customary international law. Hostile as they were to the idea of a minimum protection, states would not agree to a more demanding standard of protection. Indeed, the drafting history of FET indicates that the long-standing resistance to the international minimum standard by a group of states prompted the need for a more acceptable alternative. The prototype of the modern FET standard can be found in

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<sup>77</sup> A Orakhelashvili, ‘The Normative Basis of “Fair and Equitable Treatment”’: General International Law on Foreign Investment’ (2008) 46 *Archiv des Völkerrechts* 74, 103.

<sup>78</sup> Vasciannie (n 30) 105.

Article 1 of the 1967 OECD Draft Convention on the Protection of Foreign Property. As explained in the commentary to the Draft, the FET clause reflected the minimum standard:

The phrase “fair and equitable treatment”, customary in relevant bilateral agreements, indicates the standard set by international law for the treatment due by each State with regard to the property of foreign nationals...The standard required conforms in effect to the “minimum standard” which forms part of customary international law.<sup>79</sup>

Subsequently, following the conclusion of a number of BITs between the US and other countries, the OECD Committee on International Investment and Multinational Enterprises clarified that ‘fair and equitable treatment introduced a substantive legal standard referring to general principles of international law even if this is not explicitly stated.’<sup>80</sup> That FET embodied customary international law was also confirmed in a 1979 statement issued by the Swiss Foreign Office.<sup>81</sup> Investment treaty scholarship testifies to the fact that ‘fair and equitable treatment may simply have been viewed as a convenient, neutral and acceptable reference to the minimum standard of treatment.’<sup>82</sup> Despite pointing to the actual treaty text as a basis on which the interpretation of a FET clause should be founded, it has been noted that in contrast with the minimum standard, which was met by resistance, the FET standard emerged as a politically less sensitive alternative.<sup>83</sup>

### 5.3. The FET standard does not create rights

It has been observed that if FET is to be regarded as an autonomous standard in each case, tribunal decisions risk becoming *ex aequo et bono* through importing the arbitrators’ own

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<sup>79</sup> OECD Draft Convention on the Protection of Foreign Property (1968) 7 ILM 117, 120. See also Thomas (n 29) 45-51.

<sup>80</sup> OECD, Committee on International Investment and Multinational Enterprises, Intergovernmental Agreements Relating to Investment in Developing Countries (May 27, 1984) Doc. No 81/14, para 36.

<sup>81</sup> OECD, *Fair and Equitable Treatment Standard in International Investment Law*, Working Papers on International Investment (No 2004/3) 10.

<sup>82</sup> Newcombe & Paradell (n 59) 269

<sup>83</sup> Ibid 263.

perceptions of what is fair and equitable.<sup>84</sup> The principal issue here is the absence of restraints, neither institutional nor substantive, that would fetter the law-making by party-appointed arbitrators. As the notions of fairness and equity do ‘not connote a clear set of legal prescriptions’,<sup>85</sup> FET is inherently vague. In the absence of objective criteria, there is a risk that the determination of host state responsibility will hinge on an entirely subjective view entertained by members of an arbitral panel as to what is fair and equitable. Unrestrained by customary international law or a treaty text, tribunals can add new elements to the already growing notion of FET, broadening the scope of state responsibility to foreign investors.<sup>86</sup> Such flexibility can easily result in a lack of certainty, predictability, and credibility of international investment law and investment arbitration.<sup>87</sup> Just as investors are entitled to know in advance which laws and regulations are applicable to their investments, so should host states be given a clear and well-founded description of FET. Furthermore, as will be shown in the following section, the desirability of more predictable investment treaty law is not the only concern; interpreting FET autonomously from international law—or indeed any other applicable law—is simply inconsistent with the rule of law principles.<sup>88</sup>

This thesis supports the view that FET should be understood as a requirement that investors be treated fairly and equitably in connection with the exercise of their rights under

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<sup>84</sup> R Picherack, ‘The Expanding Scope of the Fair and Equitable Treatment Standard: Have Recent Tribunals Gone Too Far?’ (2008) 9 J World Investment & Trade 255, 258.

<sup>85</sup> Vasciane (n 30) 101.

<sup>86</sup> Picherack (n 84) 258.

<sup>87</sup> Some authors have gone even further arguing that if FET is considered as going beyond general international law, ‘it is not only indeterminate but also arbitrary’ (Orakhelashvili (n 77) 105). See also S Montt, *State Liability in Investment Treaty Arbitration: Global Constitutional and Administrative Law in the BIT Generation* (Hart Publishing, Oxford 2009) 153, arguing that creationism – ‘the relatively free invention of new rules without proper methodological foundation’ undermines the rule of law legitimacy of the system. For a similar view, see S Subedi, *International Investment Law: Reconciling Policy and Principle* (Oxford, Hart Publishing 2008) 140-1 (criticising the emerging jurisprudence for transforming the minimum protection into the maximum protection).

<sup>88</sup> Montt (n 87) 309 (stressing that an autonomous theory of FET ‘does not qualify as a system of objective and accessible commands, commands which can be seen to flow from collective agreement rather than from exercise of discretion or preferences by those persons who happen to be in position of authority’ (ibid, quoting J L Mashaw, *Greed, Chaos, and Governance. Using Public Choices to Improve Public Law* (Yale University Press, New Haven 1997) 138-9).

international and national law.<sup>89</sup> Thus, FET must not create new rights but rather govern host state conduct in relation to an investor's existing rights. Tribunals applying FET should not engage in the creation of new standards of treatment but should instead enforce investor rights in accordance with international and national law. The principle of ordinary interpretation alone does not provide a sufficient basis for arbitral tribunals to create new investor rights under the rubric of FET. According to Article 31 (3)(c) of the Vienna Convention, any relevant rules of international law applicable in the relations between the parties should be taken into account, together with the context.<sup>90</sup> Thus, even if construed as a provision independent from the customary international minimum standard, FET needs to be assessed by reference to objective benchmarks, such as the rights to which investors are entitled under international law and the applicable municipal law. For instance, a host state's failure to engage in the renegotiation of contract terms would violate FET only if such a failure violates an international treaty, customary international law, or where the applicable municipal law clearly articulates that such was the legal obligation of the host state. FET may be interpreted independently from the customary international minimum standard, but if we were to identify its substantive content by reference to investor rights objectively existing under international and national law, the standard would not include entitlements going beyond what the state parties agreed in international treaties and accepted as a customary norm.

#### 5.4. Treaty terms must be interpreted fairly and equitably

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<sup>89</sup> Orakhelashvili (n 77) 93 see also Falsafi (n 56) 362 (arguing that the scope of the minimum standard of treatment does not extend beyond recognising the supremacy of international law over national law in determining the minimum treatment that foreign investors should receive in national boundaries). A similar idea can be traced in Montt's framework whereby FET is a standard of legality under international and domestic law (see Montt (n 87) 310-47).

<sup>90</sup> Vienna Convention on the Law of Treaties (entered into force on 27 January 1980) (1969) 1155 UNTS 331.



Many of the most liberal interpretations of FET in arbitral practice drew heavily upon the maxim that treaty terms ought to be interpreted in accordance with their ordinary meaning and in light of the treaty's object and purpose. Tribunals emphasised the wording of BIT preambles referring to the creation of "favourable conditions for investments", the recognition of the need "to protect investments" and "to stimulate the flow of investments and individual business initiative." Such statements in the Chile–Malaysia BIT enabled the tribunal in *MTD v Chile* to interpret FET as treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment and implying a host state obligation to act proactively as opposed to merely avoiding prejudicial conduct to the investors.<sup>91</sup> While it is doubtful that such an interpretation has a valid basis in the treaty text and international custom, further questions arise as to the desirability of positing too high a standard of protection from the perspective of balancing the protection of investment with the host states' regulatory freedom.

It is submitted that the interpretation of FET should be guided by the understanding that subjecting investors to standards of super-protection at the expense of the host states' interest in regulating national economies will detract from the credibility of investment treaty law and lead to a backlash against the institution of investor-state arbitration. The notions of "equity" and "fairness" militate against the interpretation favouring only one party to a dispute. The question that inevitably arises in relation to a tribunal decision which interprets FET as a demanding standard of good governance is whether it is fair and equitable to grant an investor a remedy for a loss occasioned through a host state's inability to meet the high standard of behavior imposed upon it by virtue of arbitral pronouncements. Holding a state to

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<sup>91</sup> *MTD Equity Sdn Bhd and MTD Chile SA v Chile*, Award, 25 May 2004 (ICSID Case No ARB/01/7) (2005) 44 ILM 91, para 113.

a standard it cannot provide is unlikely to encourage investment in the long term.<sup>92</sup> Furthermore, the notions of fairness and equity not only call for a greater reciprocity in translating good governance standards into international obligations, but also necessitate taking into account the foreign investor's conduct, including whether it acted as a reasonable and prudent actor in calculating the risks associated with its investment.<sup>93</sup> It will be shown below that the interplay between FET and investor conduct is particularly instructive in disputes involving claims of transparency, stability and predictability of the investment framework.

## 6. Specific applications of an autonomously construed FET provision

As argued above, FET can provide a basis for the imposition of additional duties on host states only where sufficient support for such an interpretation is derived from the express language of the investment treaty or customary international law. It is also argued that the principles of treaty interpretation do not support instituting new grounds of state responsibility under the rubric of FET because the notions of fairness and equity call for a careful balancing of host states' interests and investors' rights. This section will further elaborate on these arguments by focusing on transparency, stability, predictability, and legitimate expectations, which arbitral tribunals have recognised as constitutive elements of FET. Along with offering a critical examination of relevant arbitral decisions, this section will argue that the inherent

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<sup>92</sup> N Gallus 'The Influence of the Host State's Level of Development on International Investment Treaty Standards of Protection' (2005) 6 J World Investment & Trade 711, 726.

<sup>93</sup> See P Muchlinski, 'Caveat Investor? The Relevance of the Conduct of the Investor Under The Fair and Equitable Treatment Standard' (2006) 55 ICLQ 527, 542 (analysing the emerging principle that the investor should assess investment risks, have realistic expectations, and be aware of the pitfalls of investment in a high-risk enterprise). See further *Maffezini v Spain*, Award, 11 November 2000 (ICSID Case No ARB/97/7) para 64 (the tribunal stressing that 'Bilateral Investment Treaties are not insurance policies against bad business judgments'); *Waste Management* (n 24) para 57 (the NAFTA is not designed to eliminate normal commercial risks or to compensate for a failure of a business plan). See also section 6.3. below.

vagueness of FET does not vest tribunals with a mandate to create new rights for an investor. The good governance standards of transparency, stability and predictability should give rise to state responsibility in international law only if a disputed failure by a host state rises to a violation of customary international law or otherwise breaches expressly worded provisions of an investment treaty or contract.

### 6.1. Transparency

*Metalclad v Mexico*<sup>94</sup> was among the first investment disputes in which the notion of transparency was invoked in determining a breach of FET and expropriation. The dispute concerned the investor's project for the construction and operation of a hazardous waste station and landfill. Despite assurances by federal authorities that Metalclad had all necessary permits, the municipality ordered the cessation of construction works due to the absence of a municipal permit. The tribunal held Mexico responsible for a failure to 'ensure a transparent and predictable framework for Metalclad's business planning and investment.'<sup>95</sup> Relying on the NAFTA preamble which referred to the parties' agreement to 'ensure a predictable commercial framework for business planning and investment', the tribunal construed transparency as

...the idea that all legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another party. There should be no room for doubt or uncertainty in such matters.<sup>96</sup>

In the tribunal's view, the absence of a clear rule as to the need to obtain a municipal construction permit as well as the absence of any established practice or procedure as to the

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<sup>94</sup> *Metalclad Corporation v Mexico*, Award, 25 August 2000 (ICSID Case No ARB (AF)/97/1) (2001) 40 ILM 36.

<sup>95</sup> Ibid para 99.

<sup>96</sup> Ibid para 76.

manner of handling applications for such permits, constituted a failure on the part of Mexico to ensure the transparency required by NAFTA.<sup>97</sup> This finding was sufficient to establish a breach of FET under Article 1105.<sup>98</sup>

The *Metalclad* award was partially set aside in the judicial review by the Supreme Court of British Columbia on the grounds that (1) transparency was not part of the Chapter 11 obligations and fell outside the scope of investor-state arbitration;<sup>99</sup> (2) no authority was cited or evidence introduced to establish that transparency has become part of customary international law.<sup>100</sup> Despite the fact that its finding of a breach of transparency was ruled out by a reviewing court, the *Metalclad* award exerted a considerable influence on the subsequent tribunal decisions, which found transparency and predictability to constitute an element of FET.<sup>101</sup>

*Tecmed v Mexico*<sup>102</sup> is another case which gave rise to a tendency for the interpretation of FET to encompass a duty to ensure transparency. In this case, the dispute arose from a denial to renew the investor's authorisation to operate the landfill. The decision was explained by environmental violations which had allegedly been committed in the operation of the site. In the tribunal's view, FET entitled foreign investors to expect the host state to act

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<sup>97</sup> Ibid para 88.

<sup>98</sup> Ibid para 101.

<sup>99</sup> *United Mexican States v. Metalclad Corp.* [2001] 89 BCLR 3d 359, para 58.

<sup>100</sup> Ibid para 68.

<sup>101</sup> See J Hanna Jr, 'Is Transparency of Governmental Administration Customary International Law in Investor-Sovereign Arbitrations? Courts and Arbitrators May Differ' (2005) 21 *Arbitration Intl* 187; T Weiler, 'Good Faith and Regulatory Transparency: The Story of *Metalclad v Mexico*' in T Weiler (ed) *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law* (Cameron May, London 2005) 701-45; CS Zoelner, 'Transparency: An Analysis of an Evolving Fundamental Principle in International Economic Law' (2005-2006) *Mich J Intl L* 579; UNCTAD, *Transparency* (United Nations, New York and Geneva 2003); A Kotera, 'Regulatory Transparency' in P Muchlinski, F Ortino and C Schreuer (eds), *The Oxford Handbook of International Investment Law* (OUP, Oxford 2008) 617. Also, L Paradell, 'The BIT Experience of the Fair and Equitable Treatment Standard' in F Ortino and L Liberti (eds) *Investment Treaty Law: Current Issues II* (BIICL, London 2007) 131-4; Dolzer and Schreuer (n 25) 133-40; Salacuse (n 31) 237-8.

<sup>102</sup> *Técnicas Medioambientales Tecmed SA v Mexico*, Award, 29 May 2003 (ARB(AF)/00/2) 10 ICSID Rep 130.

...in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investors, so that it may know beforehand any rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulation.<sup>103</sup>

Mexico was found responsible for an expropriation and a violation of the FET provision. The tribunal found that the refusal to renew the permit was actually used for extraneous purposes as the authorities were driven by political reasons relating to the community's opposition to the site, "regardless of the company in charge of the operation and regardless of whether or not it was being properly operated."<sup>104</sup>

A lack of transparency was at the heart of the tribunal's finding of a FET breach in *Saluka v Czech Republic*. In order to overcome a serious liquidity deficit, the investor, one of the owners of a privatised bank, attempted to negotiate a cooperative solution with the Czech government. However, the government rejected the rescue proposals, the major concern being that all the proposed schemes involved direct aid to the investor-owned bank without the state having any control over the use of the funds.<sup>105</sup> In the course of formal negotiations, some of the investor's correspondence addressed to the government agencies remained without any response.<sup>106</sup> At the final meeting between the investor, the Ministry of Finance and the Central Bank, the government representatives remained concerned about risks posed by the investor's proposal, which envisaged the transfer of assets but left open the possibility that certain toxic assets would remain in the possession of the bank.<sup>107</sup> While the investor was left with an impression that the negotiations would continue, the next day it was informed of the government's decision to put the bank into forced administration with the subsequent sales of

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<sup>103</sup> Ibid para 154.

<sup>104</sup> Ibid para 164.

<sup>105</sup> *Saluka* (n 24) para 395.

<sup>106</sup> Ibid para 392-396.

<sup>107</sup> Ibid para 404.

its assets.<sup>108</sup> The tribunal found the Czech government in violation of FET. It held that the government failed to deal with the investor's proposals in 'an unbiased, even-handed, transparent and consistent way.'<sup>109</sup> In particular, the exchange of views between the government and the investor 'lacked sufficient transparency to allow Saluka/Nomura and IPB to understand what the Government's preconditions for an acceptable solution were.'<sup>110</sup>

The evident problem with interpreting transparency as a legally binding and enforceable element of FET is its far-reaching effect on the scope of state responsibility in international law. Construed as broadly as it was in *Metalclad*, *Tecmed* and *Saluka*, transparency 'is actually not a standard at all; it is rather a description of a perfect public regulation in a perfect public world, to which all states should aspire, but very few (if any) will ever attain.'<sup>111</sup> The awards discussed above show that a breach of transparency could be discerned readily in a variety of governmental acts affecting foreign investors with the consequence that virtually any flaw in communication would lead to the award of damages to the foreign investor. The desirability of such an outcome is, however, questionable. It is true that where the operation of an investment involves communication across multiple levels of government, holding a host state responsible for any degree of inconsistency and ambiguity does not accommodate the reality of a complex regulatory environment, and transforms FET into a strict liability standard.<sup>112</sup> As highlighted by the *Feldman* tribunal in relation to a breach of transparency alleged in the context of taxation, 'it is doubtful that lack of transparency alone rises to the level of violation of NAFTA and international law, particularly

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<sup>108</sup> Ibid para 405.

<sup>109</sup> Ibid para 407.

<sup>110</sup> Ibid para 420.

<sup>111</sup> Z Douglas, 'Nothing if Not Critical for Investment Treaty Arbitration: Occidental, Eureko, and Methanex' (2006) 22 Arbitration Intl 27, 28.

<sup>112</sup> Newcombe & Paradell (n 59) 294.

given the complexities not only of Mexican but most other tax laws.’<sup>113</sup>

Practical considerations aside, a duty to act transparently cannot be elevated to an international obligation without being sufficiently supported by an international treaty text or custom. As argued above, the fact that the wording of an FET clause omits a reference to international law does not give tribunals the mandate to create new international obligations under the rubric of FET. In interpreting FET, tribunals are

[b]ound by the minimum standard as established in State practice and in the jurisprudence of arbitral tribunals. It may not simply adopt its own idiosyncratic standard of what is ‘fair’ or ‘equitable’ without reference to established sources of law.<sup>114</sup>

Lest state responsibility in international law be extended to cover failures to achieve a standard of good governance, the operation of transparency as a binding obligation will require that an investment treaty under consideration – or, as the case may be, customary international law – expressly provides so. So far as customary international law is concerned, a breach of transparency can arguably give rise to host state responsibility if it constitutes a serious violation of due process or arbitrariness.<sup>115</sup> In fact, the breaches of transparency in both *Metalclad* and *Tecmed* are more readily characterised as a departure from due process of law and arbitrariness. In both cases, the tribunals criticised the governments for inconsistency in dealing with foreign investors.<sup>116</sup> It would seem that instead of conceptualising the governments’ inconsistent acts as breaches of transparency, it would have been more appropriate for the tribunals to analyse them against the standards of due process (including a

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<sup>113</sup> *Marvin Feldman v United States of Mexico*, Award 16 December 2002 (Case No ARB(AF)/99/1) 7 ICSID Rep 341, para 133.

<sup>114</sup> *Mondev International Ltd v United States*, Award of 11 Oct 2002 (ICSID Case No ARB(AF)/99/2) (2003) 42 ILM 85, para 119.

<sup>115</sup> See e.g. *Waste Management* (n 24) para 98, defining the customary international minimum standard as inclusive of a due process requirement. The tribunal concluded that an internationally wrongful violation of due process would involve ‘a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process.’

<sup>116</sup> See above nn 92-104 and accompanying text.

duty to give a reasonable opportunity to respond) and non-arbitrariness.<sup>117</sup> Such an analysis would be compatible with customary international law but would likely entail a more stringent standard of review.

Beyond customary international norms, support for interpreting transparency as a legally binding obligation may be drawn from investment treaty texts.<sup>118</sup> For instance, Article 11 of the 2007 US-Uruguay BIT provides, in a sufficiently concrete language, for (1) the designation of a contact point to facilitate communication; (2) the publication and provision of information pertaining to measures that might affect the operation of the treaty; (3) the conduct of administrative proceedings, including reasonable notice and an opportunity for affected persons to present facts and arguments in support of their position.<sup>119</sup> The NAFTA Chapter 18 contains similar provisions. It is clear that, unlike arbitral statements, which viewed transparency as an element of FET, investment treaty provisions on transparency are more concrete and specific. Since transparency ought to be construed in accordance with the ordinary meaning of the term, a reference to a nebulous duty to ‘act in a totally transparent manner’ would be misplaced; rather, for a host state’s liability to arise it would be necessary to examine whether the disputed conduct violates any of the specifically outlined duties on notification and publication of information, and also examine the conduct of proceedings. Even then, it has been suggested that ‘the interpretation of fair and equitable treatment should not overstretch the position and function of administrative agencies by developing them into

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<sup>117</sup> Indeed, it was the denial of a municipal construction permit and an environmental decree in *Metalclad* and a refusal to renew a licence to operate in *Tecmed* that prevented the investors from pursuing their investment activities; a lack of transparency – even if present in governmental conduct – was far from causing the loss of an investment.

<sup>118</sup> For an overview of transparency provisions in international investment instruments see UNCTAD, *Transparency* (n 101); for recent practice see UNCTAD, *Bilateral Investment Treaties 1995-2006: Trends in Investment Rule-Making* (United Nations, New York 2007) 76-80.

<sup>119</sup> Treaty Between the United States of America and the Oriental Republic of Uruguay Concerning the Encouragement and Reciprocal Protection of Investment (adopted 4 November 2005 entered into force 1 November 2006) (2006) S Treaty Doc No 109-9 (2006).



consultative units and insurers for the implementation of foreign investment.’<sup>120</sup>

It is important to note, however, that the transparency obligations in Article 11 of the US Model BIT and NAFTA Chapter 18 fall outside the scope of matters which can be brought by a foreign investor before an investment tribunal in proceeding initiated directly against a host state.<sup>121</sup> Similarly, Canada’s recently revised model BIT exempts transparency provisions from the scope of its investor-state dispute resolution mechanism.<sup>122</sup> Accordingly, under these treaties a foreign investor cannot claim a breach of the transparency provisions as a ground of state responsibility, as it remains a prerogative of the state parties to determine the matter by resorting to the state-to-state litigation mechanism. Hence, one is safe to conclude that transparency has yet to translate into a legally binding obligation that would entitle investors to a direct remedy against a host state.<sup>123</sup> To date, neither customary international law nor international investment treaties provide sufficient support for interpreting transparency as an enforceable component of FET.

## 6.2. Stability and predictability of the investment framework

In *Metalclad*, the host state was found responsible for the failure to ensure transparency and predictability of the investment framework. The tribunal did not elaborate on the notion of predictability. It mentioned predictability only twice: when referring to the preamble which

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<sup>120</sup> S Schill, ‘Revisiting a Landmark: Indirect Expropriation and Fair and Equitable Treatment in the ICSID case Tecmed’ (2006) 3 (2) Transnational Dispute Management.

<sup>121</sup> NAFTA State parties have stated that no general transparency requirement exists in Article 1105. See *Glamis Gold* (n 46) para 580 (referring to *Methanex*, Rejoinder Memorial of the United States on Jurisdiction, Admissibility and the Proposed Amendment, 33 (June 27, 2001); *Metalclad*, Amended Petition of Mexico to the Supreme Court of British Columbia (Sup. Ct. B.C.) para 72 (Oct. 27, 2000); *Metalclad*, Outline of Argument of Intervenor Attorney General of Canada (Sup. Ct. B.C.), para 31–33 (Feb 16, 2001)).

<sup>122</sup> The full text is available at <<http://www.naftaclaims.com>>. See also J McIlroy, ‘Canada’s New Foreign Investment Protection and Promotion Agreement: Two Steps Forward, One Step Back?’ (2004) 5 J World Investment & Trade 621, 639.

<sup>123</sup> However compare Schreuer (58) 375 (supporting arbitral decisions which have construed transparency as a component of FET).

stated that parties agreed to 'ensure a predictable commercial framework'<sup>124</sup> and concluding that Mexico failed to do so.<sup>125</sup> The *Tecmed* formulation of FET in terms of an obligation to act in a totally transparent and consistent manner makes no reference to predictability. Nevertheless, these awards have been heavily relied upon by subsequent tribunals which have found that, along with transparency, stability and predictability were also required under FET.

For instance, it was by reference to *Tecmed* and *Metalclad* that the tribunal in *Occidental v Ecuador* created a new element of FET.<sup>126</sup> In *Occidental*, the dispute arose from a denial of VAT refunds to a foreign investor. Having initially received refunds over a certain period of time, the investor was subsequently denied further reimbursements. The SRI, an Ecuadorian tax agency, annulled the previously issued resolutions granting refunds on the ground that they had been based on a mistaken interpretation of the tax law. The tribunal found that the framework under which the investment had been made and operated was changed in an important manner by the SRI's actions.<sup>127</sup> The tribunal distinguished between the obligation to refund VAT and the obligation of the host state to ensure 'the requirements of stability and predictability under international law',<sup>128</sup> and concluded that there was an international law obligation not to alter the legal and business environment in which the investment had been made.<sup>129</sup>

Prior to *Occidental*, there had been no customary international rule which would affirm that a state should be held to monetary responsibility if the investment framework was not stable and predictable. In order to interpret FET as a customary standard that requires stability and predictability, it was necessary to show the existence of a relevant custom, which

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<sup>124</sup> (n 94) para 71.

<sup>125</sup> Ibid para 99.

<sup>126</sup> *Occidental* (n 15).

<sup>127</sup> Ibid para 184.

<sup>128</sup> Ibid para 191.

<sup>129</sup> Ibid.

the *Occidental* tribunal failed to do.<sup>130</sup> Instead, drawing exclusively on the arbitral pronouncements in *Metalclad* and *Tecmed*, the tribunal vested a duty to ensure a stable and predictable environment with a status of customary international law.<sup>131</sup> As a matter of treaty interpretation, in order to conclude that FET encompasses an obligation to maintain a stable and predictable environment a tribunal would need to analyse the wording of the applicable investment treaty instrument.<sup>132</sup> Even when construed in accordance with the ordinary meaning of the treaty terms, it appears to be too sweeping a conclusion that FET, arguably including transparency as one of its elements, encompasses a duty to ensure stability and predictability. First, while transparency or clarity can significantly *contribute* to stability and predictability of a regulatory framework,<sup>133</sup> a host state's efforts to ensure that its policies are clear, readily accessible and communicated to affected investors may not suffice because the creation of a stable and predictable regime also hinges on a wide range of other political, macro- and microeconomic factors. As the recent economic downturn has shown, the stability and predictability of an investment regime may not always depend on the clarity of laws and regulations.

The breadth of the notions of “stability” and “predictability” also militates against their automatic translation into legally binding obligations. It is submitted that, unless a breach of a concrete investment treaty obligation (such as a prohibition of arbitrary and discriminatory measures) has been established, a state cannot be held liable for a failure to

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<sup>130</sup> For criticism, see Kill (n 48) 863-6.

<sup>131</sup> *Occidental* (n 15) para 190.

<sup>132</sup> See *Glamis Gold* (n 46) paras 614-616 (the tribunal rejecting the argument that customary international law has evolved to the point where the investor becomes entitled to additional, higher guarantees. The tribunal pointed to the lack of state practice and *opinio juris* to support such an interpretation of FET).

<sup>133</sup> According to UNCTAD (n 101), ‘the overriding aim of transparency in relation to FDI policy is to enhance the predictability and stability of the investment relationship and to provide a check against circumvention and evasion of obligations, by resort to covert or indirect means’ (ibid 7). However, transparency is only one of the factors that may enhance stability and predictability of the investment framework (ibid 69).

create a clear and predictable framework.<sup>134</sup> If declaratory commitments in a treaty preamble were to be capable of giving rise to state responsibility, the latter could be triggered by a mere failure to ‘foster greater economic cooperation’ and to ‘stimulate the flow of foreign investment.’ Even if construed as a standard independent from customary international law, FET must not convert declaratory statements on stability and predictability into legally binding obligations. As correctly stressed in *Continental Casualty v Argentina*, while stability of the legal framework for investments may feature in the preamble of a BIT, it is not a legal obligation. Neither can it properly be defined as an object of a treaty; rather, it is a precondition to the *promotion* of the investment flow.<sup>135</sup>

Despite the clearly insufficient legal basis on which the *Occidental* tribunal predicated the existence of an international obligation to ensure the stability and predictability of an investment framework, a number of tribunals have adopted a similar stance. Having referred to stability and predictability as an element of the FET standard, respective tribunals have likewise failed to substantiate their findings by reference to customary international law or treaty texts. For example, in *CMS v Argentina*, the treaty preamble stating that fair and equitable treatment is desirable ‘to maintain a stable framework for investments and maximum effective use of economic resources’ was sufficient for the tribunal to conclude that a stable legal and business environment should be regarded an essential element of fair and equitable treatment.<sup>136</sup> *PSEG v Turkey* provides another example where a lack of stability played a decisive role in the finding of an FET breach. One of the claims brought before the

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<sup>134</sup> It has been observed that statements in preambles of investment treaties ‘cannot be simply conflated with a general preference for the interests of the investor over those of the host state. The overall objective in fact requires a balanced approach’ (C McLachlan, ‘Investment Treaties and General International Law’ (2008) 57 ICLQ 361, 371).

<sup>135</sup> *Continental Casualty Company v Argentina*, Award, 5 September 2008 (ICSID Case No ARB/03/9) para 258 (emphasis added).

<sup>136</sup> *CMS* (n 4) para 274.

tribunal concerned a series of legislative amendments that impeded the renegotiation of the investor's contract for the construction of an electric power plant. The tribunal criticised the government for what it characterised as 'a roller-coaster effect of the continuing changes in the legislation', including amendments relating to the legal status of the project company and the concession contract.<sup>137</sup> The tribunal noted that

[w]hile in complex negotiations, such as those involved in this case, many changes will occur beyond the control of the government, as was particularly the case with the increased costs, the issue is that the longer term outlook must not be altered in such a way that will end up being no outlook at all. In this case, it was not only the law that kept changing but notably the attitudes and policies of the administration.<sup>138</sup>

This interpretation of FET and 'stability and predictability of the investment framework' is problematic. Again, the investor's right to stability and predictability lacked foundation in customary international law and the treaty text; nor was such an entitlement guaranteed in a contract or licence. Furthermore, unlike *Occidental* and *CMS*, the *PSEG* claim did not involve a fully fledged contract<sup>139</sup> or any other form of document evidencing the host state's commitment to refrain from altering the legal regime of the investment. In the absence of a specific commitment, and bearing in mind that the disputed changes in the legislation were not targeted at the investor but designed as measures of general application,<sup>140</sup> the decision interpreting FET to include a sweeping guarantee against legislative change would impose a considerable restraint on the sovereign powers of the host state. Such restraints cannot simply be deduced from a declaration stating that stability and predictability are important and desirable for the promotion of foreign investment flows.

So far as stability and predictability are concerned, the award in *PSEG* is in stark

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<sup>137</sup> *PSEG* (n 75) para 250.

<sup>138</sup> *Ibid* para 254.

<sup>139</sup> After having been approved by Danistay, the contract was not however finalised as the parties failed to reach agreement on key commercial terms. See *ibid* paras 266-270.

<sup>140</sup> *Ibid* paras 14-15.

contrast with the view adopted by the tribunal in *Parkerings v Lithuania*, which involved a similar complaint over legislative acts altering the regime of the investment. The dispute concerned an exclusive concession to operate the street parking in Vilnius, including the right to collect parking fees and enforce parking regulations through clamping. Shortly after the contract had been signed between the investor and the municipality, the Lithuanian Parliament enacted a number of laws relating to local fees and charges, clamping, and self-government organisations. Consequently, in line with the amended laws, a hybrid fee provision in the contract was annulled by the district court, and the contract itself came into conflict with the law due to the municipal authorities no longer being in a position to conclude contracts with private entities. Despite the similarity of the background involving the modifications in the legal regime that contributed significantly to the investor's inability to continue with its project, the *Parkerings* tribunal's decision on stability differs fundamentally from that reached in *PSEG*.<sup>141</sup> The *Parkerings* tribunal held that

It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a *stabilisation* clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power.<sup>142</sup>

The tribunal did not deny the existence of the right to stability and predictability of the legal environment but simply stressed that an expectation of stability ought to be reasonable and based on specific assurances made by the host state to the investor.<sup>143</sup> This interpretation of

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<sup>141</sup> *Parkerings-Compagniet AS v Lithuania*, Award on Jurisdiction and Merits, 14 August 2007 (ICSID Case No ARB/05/8).

<sup>142</sup> Ibid para 332.

<sup>143</sup> Ibid para 333. Similarly, in *AES Summit Generation Limited and AES-Tisza Erőmű Kft v Hungary*, Award, 17 September 2010 (ICSID Case No ARB/07/22) para 9.3.29, the tribunal held that '[a] legal framework is by definition subject to change as it adapts to new circumstances day by day and a state has the sovereign right to

stability is more consistent with the minimum standard to which states agree as a matter of customary practice and with investment treaties. As argued earlier in this chapter, FET does not create an entitlement to a perfect business environment but rather guarantees the exercise of the investor's rights under international law and treaties. Beyond arbitral pronouncements, which almost exclusively draw on the wording of treaty preambles, international law does not provide for a right to a stable and predictable framework. As a matter of international law it has been recognised that

[n]o enterprise – least of all a commercial or transport enterprise, the success of which is dependent on the fluctuating level of prices and rates – can escape from the chances and hazards resulting from general economic conditions. Some industries may be able to make profits during a period of general prosperity, or else by taking advantage of a treaty or commerce or of an alteration in customs duties; but they are also exposed to the danger of ruin or extinction if circumstances change.<sup>144</sup>

While FET does not include a right to stability and predictability, it may nevertheless guarantee fairness and equity in the exercise of an investor's rights, including those arising from a contract that contains a stabilisation clause. Along with being entitled to protection against discrimination, breach of due process and arbitrariness,<sup>145</sup> an investor can resort to contractual techniques enabling it to benefit from enhanced protection through agreeing to insulate its investment from certain legislative changes. Although the protection through stabilisation may not be absolute,<sup>146</sup> the existence of specific commitments made to an investor by a host state bestows upon the investor additional rights, which FET on its own cannot create.

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exercise its powers which include legislative acts'.

<sup>144</sup> *Oscar Chinn Case (UK v Belgium)* (Judgment) [1934] PCIJ Ser A/B No 63, 88.

<sup>145</sup> 'When predictable framework is referred to, it must be asked: predictable in relation to what? It would be perfectly sound to suggest that the investor must have certainty and predictability that it will not be unlawfully deprived of its possessions, will not be subjected to violence or discrimination and will not be precluded from the access to the fair judicial process including the award of remedies' (Orakdelashvili (n 77) 93).

<sup>146</sup> As is the case with contractual commitments generally, the presence of a stabilisation clause does not insulate the investor from the effects of a governmental regulation but nevertheless adds an extra layer of protection. See Chapter VI above.

The existence of specific commitments was central to the finding of a treaty breach in a number of investment disputes brought against Argentina in connection with emergency measures that abandoned the previously agreed tariff adjustment and convertibility mechanisms. In *BG*, *CMS*, *Enron*, *LG & E*, *National Grid*, and *Sempra* the stability guarantees were enshrined not only in the regulatory framework but also in investor licences.<sup>147</sup> While these awards remain open to criticism due to the absence of a valid legal justification for elevating stability to the status of ‘an emerging standard of fair and equitable treatment in international law’, the tribunals have duly emphasised the role of specific commitments in protecting investments against unpredictable change in the legal environment.<sup>148</sup>

### 6.3. Legitimate expectations

#### A. General

An obligation of FET, including contentious entitlements to transparency, stability and predictability of the investment framework, can also be analysed through the lens of the doctrine of legitimate expectations.<sup>149</sup> Although international investment treaties barely

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<sup>147</sup> *CMS* (n 4) para 275; *Sempra* (n 15) para 303; *National Grid* (n 15) para 179; *BG* (n 15) paras 306-307; *Enron* (n 15) para 260; *LG&E Energy Corp and ors v Argentina*, Decision on Liability, 3 October 2006 (ICSID Case No ARB 02/1) (2007) 46 ILM 36, paras 124-125. The tribunal in *Azurix* found stability to be an element of full protection and security ((n 10) para 408).

<sup>148</sup> See Newcombe & Paradell (n 59) 287 (warning against referring to stability and predictability as freestanding obligations, and noting that the majority of cases where tribunals have invoked the element of stability and predictability have involved reliance on specific representations or undertakings).

<sup>149</sup> See F Vicuna, ‘Regulatory Authority and Legitimate Expectations: Balancing the Rights of the State and the Individual under International Law in a Global Society’ (2003) Intl L Forum 188, 193-4; S Fietta, ‘The “Legitimate Expectations” Principle under Article 1105 NAFTA: *International Thunderbird Gaming Corporation v. The United Mexican States*’ (2006) 3 J World Investment & Trade 423, 430; E Snodgrass, ‘Protecting Investors’ Legitimate Expectations: Recognizing and Delimiting a General Principle’ (2007) 21 ICSID Rev – FILJ 1.



contain any reference to the concept of legitimate expectations,<sup>150</sup> in construing FET as a standard that protects the investor's legitimate expectations, arbitral tribunals have drawn support from the principle of good faith and the doctrine of estoppel.<sup>151</sup> It is well established in public international law that a failure of the state to inform others of the proposed changes in policy or to retreat from previously made assurances may lead to an obligation to indemnify the party which placed reliance upon the pre-existing state of affairs to its own detriment.<sup>152</sup> The same principle has been recognised in the more specific context of international investment law. It is commonly agreed that where a host state's conduct creates reasonable and justifiable expectations on the part of an investor to act in reliance on the said conduct, a failure by the host state to honour those expectations may cause the investor or investment to suffer damages.<sup>153</sup>

## B. Specific commitments

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<sup>150</sup> Explanatory notes to expropriation clauses in the recent generation of BITs and FTAs, especially those concluded by the US, contain reference to investment-backed expectations, the latter concept originating in the US jurisprudence on regulatory takings. See *Penn Central Transport Co v New York City*, 438 US 104 (1978); *Lucas v South Carolina Coastal Council* (1992) 505 US 1029; CG Chipcase, 'From Grand Central to the Sierras: What Do We Do with Investment-backed Expectations in Partial Regulatory Takings?' (2004-2005) 23 Va Env'tl LJ 43.

<sup>151</sup> *Thunderbird*, Separate Opinion (n 24) para 25. See also Dolzer (n 30) 91 (observing that the 'substance of the standard of fair and equitable treatment will in large part overlap with the meaning of a good faith clause in its broader setting, with one significant aspect embracing the related notions of *venire contra factum proprium* and estoppel').

<sup>152</sup> Bin Cheng, *General Principles of Law as applied by International Courts and Tribunals* (CUP, Cambridge 1994) 137-43. See also WM Reisman and MH Arsanjani, 'The Question of Unilateral Governmental Statements as Applicable Law in Investment Disputes' (2005) ICSID Rev- FILJ 328.

<sup>153</sup> *Thunderbird*, Award (n 24) para 147. For arbitral decisions referring to elements of legitimate expectations, such as assurances and reliance, see *Tecmed* (n 102) para 154 (FET construed as a standard of treatment "that does not affect the *basic expectations* that were taken into account by the foreign investor to make the investment"), *CME Czech Republic BV v Czech Republic*, Partial Award and Separate Opinion, 13 September 2001 (Ad hoc—UNCITRAL Arbitration Rules) para 155 (finding the government in breach of FET 'by evisceration of the arrangements in reliance upon which the foreign investor was induced to invest'), *Waste Management* (n 24) para 98 (noting that for a breach of FET to be established it is relevant that 'the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant'). See also *Saluka* (n 24) para 302 (holding that legitimate expectations has become the dominant element of FET).

The pertinent question is: to what extent are the investor's expectations of stability and predictability legitimate and deserve protection under investment treaties? Unsurprisingly, the existence of specific commitments operates as a key qualifying condition in determining the legitimacy of expectations. In order to be entitled to protection under an FET clause, an investor's expectation must stem from a commitment, assurance, or representation by a state party.<sup>154</sup> It has been stressed that the doctrine of legitimate expectations 'should not be used as a substitute for the actual arrangements between the parties.'<sup>155</sup> The significance of specific commitments as a central element of the legitimate expectations analysis has received cogent support in arbitral decisions. For instance, in addressing the claim relating to a government's decision denying VAT refunds, the *EnCana* tribunal held that 'in the absence of specific commitments from the host State, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment.'<sup>156</sup> Similarly, the *CMS* tribunal held that, 'it is not a question of whether the legal framework might need to be frozen as it can always evolve and be adapted to changing circumstances, but neither is it a question of whether it can be dispensed with altogether when specific commitments to the contrary had been made.'<sup>157</sup> In *LG&E*, in examining the disputed conduct against the doctrine of legitimate expectations, the tribunal explained that for an investor's expectations to be "fair" such expectations should be 'based on the conditions offered by the host State at the time of the investment; they may not be established

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<sup>154</sup> The protection of legitimate expectations does not mean that the state is obliged to respect every single expectation that the investor could have had, but it is obliged to respect those expectations that are grounded on clear representations and commitments with regard to the conduct that it will observe in a given set of circumstances. See Paradell (n 101) 135, Snodgrass (n 149) 34-7.

<sup>155</sup> J Crawford, 'Treaty and Contract in Investment Arbitration' (2008) 24 *Arbitration International* 351, 374.

<sup>156</sup> *EnCana Corporation v Ecuador*, Partial Award on Jurisdiction, 27 February 2004 (LCIA Case No UN3481) (2006) 45 ILM 655, para 173.

<sup>157</sup> *Ibid* para 277 (emphasis added).

unilaterally by one of the parties; they must exist and be enforceable by law.’<sup>158</sup> The *EDF v Romania* tribunal reached a similar conclusion in its examination of the investor’s claims under the FET clause.<sup>159</sup> The tribunal found that

[e]xcept where specific promises or representations are made by the State to the investor, the latter may not rely on a bilateral investment treaty as a kind of insurance policy against the risk of any changes in the host State’s legal and economic framework. Such expectation would be neither legitimate nor reasonable.<sup>160</sup>

The *Metalclad* award also provides support—albeit implicit—for specific commitments as a condition of the protection of legitimate expectations. In fact, the *Metalclad* tribunal condemned inconsistency in the conduct of the different branches of government contrary to assurances made to the investor. Had the tribunal formulated its finding of a treaty breach in terms of an inducement into detrimental reliance and a frustration of legitimate expectations, without having recourse to the language of “transparency obligations”, the award might not have been set aside on this ground.<sup>161</sup> At the same time, an examination of the disputed conduct against the doctrine of legitimate expectations, with an emphasis on the existence of specific commitments, would not have relieved the investor from its share of responsibility because it had placed excessive reliance on the representations by the federal officials, and even continued the construction works after being notified by the municipal authorities of the need to obtain a permit.<sup>162</sup>

### C. Reasonableness of reliance: taking account of a country risk

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<sup>158</sup> *LG&E* (n 147) para 130.

<sup>159</sup> *EDF (Services) Ltd v Romania*, Award, 2 October 2009 (ICSID Case No RB/05/13).

<sup>160</sup> *Ibid* para 217.

<sup>161</sup> See Choudhury (n 58) 308 (suggesting that the conduct of Mexico in relation to *Metalclad*’s investment could be categorised as a breach of legitimate expectations).

<sup>162</sup> *Metalclad* (n 94) paras 40-42.

Another criterion of the legitimacy of an investor's expectations is reasonableness of reliance. As a starting point, an expectation of total stability and predictability is unreasonable. The tribunal in *Saluka* highlighted that

[n]o investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.<sup>163</sup>

Likewise, in *EDF v Romania*, the tribunal warned against using legitimate expectations as a shield against regulatory change. In the tribunal's view,

the idea that legitimate expectations, and therefore FET, imply the stability of the legal and business framework, may not be correct if stated in an overly-broad and unqualified formulation. The FET might then mean the virtual freezing of the regulation of economic activities, in contrast with the State's normal regulatory power and the evolutionary character of economic life.<sup>164</sup>

Along with a recognition of the impossibility of an absolute stability guarantee, there is a growing support for the view that a foreign investor must act as a prudent and responsible actor, refrain from unconscionable dealings, undertake reasonable assessment of investment risks in the host country and operate an investment in a reasonable manner.<sup>165</sup> As far as stability and predictability are concerned, an investor's expectation will hinge on whether it has understood the risk of foreseeable future regulatory change prior to entering the host state.<sup>166</sup> Before a decision to invest is made, foreign investors ought to assess the

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<sup>163</sup> *Saluka* (n 24) para 305.

<sup>164</sup> *EDF* (n 159) para 217. See also Picherack (n 84) 282 (noting that 'investors have always understood, and should continue to understand, that regulatory frameworks evolve and adapt as the needs of the State require. This is an inherent element of business risk. The fair and equitable treatment provision was not meant to transfer this risk onto States.'

<sup>165</sup> See above nn91-93 and accompanying text.

<sup>166</sup> *Muchlinski* (n 93) 551. See also *Dolzer* (n 30) 103 (pointing to the double function of the pre-investment state of the law in that it provides both the foundation of the investment decision and the limitation of its subsequent protection in a case of a dispute). For the relevance of a commercial risk, see *Fireman's Fund Insurance Company v Mexico*, Award, 17 July 2006 (ICSID Case No ARB(AF)/02/01) paras 179-181, where the investor purchased an enterprise in a delicate financial condition at the time when Mexico was in the process of

shortcomings of the existing legal and regulatory framework.<sup>167</sup>

For example, in *Saluka v Czech Republic*, the investor alleged a breach of FET, including a failure to ensure a predictable and transparent framework. In particular, the investor contended that the government breached its treaty obligations by leaving the bank with no effective mechanisms to enforce loan security which affected its capability to comply with liquidity requirements.<sup>168</sup> The tribunal observed that it was undisputed between the parties that Czech law failed to provide effective mechanisms to enforce a loan security.<sup>169</sup> Nonetheless, it noted that such legal shortcomings must have been known to the claimant when its investment had been made and an expectation that such shortcoming would quickly be fixed by the Czech legislature was unfounded.<sup>170</sup> The tribunal concluded that

...even though the lack of adequate protection of creditors' rights will most certainly have contributed to the aggravation of the bad debt problem, the Tribunal is unable to find that the Czech Republic has frustrated Nomura's legitimate and reasonable expectations and violated the "fair and equitable treatment" standard by its failure to improve the legal framework within a timescale to help to Nomura.<sup>171</sup>

The tribunal in *Parkerings v Lithuania* similarly stressed the investor's duty to assess the legal and political environment in the host state.<sup>172</sup> As part of its examination of the investor's claims relating to an alleged lack of stability and predictability in the legislative framework of the investment, the tribunal drew attention to the fact that at the time the concession agreement had been concluded, Lithuania was in the process of transition from its past status of having been part of the Soviet Republic to being a member of the European Union.

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recovering from a major financial crisis. The tribunal found that the investor took a commercial risk that its investment could be adversely affected. "It took that risk in light of its desire to have an "admission ticket" to the "personal lines" insurance business in Mexico' (ibid para 180).

<sup>167</sup> Muchlinski (n 90) 544-7.

<sup>168</sup> *Saluka* (n 24) para 349.

<sup>169</sup> Ibid para 359.

<sup>170</sup> Ibid para 360.

<sup>171</sup> Ibid para 360.

<sup>172</sup> *Parkerings* (n 141).

Legislative changes were therefore to be reasonably expected. The tribunal concluded that

[a]s any businessman would, the Claimant was aware of the risk that changes of laws would probably occur after the conclusion of the Agreement. The circumstances surrounding the decision to invest in Lithuania were certainly not an indication of stability of the legal environment. Therefore, in such a situation, no expectation that the laws would remain unchanged was legitimate.<sup>173</sup>

The tribunal held that by deciding to invest notwithstanding the possible instability, the investor assumed the business risk of legislative changes likely to be detrimental to its investment.<sup>174</sup>

In *Duke Energy v Ecuador*, the tribunal endorsed a wider interpretation of FET as being inclusive of stability and predictability requirements.<sup>175</sup> Nevertheless, it indicated that in order to be entitled to protection the investor's expectations ought to be legitimate and reasonable at the time when the investor had made the investment.<sup>176</sup> The tribunal emphasised the importance of establishing the legitimacy of investor expectations against a wider context, including 'not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State.'<sup>177</sup> In assessing the reasonableness of the investor's expectations, the tribunal pointed to the fact that the investment had been made in the political and economic context of Ecuador's energy crisis and national shortage.<sup>178</sup>

In *Olguin v Paraguay*, the tribunal confronted the question of whether the government was under a duty to preserve the integrity of the financial system.<sup>179</sup> The dispute arose from the investment deposited by the investor with a financial company La Mercantil. In exchange

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<sup>173</sup> Ibid para 335.

<sup>174</sup> Ibid para 336.

<sup>175</sup> *Duke* (n 62) para 339.

<sup>176</sup> Ibid para 340.

<sup>177</sup> Ibid para 340.

<sup>178</sup> Ibid para 347.

<sup>179</sup> *Eudoro Armando Olguin v Paraguay*, Award, 26 July 2001 (ICSID Case No ARB/98/5).

for the deposit, the investor received investment instruments, with the funds derived thereof allocated to finance the installation of a corn product plant. Subsequently, in the midst of the economic crisis of the financial system in the country, La Mercantil suspended its operations and ceased honouring payments of the investment instruments. After the investor had made unsuccessful efforts to recover its funds, a claim was brought before the ICSID tribunal contending that the Republic of Paraguay and its agencies were negligent in supervising the activities of La Mercantil, and that such negligence led to the suspension of operations of that financial institution. The tribunal noted that although the imposition of economic sanctions on a state that fails to closely monitor their financial entities was desirable, such rules did not exist in either Paraguayan law or in the BIT.<sup>180</sup> The tribunal emphasised the role of the investor's prudence as a pre-condition to establishing its entitlement for a remedy:

It seems obvious to this Tribunal that there are serious shortcomings in the Paraguayan legal system and in the functioning of various State agencies. This Tribunal is not seeking to determine whether this situation is more severe in Paraguay than in other nations. What is evident is that Mr. Olguín, an accomplished businessman, with a track record as an entrepreneur going back many years and experience acquired in the business world in various countries, was not unaware of the situation in Paraguay. He had his reasons (which this Tribunal makes no attempt to judge) for investing in that country, but it is not reasonable for him to seek compensation for the losses he suffered on making a speculative, or at best, a not very prudent, investment.<sup>181</sup>

In *Genin*, the investor's claim did not expressly raise the issue of "stability and predictability" or "the protection of legitimate expectations."<sup>182</sup> Nonetheless, in its examination of whether revoking a licence of the investor-owned bank amounted to a violation of FET, the tribunal found

...imperative to recall the particular context in which the dispute arose, namely that of a renascent, independent state, coming rapidly to grips with the reality of modern financial, commercial and banking practices and the emergence of state institutions

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<sup>180</sup> Ibid para 74.

<sup>181</sup> Ibid para 65.

<sup>182</sup> *Genin v Estonia* (n 46).

responsible for overseeing and regulating areas of activity perhaps previously unknown. This is the context in which Claimants knowingly chose to invest in an Estonian financial institution, EIB.<sup>183</sup>

The need to take into account the country risk has not, however, been commonly endorsed in arbitral practice and scholarship.<sup>184</sup> For instance, it has been argued that setting the international minimum standard according to the level of development of the host state would result in ‘relativism’ contrary to an objectively determined minimum level of protection.<sup>185</sup> Others have proposed regarding FET as an objective and non-relative standard but suggested that, unlike FET, an obligation to provide full protection and security (the standard of due diligence) should allow for adjustments depending on a state’s particular circumstances.<sup>186</sup> It has been argued, for instance, ‘an investor investing in an area with endemic civil strife and poor governance cannot have the same expectation of physical security as one investing in London, New York or Tokyo.’<sup>187</sup> This distinction between FET and the standard of full protection and security is not convincing. If the level of development of a host state and other peculiarities of its environment are to be taken into account in determining a host state’s responsibility under the full protection and security standard, it would be difficult to ignore

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<sup>183</sup> Ibid para 348. In a somewhat different setting, the tribunal in *Toto v Lebanon* emphasised the importance of assessing the country risk at the time a decision to invest had been made. The tribunal held that a long delay between the closing of the debates in the two proceedings before the Conseil d’Etat and the subsequent request by the Conseil d’Etat for submission of documents did not constitute a breach of FET. The tribunal pointed to the fact that in the intervening years Lebanon had witnessed serious disturbances. These included the assassination of the Prime Minister Rafic Hariri, a 2006 war between Lebanon and Israel, severe internal fighting between the organisation Fatah-al-Islam and the Lebanese Army, and another internal armed conflict that exploded in May 2008 triggering a 17 month long political crisis. The tribunal concluded that the circumstances ‘were not conducive to the functioning of Lebanon’s judicial system and affected the proper functioning of Lebanese courts between 2002 and 2008’ (*Toto Costruzioni Generali SpA v Lebanon*, Decision on Jurisdiction, 8 September 2009 (ICSID Case No ARB/07/12) para 165).

<sup>184</sup> For an overview, see Gallus (n 92) 711. For an earlier work, see I Brownlie, ‘Treatment of Aliens: Assumption of Risk and the International Standard’ in W Flume and others (eds), *International Law and Economic Order: Essays in honour of F.A. Mann* (Verlag C.H. Beck, München 1977) 309.

<sup>185</sup> K Hober, *Investment Arbitration in Eastern Europe: In Search of a Definition of Expropriation* (JurisNet, New York 2007) 125, 225-6.

<sup>186</sup> Newcombe & Paradell (n 59) 310. See also *Pantechniki* (n 29) para 77.

<sup>187</sup> Ibid. In another case, the tribunal found it necessary to take into account the risks that the investor assumed when it ‘rightly or wrongly, has chosen to invest in a country such as Zaire’ (see *American Manufacturing & Trading, Inc v Zaire*, Award and Separate Opinion, 11 February 1997 (ICSID Case No ARB/93/1) (1997) 36 ILM 1531, paras 7.14-7.15.).



such background conditions in examining the allegations of a breach of FET. Since it has been acknowledged that the legal and regulatory security of the investment is just as important as its physical security,<sup>188</sup> it would be unsound to take into account the level of a host state's development only under the full protection guarantee.

In order to understand the relevance of a country risk as a factor in the assessment of the legitimacy of investor expectations it is important to distinguish between the customary international minimum standard and the expectations of a perfect public regulation in a perfect state.<sup>189</sup> The problem here is that the expectation of legal security of an investment is sometimes regarded as an investor's entitlement, even despite the fact that such an entitlement lacks support in treaty texts or customary international law. It is true that the minimum protection standard, to which the investor is entitled under international law, including the expectation of physical security, should not vary depending on the host state's development. Regardless of whether the investment is made in a developed state or a state plagued by political instability and poverty, the international minimum standard must guarantee protection against discrimination, breach of due process and arbitrariness. As indicated by the arbitrator in *Pantechniki*, '[f]oreigners who enter a poor country are not entitled to assume that they will be given things like verbatim transcripts of all judicial proceedings – but they are entitled to decision-making which is neither xenophobic nor arbitrary.'<sup>190</sup>

Without affecting its entitlement to the minimum protection standard, the level of a host state's development and, as the case may be, the regulatory environment in certain

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<sup>188</sup> See *Azurix* (n 10) para 408, holding that 'the stability afforded by a secure investment environment is as important from an investor's point of view'.

<sup>189</sup> *Douglas* (n 111) 28.

<sup>190</sup> *Pantechniki* (n 29) para 76. It is however difficult to agree with the arbitrator's view that the standard should be objective because if the standard is set according to the level of the host state development it would provide no incentive to improve (ibid para 76) This argument is based on an unsubstantiated premise that holding host states liable leads to the economic and social development.

sectors of an economy will come into play in determining the reasonableness of an investor's additional, higher expectations, including those relating to the legal and regulatory security of an investment. Precisely because the notions of fairness and equity militate against a one-sided interpretation of the investment treaty provisions, the investor must not be entitled to a remedy where its high expectations have been frustrated because of a host state's inability to meet certain standards of good governance, such as total transparency, stability, predictability and efficiency. It would be unfair and inequitable for an investor to claim compensation for the lack of administrative capabilities and established practice of good governance in the case where such disadvantages were known to the investor, and even formed the basis of the investor's decision to enter the market. It has been observed that foreign investors frequently '[t]ake advantage of the lack of administrative capacities and technical expertise in developing countries to get away with things they could not get away with in developed countries.'<sup>191</sup>

For instance, in *Generation Ukraine*, the tribunal addressed the investor's claim concerning an alleged interference by the Ukrainian authorities in the investor's real estate project. In examining whether the investor's expectations had been frustrated, the tribunal found it necessary to take into account the transitional state of the host economy. It observed that the investor had been attracted to the Ukraine '[b]ecause of the possibility of earning a rate of return on its capital in significant excess to the other investment opportunities in more developed economies.'<sup>192</sup> The tribunal concluded that the investor '[i]nvested in the Ukraine

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<sup>191</sup> JE Stiglitz, 'Regulating Multinational Corporations: Towards Principles of Cross-Border Legal Frameworks in a Globalized World Balancing Rights with Responsibilities' (2008) 23 Am U Intl L Rev 451, 478. 'Worse still, some MNCs are exploiting the lack of administrative capacity as the basis of claims against developing countries under BIT provisions providing for "fair and equitable treatment" – even though they should have been fully aware of these limitations at the time they made the investments' (ibid 479).

<sup>192</sup> *Generation Ukraine, Inc v Ukraine*, Award, 15 September 2003 (ICSID Case No ARB/00/9)(2005) 44 ILM 404, para 20.37.

on notice of both the prospects and the potential pitfalls.’<sup>193</sup> The tribunal’s decision accurately captures the reality of an investor’s decision-making process whereby the absence or lack of democratic institutions and civil society is often seen as an economic advantage.

Furthermore, the voluntary assumption of risk is not limited to the general level of the host state’s development and also includes the assessment of industry-specific risks and the intensity of regulation. Thus, careful consideration of the existing investment regime is necessary not only where an investment is made in a developing state but also remains important where an investment is channelled into certain sectors of the economy of a developed state. In *Methanex v United States*, for instance, the investor contended that an environmental ban on the use of methanol-based fuel additive amounted to expropriation and breach of FET.<sup>194</sup> The tribunal found that the investor had not been given any specific commitment to the effect that the government would refrain from regulation.<sup>195</sup> It further emphasised the need to take into account the specificity of the overall framework in which the investment had been made. The tribunal highlighted the fact that

Methanex entered a political economy in which it was widely known, if not notorious, that governmental environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organizations and a politically active electorate, continuously monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons. Indeed, the very market for MTBE in the United States was the result of precisely this regulatory process.<sup>196</sup>

As the foregoing discussion shows, the assumption by an investor of a risk (political,

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<sup>193</sup> Ibid para 20.37.

<sup>194</sup> *Methanex Corporation v United States*, Final Award on Jurisdiction and Merits, 3 August 2005 (Ad hoc—UNCITRAL Arbitration Rules) (2005) 44 ILM 1345.

<sup>195</sup> Ibid Part IV Chapter D para 10.

<sup>196</sup> Ibid Part IV Chapter D, para 9. See also *LG & E* (n 147) para 130: ‘the investor’s fair expectations cannot fail to consider parameters such as business risk or industry’s regular patterns.’ See further J Kalicki and S Medeiros, ‘Fair, Equitable and Ambiguous: What is Fair and Equitable Treatment in International Investment Law?’ (2008) 22 ICSID Rev – FILJ 24, 46.

regulatory or economical) is a key element in the assessment of whether an investor's specific expectations are reasonable. This element of the legitimate expectations analysis does not detract from the minimum protection standard, which guarantees against non-discrimination, arbitrariness and due process.

## 7. Creation of Favourable Conditions for Investors: A Binding Obligation?

In addition to statements in treaty preambles referring to the creation of favourable conditions for investments as one of a treaty's objectives, a number of investment treaties provide a general obligation to encourage the creation of, or maintain, favourable conditions.<sup>197</sup> For example, Article II (1) of the Canada – Ecuador BIT stipulates that each contracting party shall encourage the creation of favourable conditions for investors of the other contracting party to make investments in its territory. This provision is followed by more specific obligations to accord investments FET and full protection and security.<sup>198</sup> The question accordingly is whether a general obligation to create and maintain favourable conditions can serve as a standalone ground of host state responsibility to an investor.

The prevailing view is that caution needs to be exercised in relying on treaty preambles, which refer to the encouragement and promotion of investment.<sup>199</sup> Even where a preamble refers to the desirability of fair and equitable treatment, a preambulatory statement of this kind cannot be regarded as a binding obligation. For example, in *Bayindir v Pakistan*, the investor contended a breach of FET despite the fact that the treaty did not contain an FET

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<sup>197</sup> See Article II of the Treaty Between the United States of America and the Republic of Panama Concerning the Treatment and Protection of Investments (adopted 27 October 1982, entered into force 30 May 1991) S Treaty Doc No 99-14 (1986).

<sup>198</sup> Ibid Article II (2).

<sup>199</sup> *Plama Consortium Ltd v Bulgaria*, Award, 27 August 2008 (ICSID Case No ARB/03/24), para 193, quoting I Sinclair, *The Vienna Convention on the Law of Treaties* (2<sup>nd</sup> edn Manchester University Press, Manchester 1987). See also Newcombe & Paradell (n 56 ) 125-6. See also *Saluka* (n 24) para 300 and *Continental Casualty* (n 131) para 258.

clause.<sup>200</sup> The investor asserted that FET could be imported from the treaty preamble which recognised the importance of FET, and through the MFN clause. Indeed, the preamble referred to the contracting parties' '[a]greeing that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources.'<sup>201</sup> However, the tribunal found such language to be of little assistance in establishing any operative obligation.<sup>202</sup> Rather, it held that the reference to FET in the preamble together with the absence of a FET clause in the treaty could be regarded as evidence that Turkey and Pakistan intended not to include an FET obligation in the treaty.<sup>203</sup>

However, it has been argued that unlike statements in treaty preambles, general obligations on the creation of favourable conditions can operate as substantive and enforceable treaty provisions. For instance, Reisman and Sloane have construed an obligation to create favourable conditions in normative terms:

The 'favourable conditions' established by BITs consist, not merely of natural phenomena such as climate resources, and access to the sea, nor even an educated population in the host state receptive to and eager to participate in the benefits of foreign investment; they also contemplate, more significantly and innovatively, an effective normative framework: impartial courts, an efficient and legally restrained bureaucracy, and the measure of transparency...

...In a BIT regime, the host state must do far more than open its doors to foreign investment and refrain from overt expropriation. It must establish and maintain an appropriate legal, administrative, and regulatory framework, the legal environment that modern investment theory has come to recognize as a *conditio sine qua non* of the

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<sup>200</sup> *Bayindir Insaat Turizm Ticaret ve Sanayi A Ş v Pakistan*, Award, 24 August 2009 (ICSID Case No ARB/03/29).

<sup>201</sup> Ibid para 154.

<sup>202</sup> Ibid para 155.

<sup>203</sup> Ibid para 155. However, the tribunal found that the reference to FET in the BIT's preamble did not rule out the possibility of importing an FET obligation through the MFN clause expressly included in the Treaty: 'even though it does not establish an operative obligation, the preamble is relevant for the interpretation of the MFN clause in its context and in the light of the Treaty's object and purpose pursuant to Article 31(1) of the VCLT' (ibid para 155).

success of private enterprise.<sup>204</sup>

Newcombe and Paradell also endorse the view that an obligation to create favourable conditions should be viewed not as a hortatory device, but as a substantive standard under which the host state must create a minimal legal, administrative, and regulatory framework.<sup>205</sup> Thus, the standard would be triggered in a case involving a systemic failure in a state's regulatory system that substantially hinders the ability of a financial company to enforce its security interests.<sup>206</sup> While noting that an obligation to create and maintain favourable conditions should not be viewed as imposing specific types of market-based regulatory policies such as privatisation and deregulation, it has nevertheless been suggested that "favourable conditions" might be interpreted as 'the minimal legal administrative and regulatory framework that fosters and sustains investment in industrialized capital-exporting states.'<sup>207</sup>

It is difficult to agree with this view. Although it has been stressed that a duty to create favourable conditions does not imply the adoption of certain economic policies but rather implies a framework based on the rule of law, it is still difficult to accept that this is a host state's duty, which in the case of a breach would justify an obligation to remedy the loss caused to an investor. First, interpreting a commitment to create favourable conditions in terms of a legal obligation leads to the imposition of an unrealistic burden. Such an interpretation may contribute to a growing perception of investment treaties as instruments leading to reverse discrimination that adversely affects local enterprises. Indeed, it is hardly conceivable that a local business could hold its government responsible for failing to create

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<sup>204</sup> WM Reisman and RD Sloane, 'Indirect Expropriation and Its Valuation in the BIT Generation' (2004)74 *British Ybk Intl L* 115, 117.

<sup>205</sup> Newcombe & Paradell (n 59) 131.

<sup>206</sup> *Ibid.*

<sup>207</sup> *Ibid* 132 (referring to Reisman and Sloane (n 204) 118).

favourable business conditions. Second, the word ‘favourable’ is open to an overly broad interpretation. It could, for instance, be argued that favourable conditions rule out highly complex and intricate regulatory regimes and presupposes minimal state intervention. Third, the absence of specific content detracts from the enforceability of such a putative obligation.<sup>208</sup> Imposing an obligation to create favourable conditions is a flagrant attempt to transform an investment treaty into an insurance policy without an insurance premium.

It is evident that beneath the argument for interpreting ‘the creation of favourable conditions’ as an enforceable treaty standard lies a new theory of international minimum protection, which according to its proponents should include ‘an effective normative framework: impartial courts, an efficient and legally restrained bureaucracy, and the measure of transparency.’<sup>209</sup> Doubts arise if an entitlement to benefits of this kind could plausibly be regarded as a minimal protection. Certainly, undertaking a business in industrialised economies may benefit from effective legislation, independent judiciary, and sufficiently restrained bureaucracy. However, even in developed states none of these hallmarks of a ‘civilised economy’ are legally binding and capable of giving rise to the state’s liability.<sup>210</sup> Furthermore, it remains highly questionable whether holding the government liable in damages has any impact on legislative, administrative and judicial decision-making.<sup>211</sup> Rather than spawning a culture of transparency and efficiency, the imposition of a duty to pay for

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<sup>208</sup> See M Sornarajah, *The International Law on Foreign Investment* (CUP, Cambridge 2010) 189 (noting that if a duty to encourage investment flows is contained not in a preamble but in a separate provision it may have some force; however, the content of such a duty cannot be assessed, as the amount of the investment that should be encouraged cannot be quantified. Thus, the duty can be satisfied as long as the state does not impede the flow of investment).

<sup>209</sup> See above n 200.

<sup>210</sup> E.g. the requirement of a breach of statutory obligation in the UK and the sufficiently serious breach requirement in the EU law. The latter requires a disputed regulation to confer rights on individuals. See further P Craig and G De Burca, *EU Law: Texts, Cases, and Materials* (4<sup>th</sup> edn OUP, Oxford 2008) 583-4.

<sup>211</sup> There is a theory that liability does not influence governmental conduct. First, damages are not usually paid from the budget of a governmental department whose decision/misconduct/omission was found wrongful. Instead, it is more common that awards are disbursed from the general treasury. For discussion of this theory, see D Cohen, ‘Regulating Regulators: The Legal Environment of the State’ (1990) 40 U Toronto L J 213.

their inability to ensure good governance standards is likely to influence adversely host states' attitudes towards investment treaties and investment arbitration. It has been accurately predicted that 'developing countries that are constantly paying damages to foreign investors for failing to provide a standard of treatment that is impossible for them to provide are unlikely to renew the treaty when it expires.'<sup>212</sup>

It is submitted that a commitment to create favourable conditions is better construed in light of the specific obligations that investment treaties customarily include in their corpus. Just as guarantees of stability and predictability need to be substantiated with reference to an international custom or a treaty text, for "favourable conditions" to be construed as encompassing efficient legislation, impartial judiciary and restrained bureaucracy, the proposed interpretation must draw sufficient support from established sources of international law. At a closer look, neither investment treaties nor customary international law enshrines the guarantee of favourable conditions. The common denominator being the prohibition of discrimination, arbitrariness and breach of due process, it can be argued that states are under a duty to create and maintain conditions that are conducive to foreign investment to the extent that the latter is protected against what international law considers to be impermissible conduct.

This view finds support in recent arbitral practice. For instance, in *Toto v Lebanon*, a duty to create and maintain favourable economic and legal conditions was included in a general promotion and protection clause of the Italy–Lebanon BIT.<sup>213</sup> In addressing the investor's claim over the increase in customs duties and taxes, the tribunal held that

[t]he Treaty does not sanction changes in legislation. It rather obliges Lebanon to create and maintain favourable economic and legal conditions. The tribunal does not regard a mere increase in customs and duties and taxes as *prima facie* evidence of

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<sup>212</sup> Gallus (n 92) 726, see also Picherack (n 84) 288-90.

<sup>213</sup> *Toto* (n 183).



failure to maintain “favourable economic and legal conditions” of the investment. However, if Toto could demonstrate that these changes in legislation were discriminatory, unreasonable, or otherwise in violation of the Treaty, the Tribunal would have jurisdiction under Article 2, paragraph 3 or other provisions of the Treaty.<sup>214</sup>

Let alone the responsibility for a breach of a “favourable conditions” standard, arbitral tribunals have held that a mere failure to fulfil the specific objectives of administrative regulations without something more does not necessarily rise to a breach of international law. For instance, in *GAMI*, the investor contended that Mexico’s failure to implement the Sugar Program constituted a violation of its investment obligations, including an obligation to accord FET. The tribunal held that ‘the failure to fulfil the objectives of administrative regulations without more does not necessarily rise to a breach of international law.’<sup>215</sup> After having examined the implementation of the program, the tribunal found no evidence to conclude that the failures in the Sugar Program were both directly attributable to the government and directly causative of GAMI’s loss.<sup>216</sup> It drew attention to the fact that the government was not the only actor in realising the program’s objectives.<sup>217</sup>

Desirable as it may be to ensure efficient legislation, impartial judiciary, and restrained bureaucracy, the determination of a host state’s liability to an investor requires the identification of specific acts and omissions. Theoretical considerations aside, it is clear that the inherent vagueness of the term “favourable conditions” and the sheer scale of a promise contained therein would make it too easy to claim a breach. Yet in order to establish a breach by a host state of its obligations and identify a causal link between a breach and the damage suffered by an investor, an investor’s claim must not be formulated in overly-broad terms but should refer to a specific conduct. The award in *Pantechniki v Albania* provides a pertinent

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<sup>214</sup> Ibid para 129-130.

<sup>215</sup> Ibid para 97.

<sup>216</sup> Ibid para 110.

<sup>217</sup> Ibid.

example. The investor contended that Albania should be liable because “powerful public officials were complicit in the pyramid schemes that had so enraged the populace.”<sup>218</sup> The tribunal pointed out that the premise of the investor’s claim was problematic:

The Claimant has seized on a general perception that Albania’s struggling public institutions were disserved by influential and unscrupulous officeholders. But a claim before an international tribunal cannot be made good by casual references to general perception. Specific conduct must be alleged and proved.<sup>219</sup>

Although in *Pantechniki* the arbitrator did not discuss an obligation to create favourable conditions, its finding supports the view that specific conduct rather than a general allegation of a failure on the part of decision-makers is necessary in order to establish responsibility. The determination of a host state’s duties in concrete terms is instrumental not only in proving the existence of a breach and meeting causation requirements but also in terms of its signalling effect. Regardless of whether a commitment to create favourable conditions is made in the preamble of a treaty or included among substantive standards, it is true that both investors and host states

[n]eed to know beforehand what kind of measures entail the international responsibility of the State and, accordingly, against which kind of political and administrative risk the fair and equitable treatment standard protects (and conversely, what risks the investor takes or should separately insure against).<sup>220</sup>

8. FET and general principles of law: towards the convergence of the international minimum and the national treatment standards

The development of FET as a leading investment protection standard has been marked by a tendency for a retreat from the policies prioritising the protection of a foreign

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<sup>218</sup> *Pantechniki* (n 29) para 83.

<sup>219</sup> *Ibid.*

<sup>220</sup> S Schill & B Kingsbury, ‘Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law’ (2009) New York University Public Law and Legal Theory Working Papers, 19.

investment.<sup>221</sup> As far back as in 2002, the United States Trade Act identified the principal negotiating objectives of the United States regarding foreign investment “to reduce or eliminate artificial or trade-distorting barriers to foreign investment, while ensuring that foreign investors in the United States are not accorded greater substantive rights to investment protections than the United States investors in the United States.”<sup>222</sup> The revision by major industrialised states of their investment treaty programmes, including the adoption of more restrictive formulations of FET, has been characterised as a revival of the Calvo principle.<sup>223</sup> It has been argued, for instance, that international rules on investment protection should not be more rigorous than those applied by domestic courts in developed states.<sup>224</sup> Thus, the treatment of investors in domestic legal systems is seen as a benchmark below which the level of international minimum protection should not fall.

Convergence of the much debated international minimum standard with the national treatment standard may indeed facilitate identifying a common denominator as a foundation of a standard that would command greater acceptance among different stakeholders. National treatment has long been established as a strong alternative to the international minimum

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<sup>221</sup> It has been observed that “[co]nstantly envisioning itself as the condemned party in each new arbitral award issued far away, Washington appears to have lost sight of the unquestionable benefits that modern investment treaties have bestowed upon American business and the American economy in general. International law cannot be a one-way street, and as capital-exporting States more frequently become respondents in investment arbitration, they will be forced to adopt a long-term review of developments and their own self-interest to preserve the hard-won gains they have achieved” (see N Rubins, ‘*Loewen v. United States: The Burial of an Investor-State Claim*’ (2005) 21 Arb Intl 1, 36). See also FO Vicuna, ‘Foreign Investment Law: How Customary Is Custom?’ ASIL Proceedings (2005) ASIL Proc 98, noting that some states ‘appear to be moving backwards as a result of their transitions from capital-exporter to capital-importer status. A number of debates in the United States in connection with the North American Free Trade Agreement (NAFTA) and other international bodies are clearly reminiscent of discussions in Latin America in the past...’ See also McIlroy (n 122) 637 (on the Canadian experience); Schwebel (n 41); G Sampliner, ‘Arbitration of Expropriation cases Under U.S. Investment Treaties—A Threat to Democracy or the Dog that Didn’t Bark?’ (2003) 18 ICSID Rev-FILJ 1; Subedi (n 57) 132-5.

<sup>222</sup> Trade Act of 2002, Pub L 107-210 (107 Cong., 2d Sess.) sec 2102, cited in Sampliner (n 221) 36-7.

<sup>223</sup> See W Shan, ‘From “North-South Divide” to “Private-Public Debate”’: Revival of the Calvo Doctrine and the Changing Landscape in International Investment Law’ (2006-2007) 27 Northwest J Intl L & Bus 631.

<sup>224</sup> Montt (n 87) 81.

standard advocated by Western states.<sup>225</sup> The recent tendency for questioning by developed states of the international standard of foreign investment protection can be seen as a reversal to the principle of national treatment in state practice.<sup>226</sup> For instance, the possibility that UK investment treaties might require a higher level of compensation be paid to foreign investors of the nationalised Northern Rock was debated in the UK House of Commons. The idea of investment treaties granting foreign shareholders higher protection was flatly rejected. In the words of Lord Davies, the then Government Deputy Chief Whip,

Nothing could be more offensive to the small shareholder than the idea that someone based abroad would be able to take advantage of bilateral treaties that were designed to...safeguard, on the whole, British taxpayers regarding regimes that can act on occasion in an extremely arbitrary and unfair manner.<sup>227</sup>

The statement illustrates two important aspects of the international minimum standard: the idea that the protection of foreign investors is designed to safeguard against serious incidences of arbitrary and unfair treatment, and the convergence of national and international standards of treatment.

Nevertheless, if national investment protection policies were to be used as a benchmark in determining the level of minimal protection that investors can enjoy under international law, this would in essence reinforce the long debated position according to which, once endorsed by civilized nations, a standard of treatment was regarded as internationally binding.<sup>228</sup> Although the protection of property rights and economic freedoms

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<sup>225</sup> See Roth (n 37) 111 concluding that both the equality doctrine and the international minimum standard were so heavily represented in international practice as to make it difficult to judge which of them should be given preference. See also Brownlie (n 37) 502. Despite its opposition to the national treatment standard at the 1930 Hague Codification Conference, the United States subsequently endorsed it in its submission in the *Norwegian Ships* arbitration (ibid).

<sup>226</sup> See NJ Calamita, 'The British Bank Nationalizations: An International Law Perspective' (2009) 58 ICLQ 119, 122-3.

<sup>227</sup> Ibid 123 (quoting Hansard HL Deb cols 1473-82).

<sup>228</sup> Roth (n 37) 87 'The minimum standard is the expression of the common standard of conduct which civilized States have observed and still are willing to observe with regard to aliens... for a given general principle to have weight as a source of law it is only necessary that the principle is found in general at the basis of national legal

in developed countries has proven to be conducive to the healthy performance of businesses in a regulated environment,<sup>229</sup> it would be both theoretically and practically ill-founded to determine the international minimum standard by an exclusive reference to a certain group of countries. It is conceivable that in some cases the substantive law of a developed state may fall below the postulated international standards.<sup>230</sup>

It is submitted that the better view would be to take into account normative stances favoured by national governments to the extent that they cumulatively contribute to the formation of general principles of law. As an appropriate source of law under Article 38 of the Statute of the ICJ, general principles can be ascertained through a comparison of the rules of major domestic legal systems governing judicial review of economic regulation.<sup>231</sup> In practical terms, recourse to general principles of law would facilitate the approximation of international rules on the protection of foreign investment with national approaches, thus preventing a host state from asserting higher protection for its investors than that accorded to foreign investors under a host state's domestic law. As a matter of international law, '[a] state would act in bad faith if it objected, on the international level, to the applicability of a rule the substance of which it has formulated and accepted as just and appropriate within its own jurisdictional sphere.'<sup>232</sup> General principles of law may be particularly instructive in

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systems.'

<sup>229</sup> Montt (n 87)81.

<sup>230</sup> Historically known examples include some of the condemned policies in Nazi Germany as well as agrarian expropriations in Mexico. (Roth (n 37) 86). For recent examples, see R Higgins, 'The Taking of Property by the State: Recent Developments in International Law' (1982) 176 *Recueil des Cours* 259, 308-10, discussing the UK government initiated renegotiation of petroleum licences in the 1970s. The 1975 Petroleum and Submarine Pipeline Act provided for 51% acquisition by the British National Oil Corporation of all petroleum licences and introduced the requirement to obtain ministerial consent for many oilfield activities. If adopted by the government of a less developed country, changes of this scale would be viewed as a nationalisation triggering the state obligation to compensate affected investors. The recent move toward the revision of oil concessions in Ecuador and Bolivia offers pertinent examples. Nonetheless, in adopting the 1975 Act the UK Government took the view that a sovereign right to legislate in respect of the natural resources on its shelf was in no way impeded by contracts that it had previously entered into with foreign oil companies.

<sup>231</sup> See R Dolzer, 'Indirect Expropriations: New Developments?' (2002) 11 *NYU Envtl L J* 64, 76.

<sup>232</sup> *Ibid.*

determining the existence of a basic agreement about the scope and meaning of an internationally accepted minimum standard of investment protection. Do national legal systems, including the principles governing judicial review of governmental action, enable local enterprises to claim damages for a lack of stability, predictability, transparency, and failure to negotiate? To what extent can a tribunal substitute its own judgment for that of a responsible governmental body? While an in-depth comparison of national legal orders falls outside the scope of this thesis, a cursory overview of the literature on comparative judicial review and recent scholarship which analyses investment arbitration as a form of administrative law reveals the prevalence of deferential, process-orientated systems of judicial review.<sup>233</sup>

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<sup>233</sup> See G Van Harten, *Investment treaty arbitration and public law* (OUP, Oxford 2007); Kingsbury & Schill (n 220); Montt (n 87).

## CONCLUSION

The purpose of this study has been to outline the frontiers of state responsibility in investment treaty law and to examine the role of the traditional expropriation standard and non-expropriatory standards of treatment in determining the consequences of a host state's interference with a foreign investment. From the outset, it has been shown that the indeterminacy and inherent breadth of the notion of investment will frequently allow the extension of the protection afforded to investment to virtually any economic rights arising from a commitment of resources in the expectation of profits. Significantly, the fact that international treaties have adopted the term of 'investment' in lieu of 'property' means that the previous tendency to associate investment protection with protection against expropriation no longer holds true. Rather, the modern investment treaty regime protect investors against a host state's interference in a variety of economic settings.

A closer look at the tests developed by arbitral tribunals in addressing claims of expropriation has revealed the inadequacy of deploying the conceptual frameworks that had evolved in a different historical and legal context. As shown in Chapter II, the sole effect doctrine and its yardstick of substantial deprivation fails to offer a reliable analytical tool for deciding whether disputed governmental conduct should give rise to a host state's international responsibility. The way that investment is defined in international investment instruments, coupled with the availability of corporate structuring and the emphasis on the case-by-case determination of expropriation claims, all enable an investor to easily satisfy or circumvent the substantial deprivation test. Furthermore, not only is it practically and conceptually problematic to identify the point beyond which a deprivation becomes substantial, but the very threshold of substantiality does not have a basis in international investment agreements, which usually protect the whole investment as well as various rights

arising from it. Neither is it necessary to satisfy the substantial deprivation test in order to establish a breach of non-expropriatory standards of treatment. As arbitral practice reveals, the latter can be successfully invoked with a view to obtaining the same remedy as in the case of expropriation regardless of whether the disputed conduct is substantially destructive and expropriatory.

The principal failing of the expropriation standard, however, is its focus on the fact of deprivation and the mandatory compensation requirement, both of which effectively allow an investor to claim a breach of treaty every time the investor incurs any loss in the value of its investment or is otherwise restricted in its use and control. As the matter of deprivation becomes a controlling factor, investment treaties are transformed into instruments of insurance against regulatory change. While this is undesirable from the perspective of developing a credible, balanced and sustainable investment protection regime, the deprivation-focused approach is also at odds with the underpinnings of state responsibility under non-expropriatory standards of treatment. As argued in Chapter III, expropriation should be abandoned in favour of a unified concept of investment treaty breach. Under the proposed standard, a disputed governmental action would give rise to a state's responsibility to an investor only if such action has violated the guarantees of non-discrimination, non-arbitrariness, and due process of law.

In justifying the need for a unified concept of investment treaty breach, this thesis draws attention to the existence of multiple and overlapping causes of action. As shown in Chapters IV to VII, a governmental action can be variously challenged as a breach of FET, arbitrary measure, a failure to provide effective means of asserting claims, or a violation of the national treatment standard. Recent arbitral practice reveals that the availability of multiple grounds of recovery has been deployed by investors to circumvent the procedural and substantive pre-conditions to investment arbitration expressly stipulated in international



investment instruments. Inconsistency and uncertainty aside, such practices only exacerbate concerns over the credibility and legitimacy of the whole investment protection regime. Bringing the standards of treatment under the umbrella of an overarching investment protection guarantee might be the way forward.

In order for the existing investment treaty network to evolve into a balanced and sustainable international mechanism, both the drafting of international investment agreements and their interpretation should be substantially revised. Along with eliminating multiple and redundant provisions, a high-scrutiny approach to evaluating a host state's disputed policies and decisions should be abandoned in favour of judicial and arbitral restraint. Although institutional reform would seem to be necessary, treaty drafters may facilitate the process of change by discarding open-ended and highly contested treaty provisions. Despite the existence of a large number of BITs containing broadly defined provisions on dispute resolution, far-reaching umbrella clauses and FET requirements, a number of new generation BITs and FTAs demonstrate the international community's desire to curb the expansion of investment treaty protection by expressly delimiting the scope of the relevant treaty provisions. Until such revision is undertaken on a larger scale, the meaning and the ultimate reach of investment treaty guarantees remain precariously open to diverse, inconsistent and often ill-founded interpretation reflecting the individual convictions of party-appointed arbitrators.

FET can, it has been argued, serve as an overarching standard of investment treatment and a basis for the concept of an investment treaty breach only if construed in accordance with customary international practice and general principles of law. Investment arbitration and treaty practice both reveal that so far as the substantive protection of investment is concerned, the entitlement of the investor to procedural fairness, non-arbitrary and non-discriminatory treatment is largely undisputed. Additional guarantees of transparency,

stability and predictability should not be regarded as a breach of FET and an international wrong, unless a clearly stated and legally enforceable obligation to that effect has been provided in a relevant treaty text, customary international law or the national legal framework. Construing FET as a standard of super-protection and as a guarantee of a perfect regulatory regime not only lacks a basis in investment treaties and customary international law but is also highly questionable because of the absence of an equivalent guarantee in national legal systems of developed as well as developing states. Although an expansive and pro-investor interpretation of the standard remains a real possibility under many existing BITs, tribunals should be cognisant of the potential to create a backlash and undermine the long-term availability of investment protection.

As regards the proposal to replace expropriation with the FET standard, it can of course be argued that without such an instrumental provision as the prohibition of uncompensated expropriation, an investor would be left unprotected and vulnerable. Indeed, can a standard of non-discrimination, non-arbitrariness or due process of law alone safeguard an investor's investment from deleterious effects of governmental intervention? What if an investor's land has been directly taken without compensation by virtue of a legislative act aimed at restoring the rights of historically disadvantaged people? Would the legitimate purpose behind such an act suffice for its characterisation as non-arbitrary, non-discriminatory and procedurally lawful? There may be a valid concern that the proposal to adopt an overarching standard of treatment may work well in the regulatory interference context but fail in a more traditional setting that involves a direct and physical taking of property. Here, it is submitted that a holistic interpretation of the non-discrimination, non-arbitrariness and due process guarantees would allow the protection of investors without having to resort to the expropriation standard. Pursuant to the argument developed in Chapter VI, where the rights in respect of a farm have been *bona fide* acquired and duly evidenced,

the obligation to treat investments in a non-arbitrary, non-discriminatory and procedurally lawful manner would require the host state to consider the acquired rights when making a provision for compensation (as opposed to guaranteeing full compensation). In particular, an obligation to treat investments in a non-discriminatory and non-arbitrary manner and in compliance with due process would bring into play the provisions of domestic law governing the protection of property and contractual rights and the relevant contractual and proprietary remedies.

Since the argument for the replacement of expropriation by an alternative standard of treatment places a greater emphasis on domestic courts and remedies and envisages a greater role for insurance instruments and contracts, it might be argued that this will render the process of investing costly to investors and may hinder the flow of capital that host states need. However, if both a host state's economy and an investor were to benefit from the flow of investment, the 'host state pays' rule would clearly be incompatible with the idea of investment protection. Making a host state compensate an investor for failing to put in place a perfect regulatory framework would inevitably cast doubt on the advantages of foreign investment and the necessity of international mechanisms for its protection. Questions will also arise about the propriety of conferring the benefits of protection upon a foreign investor, when such protection is beyond the reach of domestic investors in either the home state or the host state. The idea of the customary international minimum standard behind the proposed overarching standard of treatment would seem to provide a sufficient degree of protection to a foreign investor without, however, insulating it from the effects of governmental action and creating the overreaching protection guarantees.

Bringing the range of investment protection guarantees under the umbrella of FET as a single standard of investment treatment, restrained by reference to customary international law and general principles of law, would not alone address the existing shortcomings. Even

where a government has acted arbitrarily and discriminatorily, an investor's entitlement to a monetary redress should depend on the existence of a properly acquired and duly evidenced benefit. Lest the prohibition of discrimination, arbitrariness and procedural unfairness is transformed into a means of conferring upon an investor the benefits to which it had otherwise not been entitled, the determination of a treaty breach should be accompanied by a rigorous analysis of a pre-existing right. Thus, a host state's refusal to provide financial aid to a failing enterprise, even if discriminatory and procedurally flawed, would not constitute a breach unless the state had committed itself, in express terms, to render financial assistance. Likewise, the discriminatory character of the enforcement of laws prohibiting the exploitation of certain gaming equipment would not suffice to grant an investor damages for the closure of its gaming business, unless the right to operate such business had been *bona fide* acquired and duly evidenced. In a similar vein, an arbitrary change in a government's privatisation policy should entitle an investor to compensation for the lost opportunity to acquire additional shares only if the investor's right to such acquisition and the corresponding obligation on the part of the government had been expressly agreed in a valid and enforceable contractual or quasi-contractual instrument.

The proposal to do away with expropriation may be regarded as too radical a change in the existing composition of investment treaty protection. However, from both conceptual and practical points of view, expropriation has retained only a limited value as a distinct standard. Furthermore, the maxim that 'expropriation should always be compensated for' did not enjoy the status of an established international rule. The validity of its underlying 'deprivation—compensation' formula being strongly doubted in the modern regulatory environment, the treaty standard on expropriation has also become redundant in the face of the growing recourse to non-expropriatory provisions. The process of change can be furthered by states through the overhaul of their international investment agreements.

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