Florida State University Journal of Transnational Law & Policy

Volume 16 | Issue 2 Article 5

2007

Public Purpose, Private Losses: Regulatory Expropriation and Environmental Regulation in International Investment Law

Justin R. Marlles

Public Purpose, Private Losses: Regulatory Expropriation and Environmental Regulation in International Investment Law

Cover Page Footnote

University of Virginia School of Law, J.D. candidate, 2007.

PUBLIC PURPOSE, PRIVATE LOSSES: REGULATORY EXPROPRIATION AND ENVIRONMENTAL REGULATION IN INTERNATIONAL INVESTMENT LAW

JUSTIN R. MARLLES*

* University of Virginia School of Law, J.D. candidate, 2007.

I. INTRODUCTION TO REGULATORY EXPROPRIATION

In what was called a "roadshow at times reminiscent of high farce" by the global press, representatives from the Russian government in October 2006 led a group of journalists and environmental activists on a "breakneck tour of alleged environmental violations" perpetrated by Western energy companies laying the infrastructure for a massive oil and gas project, dubbed Sakhalin-2, in eastern Siberia.[1] Due to these supposed violations, the Russian Ministry of Natural Resources used its regulatory power to revoke the foreign investors' environmental operating license, freezing the construction process and throwing completion of the project into doubt.[2] However, following two and-a-half months of deadlock, in late December 2006, the foreign investors acquiesced to handing over a majority stake in the project to a government-controlled energy company and agreed to revise the contract between themselves and the Russian government to the enormous benefit of the government.[3] Shortly thereafter, Russian President Vladimir Putin announced that Sakhalin-2's environmental issues were "considered resolved," and construction was able to continue.[4]

The Sakhalin-2 incident is simply the most recent example of what international law refers to as "regulatory expropriation." Regulatory expropriation is a term describing any scenario in which a capital-importing state uses its regulatory powers to deprive foreign investors of their property or the effective enjoyment thereof.[5] In the past, states were frequently open about seizing

1. Tom Parfitt, *Kremlin Attack Dog Vows to Take on Shell in the Battle of Sakhalin*, THE GUARDIAN (London), Guardian Financial Pages, Oct. 4, 2006, at 25, *available at* http://business.guardian.co.uk/story/0,,1886783,00.html.

2. *See id.*

3. *See Shell's Sakhalin Rout Shines Light on Others*, PETROLEUM INTELLIGENCE WKLY, Jan. 1, 2007.

4. Steven L. Myers, *Russia Strong-arms Energy-hungry West; Moscow Can Afford to Ignore its Critics*, INT'L HERALD TRIB., Dec. 28, 2006, at 5.

5. *See* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 712 rep. note 7 (1987) (referring to "regulatory expropriation" as "creeping expropriation"); Elyse M. Freeman, Note, *Regulatory Expropriation Under NAFTA Chapter 11: Some Lessons From the European Court of Human Rights*, 42 COLUM. J. TRANSNAT'L L. 177, 181

property held by foreign investors. Indeed, states have often passed laws which, on their face, forced a transfer of property rights out of the hands of foreign nationals. Such was the case in *Kuwait v. Aminoil*, where the Kuwaiti government enacted a Decree Law terminating a valuable petroleum concession granted to the American Independent Oil Company (Aminoil) and taking away the company's remaining facilities in Kuwait.[6]

While customary international law recognized early on that governments engaging in expropriation had a duty to compensate foreign investors for their losses, there were few limits on how government expropriation of foreign investments might take place, or even a clear notion of what expropriation constituted.[7] However, in the interest of attracting capital from abroad, many countries over the last two decades have begun participating in bilateral investment treaties (BITs), as well as multilateral investment treaties such as the North American Free Trade Agreement (NAFTA) and the Energy Charter Treaty (ECT). These treaties work to attract capital to the treaty parties by limiting the potential for host government interference with foreign investments. Moreover, the proliferation of treaties like NAFTA, the ECT, and numerous BITs has also shaped the development of the customary international law of expropriation. As a result, it has become more difficult for governments who are not parties to such investment treaties to engage in open takings without paying significant compensation. NAFTA, the ECT, and almost all BITs are united in requiring governments to pay compensation to foreign investors when direct governmental expropriation occurs which resembles a physical taking. Article 1110 of NAFTA, Article 13 of the ECT, and Article 6 of the U.S. Model BIT all use similar language in requiring compensation for actions constituting expropriation or measures equivalent to expropriation.[8] Yet besides *de jure* expropriation of a direct nature approximating a physical taking (as in *Aminoil*),

---

(2003). Generally, "regulatory expropriation," "creeping expropriation," and "regulatory takings" all refer to the same legal concept. For one author's interchangeable use of "regulatory expropriation" and "regulatory takings," *see* Rainer Geiger, *Regulatory Expropriations in International Law: Lessons from the Multilateral Agreement on Investment*, 11 N.Y.U. ENVTL. L.J. 94, 96 (2002).

6. *See* Kuwait v. American Indep. Oil Co. (Aminoil), 21 I.L.M. 976, para. lxv, at 997 (1982).

7. *See* Chorzów Factory, Claim for Indemnity (Ger. v. Pol.), 1928 P.C.I.J. (ser. A) No. 17, at 41 (Sept. 13), *available at* http://www.icj-cij.org/cijwww/cdecisions/ccpij/serie_A/A_17/54_Usine_de_Chorzow_Fond_Arret.pdf.

8. *See* North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., art. 1110, 107 Stat. 2057, 32 I.L.M. 605, 641 (1993) [hereinafter NAFTA]; The Energy Charter Treaty, art. 13, Dec. 17, 1994, 34 I.L.M 360. [hereinafter ECT]; Office of the United States Trade Representative, *U.S. Model Bilateral Investment Treaty*, art. 6 (Nov. 2004), http://www.ustr.gov/Trade_Sectors/Investment/Model_BIT/Section_Index.html [hereinafter U.S. Model BIT].

there continues to be considerable controversy over which behavior constitutes expropriatory action (much less measures "equivalent to" expropriatory action) under international law. This is particularly true in the realm of government regulation, when a government, often through subsidiary agencies, asserts its sovereign right to limit how industry located within its borders carries on business. By regulating in this manner, these government controls can have the effect of diminishing the value of a foreign-owned investment without the government necessarily taking ownership of the investment.

The primary purpose of this analysis is to determine the point at which the normal exercise of government regulatory powers becomes compensable regulatory expropriation under the arbitral jurisprudence of NAFTA, customary international law (as captured in various BITs), and the standards of the ECT. Furthermore, it will attempt to compare and contrast notions of regulatory expropriation between these three international regimes. Overall, through this tripartite comparative approach, the reader should emerge with a fuller understanding of the current state of regulatory expropriation in international law.

This note will also review and respond to existing critiques of regulatory expropriation. While some of these criticisms of the international legal doctrine of regulatory expropriation are economic in nature, others focus on the threat that regulatory expropriation poses to government efforts at progressive environmental regulation.[9] This analysis will highlight many awards in which environmental regulation was used as a genuine tool of government expropriation and attempt to rebut the argument that the doctrine of regulatory expropriation has been misused by multi-national corporations in order to avoid environmental standards set by government regulatory agencies.

In sum, the analysis below will proceed in a bifurcated fashion. In the first section, it will summarize the current state of the doctrine of regulatory expropriation under NAFTA, customary international law (plus various BITs), and the ECT. In the second section, this analysis will attempt to respond to those critics who claim there is no place in international law for regulatory expropriation, or that environmental regulation by sovereign governments should be exempt from the doctrine of regulatory expropriation.

---

9. *See* Vicki Been, *Does an International "Regulatory Takings" Doctrine Make Sense?*, 11 N.Y.U. ENVTL. L.J. 49, 50-51 (2002); Howard Mann & Konrad von Moltke, *Nafta's Chapter 11 and the Environment* 47 (Int'l Inst. for Sustainable Dev., Working Paper 1999).

II. CHRONOLOGICAL ANALYSIS OF REGULATORY EXPROPRIATION IN NAFTA ARTICLE 1110 JURISPRUDENCE

A. Introduction to NAFTA Article 1110

One of the best-developed, and most controversial, provisions in international law covering regulatory expropriation is Article 1110, Chapter XI of the North American Free Trade Agreement (NAFTA).[10] Article 1110(1) states that NAFTA parties may not

> directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except: (a) for a public purpose; (b) on a non-discriminatory basis; (c) in accordance with due process of law and Article 1105(1) [Minimum Standard of Treatment]; and (d) on payment of compensation in accordance with paragraphs 2 through 6.[11]

Article 1110 is only one of many NAFTA provisions geared towards protecting foreign investors; other sections include Article 1102 (national treatment), Article 1103 (most favored nation treatment) and Article 1104 (minimum standard of treatment). However, Article 1110 has played a prominent role in a number of arbitrations brought under the NAFTA dispute resolution mechanism set out in Articles 1116(1)(a) through 1137.[12] To resolve Article 1110 disputes, NAFTA member states (Canada, Mexico, and the United States) consented to arbitration in Article 1122 either through the auspices of the International Center for Investment Disputes (ICSID) or under UNCITRAL rules, with the choice between the two left up to the initiating party.[13]

The broad language used in Article 1110(1), such as "indirectly nationalize or expropriate" and "measure tantamount to nationalization," plainly takes aim at government behavior beyond traditional expropriatory acts such as government occupation of an investor's property, or forced transfer of title. Moreover, it is clear that Article 1110 applies equally to both government regulations and legislation, as NAFTA's investor protections cover "any law,

---

10. *See* NAFTA, *supra* note 8, art. 1110.
11. *Id.* art. 1110.
12. *See id.* arts. 1102-04, 1110, 1116-37.
13. *See id.* arts. 1120, 1122.

regulation, procedure, requirement or practice."[14] Article 1110's standards for expropriation (limiting it to non-discriminatory measures enacted for a public purpose in accordance for due process) are not all that remarkable and were primarily drawn from widely accepted provisions of pre-existing BIT's signed by NAFTA members, along with customary international law. In spite of this, it is worth noting that many battles relating to the expropriatory qualities of environmental regulation revolve around the public purpose prong in Article 1110(1)(a).

The larger debate, however, has frequently tended to center on how far a regulation must go to achieve the act of expropriation in the first place. Vicki Been and Joel Beauvais write that "[n]o attempt was made . . . in NAFTA itself to address directly the problem of how to distinguish legitimate noncompensable regulations having an effect on the economic value of foreign investments and 'regulatory takings' requiring compensation."[15] Thus, in the regulatory context, although NAFTA provides strong guidelines on how to properly engage in expropriation once an expropriation has been identified, it has been left to NAFTA arbitral tribunals to determine which regulatory actions should be categorized as expropriations.[16]

B. Article 1110 Jurisprudence

Fortunately, there is a significant, if not always consistent, body of arbitral awards involving matters of regulatory expropriation and the interpretation of NAFTA's Article 1110. Foremost among these arbitral awards is that of *Metalclad Corp. v. United Mexican States*, decided through the auspices of ICSID.[17] Although this case has received substantial analysis by scholars of international law, an overview is merited here as *Metalclad* remains the strongest pro-investor interpretation of Article 1110 that any NAFTA tribunal has yet issued.[18] Decided in 2000, the series of expropriatory acts in *Metalclad* began when the Mexican municipality of Guadalcazar denied a building permit to the

---

14. *Id.* art. 201(1).

15. Vicki Been & Joel C. Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, 78 N.Y.U.L. REV. 30, 54 (2003).

16. *See id.* at 55.

17. Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000), *available at* http://www.worldbank.org/icsid/cases/mm-award-e.pdf [herinafter *Metalclad Corp.*].

18. *See* Vicki Been, *NAFTA's Investment Protections and the Division of Authority for Land Use and Environmental Controls*, 20 PACE ENVTL. L. REV. 19, 37 (2002).

American company, Metalclad Corp., which had just completed construction of a hazardous waste disposal facility based on assurances by the Mexican federal government that the company had acquired all the necessary permits.[19] After Metaclad initiated arbitration, the Governor of the Mexican State of San Luis Potosi designated the Metalclad property as an ecological preserve, which "had the effect of barring forever the operation of the landfill."[20]

The tribunal easily determined that an expropriation had occurred, stating that

> expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property . . . but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.[21]

Thus, in breaking down this definition of regulatory expropriation, it becomes clear that the tribunal is focusing on three interlinked factors: (1) interference with *use*, (2) interference with reasonable *investor expectations*, and (3) *diminution in value* of the investment.

First, it is apparent that the tribunal views interference with actual use as a crucial element of regulatory expropriation. According to the tribunal, the actions of San Louis Potosi "barr[ed] forever the operation of the landfill."[22] The tribunal's emphasis on Metalclad's *use* of the investment, rather than on the traditional question of *control* of the investment (which relates back to notions of physical possession), is an essential departure from older ideas of expropriation.[23] It is important at this juncture to distinguish "use" of an investment and "control" of an investment as two separate concepts. "Control" is "[t]he direct or indirect power to direct the management and policies of a person or entity" and is closely tied to the ownership, possession, and holding title to a physical

---

19. *See Metalclad Corp.* at paras. 33, 38.
20. *Id.* at para. 109.
21. *Id.* at para. 103.
22. *Id.* at para. 109.
23. The difference between *use* and *control* is illustrated by a hypothetical situation in which the Mexican government passes a law giving it the power to appoint the management of Metalclad's hazardous waste facility, while still allowing the facility to operate. Such a decision would certainly deprive Metalclad of *control* (even if Metalclad continued to receive income from the operation), whether or not the *use* of the investment changes.

asset.[24] The question of use is a different matter altogether, as "use" is the "application or employment of something."[25] A foreign investor may control his or her asset but may not have a legal right, due to government regulation, to put it to its intended use. To draw a rough analogy, an individual may own an automobile that sits in her driveway but has at the same time been denied a license by the government and is therefore unable to drive it. This small example demonstrates the basic idea behind regulatory expropriation through denial of expected use. Conversely, it may be that the asset of a foreign investor is being put to its intended use, but the foreign investor no longer has control of it because she is not the titled owner of the investment under local law and receives no profits from its intended use. Tribunals relying on the *use* concept of expropriation are more likely to find government action to be regulatory expropriation than tribunals relying on the *control* concept of expropriation, although the two concepts are not mutually exclusive.

While use of the Metalclad property as a hazardous waste facility was no longer possible because the Governor's ecological decree forbade "any conduct that might involve the discharge of polluting agents on the reserve soil," the tribunal seemed unconcerned with alternative, less profitable uses for the facility, ultimately granting Metalclad the full value of its initial investment.[26] The tribunal's determination that a total deprivation in value had occurred can be traced to the complete disappointment of the expectations of the investor, thus introducing the second element of *Metalclad*'s definition of expropriation. Even though the Metaclad property and facility may have been put to a range of less profitable uses, the primary use, which the Mexican government had led the company to believe was acceptable, was foreclosed following the actions of Guadalcazar and San Luis Potosi officials. The tribunal mentions several times that "Metaclad was entitled to rely on the representations of federal officials,"[27] and "the representations of the Mexican federal government, on which Metalclad relied," led it to conclude that an indirect expropriation had taken place.[28]

Third, there is the matter of the diminution in value of the investment. In the damages section of the award, the tribunal opined that the actions of the local and state governments had "negate[d] the possibility of any meaningful return on Metalclad's

24. BLACK'S LAW DICTIONARY 353 (8th ed., 2004).
25. *Id.* at 1577.
26. *Metalclad Corp.*, at paras. 110-12, 131.
27. *Id.* at para. 89.
28. *Id.* at para. 107.

investment," ultimately stating that "Metalclad has completely lost its investment."[29] However, the tribunal was unclear as to whether a complete deprivation of value was a necessary condition of regulatory expropriation, or was simply a sufficient condition.

In examining the *Metalclad* award, it is interesting that the tribunal generally seems unconcerned about the purpose for which the expropriation occurred, even though "public purpose" is one of the three key guidelines for proper or "legal" expropriation under Article 1110.[30] This raises questions regarding the utility of the public purpose prong of measuring proper expropriation in international law. Initially, the tribunal, in determining that an expropriation occurred, notes that Guadalcazar's denial of the permit took place "without any basis in the proposed physical construction or any defect in the site" (perhaps hinting that public purpose considerations are not entirely dead).[31] However, when considering the Governor's ecological decree, the tribunal states that it need not "decide or consider the motivation or intent of the adoption of the Ecological Decree" and that "implementation of the Ecological Decree would, in and of itself, constitute an act tantamount to expropriation."[32] These statements indicate that in instances where government regulatory action achieves a complete taking, the purpose of this taking is more or less irrelevant.

In the same year *Metalclad* was handed down, a very different decision dealing with the matter of regulatory expropriation under NAFTA emerged. The dispute in *S.D. Myers, Inc. v. Canada* arose when an American company, planning to engage in PCB remediation (the extraction and recycling of PCBs) by exporting PCB materials from Canada to the United States, found its potential business eliminated when the Canadian government issued a series of orders banning the export of PCBs out of Canada.[33] Eventually, the Canadian government reopened the border for PCB export; however, damage to the American company was already done.[34] The decision of the Canadian government had a thinly veiled protectionist motive and can be partly attributed to intensive lobbing by the Canadian PCB disposal industry.[35] Even so, the tribunal in its award determined that an expropriation had not taken place.[36]

---

29. *Id.* at para. 113.
30. *See* NAFTA, *supra* note 8, art. 1110.
31. *Metaclad Corp.*, at para. 106.
32. *Id.* at para. 111.
33. *See* S.D. Myers, Inc. (U.S.) v. Canada, First Partial Award, paras. 117, 123, 127, 40 I.L.M. 1408 (2001) (NAFTA Ch. 11 Arb. Trib. 2000), *available at* http://www.naftaclaims.com/disputes_canada_sdmyers.htm [hereinafter S.D. Myers, Inc.]
34. *See id.*at para. 127.
35. *See id.* at para. 122.
36. *See id.* at para. 287.

In rendering its decision, the *S.D. Myers* tribunal relied on the definition of expropriation (as it believed it to be) under customary international law.[37] The tribunal stated that "the term 'expropriation' carries with it the connotation of a 'taking' by a governmental-type authority of a person's 'property' with a view to transferring ownership of that property to another person, usually the authority that exercised its de jure or de facto power to do the 'taking.'"[38] The tribunal followed up this opaque definition of expropriation with a declaration directly contradicting the reasoning of the *Metalclad* tribunal.[39] In paragraph 281 of the Partial Award, the tribunal wrote that "[t]he general body of precedent usually does not treat regulatory action as amounting to expropriation. Regulatory conduct by public authorities is unlikely to be the subject of legitimate complaint under Article 1110 of NAFTA, although the Tribunal does not rule out that possibility."[40] The tribunal continued, stating that "[e]xpropriations tend to involve the deprivation of ownership rights; regulations a lesser interference" and that "[t]he distinction between expropriation and regulation screens out most potential cases of complaints concerning economic intervention by a state and reduces the risk that governments will be subject to claims as they go about their business of managing public affairs."[41] Altogether, paragraphs 281 and 282 of *S.D. Myers* are a broad departure from the *Metalclad* award, in which the tribunal held that expropriatory acts under NAFTA included "incidental interference" with the use of an investment which diminished the economic benefit of that investment.[42]

The *S.D. Myers* tribunal concentrated on two areas in particular in rejecting the plaintiff's expropriation argument. First, the tribunal focused on the length of time that the deprivation of the investor's use of the property took place. The tribunal determined in its review of S.D. Myers's expropriation claim that

> [a]n expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although it may be that, in some contexts and circumstances, it would be appropriate

37. *See id.* at para. 280.
38. *Id.*
39. *See id.* at paras. 281-82.
40. *Id.* at para. 281.
41. *Id.* at para. 282.
42. Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, para. 103, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

> to view a deprivation as amounting to an expropriation, even if it were partial or temporary.[43]

The tribunal's discussion of expropriation in terms of "the ability of an owner to make *use*" of an investment reinforces the *Metalclad* tribunal's definition of expropriation ("interference with the *use* of property"), [44] particularly its focus in the context of regulatory expropriation on *use* of an investment over that of *control*.[45] More importantly, the *S.D. Myers* award adds a temporal element to the *use* prong of the *Metalclad* test for expropriation when it states that "[i]n this case the closure of the border was temporary" and that "[t]his may have significance in assessing the compensation to be awarded in relation to CANADA's violations of Articles 1102 and 1105, but it does not support the proposition on the facts of this case that the measure should be characterized as an expropriation within the terms of Article 1110."[46] The important lesson to be taken away from this award seems to be that temporary deprivations of property (eighteen months or less, as was the case here) are unlikely to be found to be expropriations under Article 1110, although such a finding is not impossible.

Second, the *S.D. Myers* tribunal rejected the investor's argument that the language in Article 1110, requiring compensation for government actions "tantamount to nationalization," expanded traditional notions of expropriation to include any government action interfering with property rights.[47] In the award, the tribunal took an approach similar to *Pope & Talbot* in opining that the "tantamount to" language did not expand NAFTA's protections to state action "beyond the customary scope of the term 'expropriation' under international law," although it did recognize that "the drafters of the NAFTA intended the word 'tantamount' to embrace the concept of so-called 'creeping expropriation' [indirect expropriation]."[48] It should also be noted that the *S.D. Myers* tribunal, in examining the meaning of the "tantamount to" language of Article 1110, remarked that NAFTA tribunals "must look at the real interests involved and the purpose and effect of the government measure" rather than "technical or facial considerations."[49] This is

43. *S.D. Myers, Inc.*, at para. 283.
44. *Metalclad Corp.*, at para. 103 (emphasis added).
45. *Id.*
46. *S.D. Myers, Inc.*, at para. 284.
47. *See id.* at para. 142.
48. *Id.* at paras. 285-86.
49. *Id.* at para. 285.

clearly a different approach from the *Metalclad* tribunal's emphasis of effect over purported public purpose.[50]

While the *S.D. Myers* opinion appears to provide some ammunition to those wishing to eliminate regulatory takings from the purview of NAFTA Article 1110, the award has significant weaknesses limiting its usefulness in this regard. Even though the tribunal does write that "[t]he general body of precedent usually does not treat regulatory action as amounting to expropriation," it qualifies this declaration by stating that "the Tribunal does not rule out [the] possibility" that regulatory conduct by public authorities may be the subject of a "legitimate complaint" under Article 1110.[51] Moreover, it is likely that the tribunal was overcompensating for the plaintiff's attempts to broaden Article 1110 to cover governmental action outside those areas recognized under customary international law. Finally, the assertion in *S.D. Myers* that regulations promulgated for a public purpose are not expropriatory was rejected in no uncertain terms by the tribunal in the 2006 award of *Azurix Corp. v. Argentina*.[52]

The interim award in the *Pope & Talbot, Inc. v. Canada* arbitration, although issued only several months before *S.D. Myers* and *Metalclad*, draws from a different concept of expropriation.[53] Pope & Talbot, an American-owned company in the business of exporting lumber from Canada to the United States, lodged the complaint in this arbitration.[54] The alleged expropriation occurred when Canada put into force a fee-quota system to limit the export of lumber to the United States from the province where Pope & Talbot harvested its trees, while allowing the unlimited fee-free export of lumber from other provinces in which Canadian-owned lumber companies were operating.[55] The tribunal agreed with Pope & Talbot that "access to the . . . market is a property interest subject to protection under Article 1110," although it eventually determined that no expropriation had occurred.[56]

The *Pope & Talbot* tribunal at first appears to be headed towards a broad interpretation of Article 1110, when it states in the

---

50. *See Metalclad Corp.*, at para. 111.

51. *S.D. Myers, Inc.*, at para. 281.

52. See Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, paras. 310-11 (Jul. 14, 2006), *available at* http://www.worldbank.org/icsid/cases/pdf/ARB0112_Azurix-Award-en.pdf. (*Azurix*, though not a NAFTA case, has nonetheless exercised significant influence in later NAFTA arbitral awards).

53. *See* Pope & Talbot, Inc. (U.S.) v. Canada, Interim Award, 40 I.L.M. 258 (2001) (NAFTA Ch. 11 Arb. Trib. 2000), *available at* http://www.naftaclaims.com/disputes_canada_pope.htm [hereinafter Pope & Talbot, Inc.]

54. *See Pope & Talbot, Inc.*, at paras. 4-5.

55. *See id.* at paras. 6-7.

56. *Id.* at para. 96.

award that "[r]egulations can indeed be exercised in a way that would constitute creeping expropriation" and that "a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation."[57] However, it quickly returns to the traditional concept of control originating from physical *de jure* expropriations, in emphasizing that Pope & Talbot continues to direct the day-to-day operations of the investment.[58] The tribunal goes on, stating:

> Canada does not supervise the work of the officers or employees of the Investment, does not take any of the proceeds of company sales (apart from taxation), does not interfere with management or shareholders' activities, does not prevent the Investment from paying dividends to its shareholders, does not interfere with the appointment of directors or management and does not take any other actions ousting the Investor from full ownership and control of the Investment.[59]

The *Pope & Talbot* tribunal acknowledges that regulatory "interference with the Investment's ability to carry on its business" can be a taking, but only when "that interference is sufficiently restrictive to support a conclusion that the property has been 'taken' from the owner."[60] This notion of sufficiently restrictive interference seems to require a substantial deprivation in value, coupled with a loss of control over the enterprise.[61]

Altogether, the *Pope & Talbot* tribunal supports a narrow standard of regulatory expropriation that would require an investor to demonstrate loss of control over the property resulting in a substantial drop in value. The tribunal's exclusive reliance on indicators of *control* in determining whether an expropriation has taken place (rather than the investor's ability to make expected *use* of the property) is surprising, given the decisions in *Metalclad* and *S.D. Myers* emphasizing *use*. Furthermore, a significant weakness in the *Pope & Talbot* award becomes manifest when one considers that investor expectations—a crucial aspect of the *Metalclad* and *Feldman* awards (and most other present-day expropriation cases)—are hardly mentioned by the tribunal.

---

57. *Id.* at para. 99.
58. *See id.* at para. 100.
59. *Id.*
60. *Id.* at paras. 101-02.
61. *Id.* at para. 102.

Nevertheless, the *Pope & Talbot* opinion remains useful for one major point of NAFTA regulatory expropriation law: the tribunal's determination that the "tantamount to expropriation" language in Article 1110 means nothing more than "equivalent to."[62] In so holding, the tribunal rejected the complainant's argument that the "tantamount to" language in NAFTA expanded in one fell swoop the concept of expropriation beyond customary international law.[63] The determination in *Pope & Talbot* that "something that is 'equivalent' to something else cannot logically encompass more" was adopted in *S.D. Myers* and remains relatively well accepted.[64] Notably, *Pope & Talbot's* notions of control (i.e., loss of control approximating a direct physical taking) have also remained influential, as they were accepted as customary international law by the tribunal in the 2005 *CMS Gas v. Argentina* award.[65]

The award in *Feldman v. Mexico*, which remains somewhat overlooked in regulatory expropriation literature, emerged two years after the decision in *Metalclad* and reflects an attempt by the tribunal to reconcile the diverse approaches to regulatory expropriation law under NAFTA Article 1110. The dispute in this case arose from a disagreement between an American-owned company (CEMSA) and the Mexican government regarding tax rebates available for the export of cigarettes from Mexico.[66] The complainant alleged that Mexican producers applied political pressure to the Mexican government, causing the government to take administrative and legislative steps to provide rebates for exports undertaken by domestic cigarette producers but "deny[ing] rebates for exports by resellers of cigarettes" like the complainant.[67] Although the government decided to apply the special rebate to resellers the following year after the complainant initiated litigation in the Mexican courts, government officials continued to take measures making it difficult for the complainant to recover the rebates to which it was entitled, eventually driving it out of the cigarette export business.[68]

In response to the actions of the Mexican government, CEMSA requested arbitration under NAFTA and the ICSID Convention,

62. *Pope & Talbot, Inc.*, at para. 104.
63. *See id.* at para. 103.
64. *See S.D. Myers, Inc.*, at para. 286.
65. *See* CMS Gas Transmission Co. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/01/8, Final Award, para. 263, 44 I.L.M. 1205 (2005), *available at* http://www.worldbank.org/icsid/cases/CMS_Award.pdf.
66. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, paras. 1, 7, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002), *available at* http://www.worldbank.org/icsid/cases/feldman_mexico-award-en.PDF.
67. *Id.* at para. 10.
68. *See id.* at paras. 13-18, 91.

asserting that "the various actions of the Mexican authorities . . . in denying the . . . rebates on cigarette exports to CEMSA, resulted in an indirect or 'creeping' expropriation of the Claimant's investment and were tantamount to expropriation under Article 1110."[69] In making its argument, the complainant emphasized its reasonable reliance on the statements of Mexican officials relating to the rebate program, perhaps hoping to repeat the success of a similar argument in the *Metalclad* case.[70]

Because *Feldman* involved the tax policies of the Mexican government—taxation being an essential regulatory power at the heart of state sovereignty—the tribunal manifested a desire to reaffirm the general right of governments to regulate for the public good.[71] Unfortunately, the *Feldman* tribunal overcompensated in attempting to guard against a scenario in which every government regulation resulting in a decrease in the value of a foreign investment becomes expropriatory. In holding that CEMSA's property was not expropriated, numerous statements by the tribunal indicated a return to defining regulatory expropriation in terms of the deprivation of control over the investment approaching a direct physical taking, rather than as a substantial limitation on its use. *Metalclad* was distinguished on the grounds that the investor "was deprived of *all* beneficial use of its property."[72] The fact that the *Metalclad* tribunal was concerned with *use* over physical *control* escaped the reasoning of the *Feldman* tribunal, which held:

> [T]he regulatory action (enforcement of long-standing provisions of Mexican law) has not deprived the Claimant of control of the investment, CEMSA, interfered directly in the internal operations of CEMSA or displaced the Claimant as the controlling shareholder. The Claimant is free to pursue other continuing lines of export trading, such as exporting alcoholic beverages, photographic supplies, or other products for which he can obtain from Mexico the invoices required under Article 4, although he is effectively precluded from exporting cigarettes. Thus, this Tribunal believes there has

69. *Id.* at para. 89.
70. *See* Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, paras. 41, 107, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).
71. *See Feldman*, paras. 103, 113.
72. *Id.* at para. 148 (emphasis added).

> been no "taking" under this standard articulated in *Pope & Talbot*, in the present case.[73]

It should also be noted that the *Feldman* tribunal did examine the expectations of the investor as was recommended by *Metalclad*, but it determined that while "[t]he assurances received by the investor from the Mexican government in *Metalclad* were definitive, unambiguous and repeated," the statements by government officials in *Feldman* were contradictory and informal.[74] This standard for examining investor expectations is a valuable one, and can be expected to reappear in future NAFTA rulings.

The most recent regulatory expropriation case which has emerged from NAFTA, *Methanex v. United States*, caps off the post-*Metalclad* trend towards a narrowing of Article 1110's application to regulatory expropriations.[75] *Methanex* involved a claim in the amount of $970 million "by a Canadian corporation that California regulations requiring the phase out of the gasoline additive MTBE effected a 'regulatory taking' by reducing the Canadian company's market for methanol, a substance used to produce MTBE."[76] The investment alleged to have been subjected to measures "tantamount to expropriation" was Methanex's share in the California and US gasoline oxygenate markets.[77] The tribunal reluctantly accepted that intangibles such as market share and goodwill could be expropriated, while pointing out that "it is difficult to see how they might stand alone."[78]

More importantly, the tribunal unmistakably favored the *control* concept of expropriation over the *use* concept. In holding that Methanex failed to establish "that the California ban manifested any of the features associated with expropriation," the tribunal pulled directly from the regulatory expropriation standard in *Feldman v. Mexico*, and stated that a regulatory action must "deprive[ ] the Claimant of control of his company," "interfere[] directly in the internal operations," or "displace[ ] the Claimant as the controlling shareholder."[79]

---

73. *Id.* at para. 152.
74. *Id.* at paras. 148-49.
75. Methanex Corp. v. United States, Final Award, 44 I.L.M. 1345 (2005) (NAFTA Ch. 11 Arb. Trib. 2005), *available at* http://naftaclaims.com/Disputes/USA/Methanex/Methanex_ Final_Award.pdf [hereinafter Methanex Corp.]
76. Been, *supra* note 18, at 19. *See also Methanex Corp.*, at pt. IV, ch. D, para. 1.
77. *See Methanex Corp.*, at pt. I, para. 1.
78. *Id.* at pt. IV, ch. D, para. 17.
79. *Id.* at pt. IV, ch. D, para. 16 (quoting Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, 42 I.L.M. 625, 657 (2003) (NAFTA Ch. 11 Arb. Trib. 2002)).

Finally, the *Methanex* tribunal moved closer to the determination in *S.D. Myers* and away from that of *Metalclad* in ruling that regulations passed for a pubic purpose are not expropriations, even if there is a diminution in value and no compensation is paid. However, the *Methanex* tribunal provided an important qualification to this holding, stating:

> [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.[80]

The *Methanex* tribunal's ideas about the public purpose justification in regulatory expropriation are fascinating in two respects. First, they run directly counter to the *Feldman* ruling, where the tribunal opined that "[i]f there is a finding of expropriation, compensation is required, *even if* the taking is for a public purpose, non-discriminatory and in accordance with due process of law and Article 1105(1)."[81] It therefore appears *Methanex* has completely abandoned Article 1110(1)(d) of NAFTA Chapter XI, which requires the payment of compensation in most instances of regulatory expropriation. Second, the *Methanex* tribunal makes a special exception to the general "rule of no compensation" if the foreign investor can demonstrate that it relied on specific government commitments.[82] In doing so, *Methanex* fashions investor expectations the doorway through which all regulatory expropriation claims must pass. Moreover, this doorway is a particularly small one, as the claimant must demonstrate "specific government commitments" (reflecting the *Feldman* requirement of "definitive, unambiguous and repeated" government statements), and additionally that the investor has relied on these commitments. Altogether, the *Methanex* tribunal's assertion that public purpose trumps all is wildly inconsistent with the majority of previous NAFTA holdings, and has yet to be ratified by any further arbitral

80. *Id. at* pt. IV, ch. D, para. 7.

81. Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 98, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002) (emphasis added).

82. *See Methanex Corp.*, at pt. IV, ch. D, para. 8.

award rendered under NAFTA, the ECT, or customary international law.

In sum, the string of recent Article 1110 regulatory expropriation cases, beginning in 2000 with *Pope & Talbot* and continuing through 2005 with the *Methanex* award, constitutes a complex, sometimes contradictory, but not entirely incoherent jurisprudential tangle. While Barry Appleton takes the position that the unifying factor among these NAFTA cases is that regulatory expropriation exists when "a government action . . . deprives a property holder sufficiently," this explanation seems overly broad.[83] Furthermore, it fails to account for the expansion and contraction of the scope of regulatory expropriation as one moves from *Metalclad* and *S.D. Myers* to *Feldman* and *Methanex*, and the accompanying change in the control-use paradigm. Rather, in order to best comprehend the present state of NAFTA regulatory expropriation doctrine, it is necessary to return to the three interlinked factors of *Metalclad,* placing them in the context of subsequent awards. Although the first *Metalclad* factor (interference with use) might initially appear to have been supplanted by the control test set out in *Feldman* and reaffirmed in *Methanex*, there is a viable and more satisfying explanation which reconciles these cases.

It is the position of this analysis that control and use constitute *two separate* standards by which NAFTA regulatory expropriation can be determined and that each standard has a "continuum" or spectrum on which government acts may be measured to determine if they are expropriations.[84] A complete deprivation of use alone (without any diminution in control) is clearly a taking, whereas anything less than a complete use deprivation has since been found by NAFTA tribunals to be insufficient.[85] Moreover, there is a temporal dimension to use expropriation, in that any deprivation of use must generally be more than temporary or fleeting (at least longer than one year) to be a regulatory expropriation.[86] On the other hand, regulations that significantly (but perhaps not completely) interfere in the internal operations of an in-

83. Barry Appleton, *Regulatory Takings: The International Law Perspective*, 11 N.Y.U. ENVTL. L.J. 35, 45 (2002).

84. See Michael G. Parisi, *Moving Toward Transparency? An Examination of Regulatory Takings in International Law*, 19 EMORY INT'L L. REV. 383, 390 (2005), who writes that in determining matters of regulatory expropriation, one must ask "at what point along the continuum of interference does a host government expropriate rather than exercise its police powers through implementing regulatory measures?".

85. *See* Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, para. 113, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

86. *See* S.D. Myers, Inc. (U.S.) v. Canada, First Partial Award, para. 284, 40 I.L.M. 1408 (2001) (NAFTA Ch. 11 Arb. Trib. 2000). *See also* Parisi, *supra* note 84, at 396.

vestment or displace the claimant as the controlling shareholder doubtlessly constitute regulatory expropriation under the control standard, although the investor may retain some small ability to direct the management of the investment.[87]

Besides interference with control/use, investor expectations also serve a vital function in a NAFTA Article 1110 analysis. Although secondary to questions of use or control, the disappointment of investor expectations may serve as a "booster" by pushing a government regulation that lies within the grey area of the use or control spectrums towards the side of expropriation. The NAFTA cases reviewed here indicate that there are limits to investor expectations, and that disappointment of reasonable investor expectations is only a factor where government officials have made affirmative representations to the foreign investor regarding the state of regulation affecting its investment.[88] Furthermore, these representations by government officials must be of a formal and consistent nature, as well as "definitive, unambiguous and repeated."[89]

Of course, for an expropriation to have taken place, the Article 1110 claimant must also demonstrate that the government regulation has led to some diminution in value of its investment.[90] A government regulation which deprives the investor of the total value of the investment, as occurred in *Metalclad*, is certainly sufficient to meet the damages criteria under the NAFTA expropriation standard.[91] Indeed, regulation resulting in a complete loss may constitute expropriation regardless of whether the use/control or expectations criteria are met. Vicki Been and Joel Beauvais write, "*Metalclad* is . . . commonly cited as applying the U.S. courts' per se rule requiring compensation whenever regulation destroys one hundred percent of the value of the property."[92] The bulk of regulatory expropriation cases under Article 1110, however, involve only a partial deprivation of value due to government regulation, rather than a complete deprivation as occurred in *Metalclad*. Thus, in instances where there is not a complete taking, the investor must demonstrate that the regulations at least caused a "substantial deprivation" in value or "negate[d] the possi-

87. *See Methanex Corp.*, at pt. IV, ch. D, para. 16.

88. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, paras. 148-49, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002) [hereinafter Feldman]; *Metalclad Corp.*, at para. 89.

89. *Feldman*, at paras. 148-49.

90. *See Metalclad Corp.*, at para. 103.

91. *Id.* at para. 113.

92. Been & Beauvais, *supra* note 15, at 62-63.

bility of any meaningful return."[93] Regulations having only an incidental effect on the value of an investment are not expropriations, as "[r]easonable governmental regulation . . . cannot be achieved if any business that is adversely affected may seek compensation."[94]

Finally, the five NAFTA cases reviewed in this section are significantly split on the weight a tribunal should accord to the public purpose justification for government regulation resulting in a loss of control/use, the disappointment of government-created investor expectations, and a deprivation of value. On the one hand, the tribunal in *Methanex*, the most recent NAFTA case, seems to suggest that a regulation enacted in good faith for a public purpose is almost never expropriatory.[95] On the other hand, the *Metalclad, Feldman*, and *Pope & Talbott* awards indicate that a public purpose justification advanced under Article 1110(1)(a) is perhaps not even relevant in determining whether an expropriation has taken place.[96] The *Feldman* tribunal's statement that "[i]f there is a finding of expropriation, compensation is required, *even if* the taking is for a public purpose, non-discriminatory and in accordance with due process of law and Article 1105(1)" is unambiguous in this regard.[97] The *S.D. Myers* tribunal appears to cut a middle path, opining that NAFTA tribunals must consider both "the purpose and effect of the government measure."[98] In light of the preceding jurisprudence, the *Methanex* tribunal's decision to grant governments a *carte blanche* in regulating runs directly counter to almost all previous awards, as well as the text of Article 1110 itself. After all, although Article 1110(1)(a) states that governments may not "directly or indirectly nationalize or expropriate an investment of an investor of another Party . . . except: (a) for a public purpose," it also requires "(d) payment of compensation" for the investor.[99] There is absolutely nothing in Article 1110(1) to indicate that the "public purpose" requirement trumps the "payment of compensation" requirement. Also, Article 1110(1)(a) would become redundant if one accepts that a government regulation enacted for a "public purpose" and meeting the previously discussed aspects of

93. *Metalclad Corp.*, at para. 113. *See also Pope & Talbot, Inc.*, at para. 102.

94. *Feldman*, at para. 103. *See also* Parisi, *supra* note 84, at 396.

95. *See* Methanex Corp. v. United States, Final Award, pt. IV, ch. D, para. 7, 44 I.L.M. 1345 (2005) (NAFTA Ch. 11 Arb. Trib. 2005).

96. *See Feldman*, at para. 98; *Metalclad Corp.*, at para. 111; Pope & Talbot, Inc. (U.S.) v. Canada, Interim Award, para. 99, 40 I.L.M. 258 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

97. *Feldman*, at para. 98 (emphasis added).

98. *See* S.D. Myers, Inc. (U.S.) v. Canada, First Partial Award, para. 285, 40 I.L.M. 1408 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

99. NAFTA, *supra* note 8, art. 1110(1).

expropriation is not expropriatory. Given that Article 31 of the Vienna Convention on the Law of Treaties requires that "[a] treaty [like NAFTA] shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose,"[100] *Methanex*'s decision to ignore Article 1110(1)(d) while rendering Article 1110(1)(a) redundant runs counter to the ordinary meaning of Article 1110 and should thus be strongly questioned.

III. ELEMENTAL ANALYSIS OF REGULATORY EXPROPRIATION IN CUSTOMARY INTERNATIONAL LAW AND BILATERAL INVESTMENT TREATIES

A. *Identifying Regulatory Expropriation*

1. *Introduction to the Law of Regulatory Expropriation in Customary International Law and Bilateral Investment Treaties*

Even though jurisprudence specifically related to NAFTA Article 1110 has helped shape the contours of the law of international regulatory expropriation, the cannon of transnational takings extends well beyond the realm of NAFTA. In fact, NAFTA is only one recent development in the long history of expropriation law. Today, in addition to NAFTA jurisprudence, the elements of regulatory expropriation in customary international law have been influenced by a plethora of bilateral investment treaties (BITs) between capital-exporting and capital-importing countries and are detailed in the many awards issued by arbitral tribunals. The importance of BITs in the development of the law of regulatory expropriation cannot be exaggerated, as BITs have served both to capture the essence of expropriation doctrine under customary international law and in some instances to modify its terms. Today, there are more than 1500 BITs between approximately 160 nations.[101] Scholars have determined that "[v]irtually all of these agreements contain expropriation provisions."[102] As a result, in order to understand the current state of regulatory expropriation in international law outside of the *lex specialis* of NAFTA, numerous arbitral awards using international law to examine the meaning of BIT expropriation clauses will be considered.

---

100. Vienna Convention on the Law of Treaties, art. 31, May 23, 1969, 1155 U.N.T.S. 331, *available at* http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf

101. *See* Been & Beauvais, *supra* note 15, at 50.

102. *Id.*

However, one must not forget that outside the context of BITs with detailed expropriation clauses, doctrines relating to expropriation are also part of non-treaty customary international law. According to § 712 of the Restatement (Third) of Foreign Relations Law:

> A state is responsible under international law for injury resulting from:
> (1) a taking by the state of the property of a national of another state that
> (a) is not for a public purpose, or
> (b) is discriminatory, or
> (c) is not accompanied by provision for just compensation.[103]

Unfortunately, § 712 does not outline the aspects of a "taking," although the comments to the section explain that "[a] state is responsible . . . for an expropriation of property under Subsection (1) when it subjects alien property to taxation, regulation, or other action that is confiscatory, or that prevents, unreasonably interferes with, or unduly delays, effective enjoyment of an alien's property."[104] Regulatory expropriation's role in customary international law has also been recognized by the Iran-U.S. Claims Tribunal, which declared in the *Harza Engineering Co.* award that "a taking of property may occur under international law, even in the absence of a formal nationalization or expropriation, if a government has interfered unreasonably with the use of property."[105]

2. Identifying Regulatory Expropriation: Loss of Control

The basic elements of regulatory expropriation under customary international law, as captured through numerous BITs and related arbitral awards, do not differ all that much from the elements of expropriation previously explored in the Article 1110 NAFTA cases. Plaintiffs alleging the breach of a BIT expropriation clause, or expropriation under customary international law, must still demonstrate a loss of control over the investment, the disappointment of certain expectations regarding the investment,

---

103. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 712 (1987).

104. *Id.* § 712 cmt. g.

105. Allahyar Mouri, THE INTERNATIONAL LAW OF EXPROPRIATION AS REFLECTED IN THE WORK OF THE IRAN-U.S. CLAIMS TRIBUNAL 70 (Martinus Nijhoff Pub. 1994) (citing *Harza Engineering Co.*, 1 Iran-U.S. Cl. Trib. Rep. 499, 504-05 (1982)). *See also* Parisi, *supra* note 84 at 394-95.

and a diminishment of value due to government action. This useful tripartite approach appears in Annex B of the U.S. Model BIT, which is "intended to reflect customary international law concerning the obligation of States with respect to expropriation."[106] Notably, the split between customary international legal notions of regulatory expropriation (as included in BIT clauses and fleshed out by ICSID arbitral panels) and the NAFTA concept of regulatory expropriation stems from divergent ideas about the interplay among the three elements of expropriation, as well as the degree of interference/loss necessary to activate each of these elements. Regarding the element of "control," two recent arbitral awards indicate that under customary international law, the spectrum of government actions constituting "loss of control" is narrower than that of many NAFTA expropriation cases.[107]

The two awards addressing the issue of loss of control in matters of expropriation include *Compañía del Desarrollo de Santa Elena, S.A. v. Costa Rica* (*Santa Elena*), rendered in 2000, and *Azurix Corp. v. Argentina*, handed down in 2006.[108] The *Santa Elena* award, decided through the ICSID dispute resolution mechanism, is unique in that no BIT applied to the dispute.[109] Instead, the tribunal based its decision purely on the customary international law of expropriation.[110] The controversy in this case involved a disagreement regarding the proper amount of compensation owed under international law by the Costa Rican government to a group of American investors whose property was expropriated in order to expand the size of the Santa Rosa National Park.[111] Although the taking was achieved through a government decree which declared "the property . . . is hereby expropriated," thus placing the dispute somewhat outside the realm of normal regulatory expropriation, the context of the *Santa Elena* case and the issues explored by the tribunal make it an award which cannot be ignored in any thorough examination of environmental regulatory expropriation.[112]

Although this was "a case of expropriation in which the fundamental issue before the Tribunal [was] the amount of compensa-

---

106. U.S. Model BIT, *supra* note 8, Annex B, §1.

107. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, para. 322 (Jul. 14, 2006) [hereinafter Azurix]; Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica, ICSID (W. Bank) Case No. ARB/96/1, Final Award, para. 77, 39 I.L.M. 1317 (2000), *available at* http://www.worldbank.org/icsid/cases/santa elena_award.pdf [hereinafter Santa Elena].

108. *See Santa Elena*; *See Azurix Corp.*

109. *See Santa Elena*, at para. 65.

110. *Id.*

111. *See id.* at paras. 15-18, 20.

112. *Id.* at para. 18.

tion to be paid by Respondent," and although "Respondent's right to expropriate the Property [was] not in dispute," Costa Rica and the American investors disagreed on the actual date when the expropriation took place.[113] Costa Rica asserted that the expropriation decree expressed only an "intention" to expropriate, and that the actual expropriation of the property occurred later, whereas the foreign investors claimed that the expropriation occurred around the date of the decree.[114] As a consequence of this disagreement regarding the date of the expropriation, the tribunal found itself looking into what constituted expropriatory action in the first place. Altogether, the tribunal, in examining the question of control, opined that one of the key steps in determining whether expropriation has taken place is identifying "the extent to which the measures taken have deprived the owner of the normal control of his property."[115] In its award, the tribunal held "[t]here is ample authority for the proposition that a property has been expropriated when the effect of the measures taken by the state has been to deprive the owner of title, possession or access to the benefit and economic use of his property."[116] Ultimately, the arbitrators stated that the date of expropriation occurred when the Costa Rican government issued its decree, which is when the "practical and economic use of the Property by the Claimant was irretrievably lost."[117]

The remarks of the tribunal in the *Santa Elena* case reveal that under international law, the loss of control must be complete before expropriation will be found, and moreover that this loss must be for some significant period of time. For instance, throughout the award, the tribunal remarked that expropriation occurred where government interference has rendered property rights "practically useless" or when the use of the property has been "irretrievably lost."[118] This language suggests that a partial deprivation of control under international law would not constitute measures of sufficient extent to comprise expropriation, in contrast with NAFTA cases such as *Feldman*, which imply that a substantial, but less-than-total deprivation of control (such as interference with an investment's internal operations) can still constitute expropriation.[119] Another difference between the *Santa Elena* and NAFTA

113. *See id.* at paras. 54-55, 74.
114. *See id.* at paras. 79-80.
115. *Id.* at para. 76.
116. *Id.* at para. 77.
117. *Id.* at paras. 80-81.
118. *See id.* at paras. 78, 81.
119. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 152, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002).

approaches is that the *Santa Elena* tribunal did not appear to differentiate between matters of *control* and *use*, often mentioning the two interchangeably. In contrast, the control-use divide significantly affected almost every NAFTA case reviewed in this analysis.[120] Lastly, as for the temporal dimension of deprivation of control, the *Santa Elena* panel relied on an earlier decision from the Iran-U.S. Claims Tribunal, in stating that a deprivation must be more than "merely ephemeral," indicating that the time-element of control cannot be overlooked in customary international law.[121]

The tribunal in *Azurix Corp. v. Argentina* also dealt with the control element of expropriation, although this time in the context of the United States-Argentina BIT.[122] Under the terms of Article IV(1) of the BIT, investments in either signatory nation may not

> be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization . . . except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2).[123]

Azurix Corp., the subsidiary of an American corporation and the complainant in this case, had received a concession to provide water and sewage services to the Province of Buenos Aires, Argentina.[124] Azurix claimed that its investment in Buenos Aires was damaged by "measures . . . tantamount to expropriation," when the regulatory agency in charge of overseeing the concession (among other things) refused to allow Azurix to increase tariffs for water and sewage delivery.[125] The tribunal, while acknowledging that "cumulative steps which individually may not qualify as an expropriating measure may have the effect equivalent to an outright expropriation,"[126] opined that an expropriation had not occurred.[127] The tribunal decided that there was no expropriation because

---

120. *See Santa Elena*, at para. 77.

121. *Id.* (citing *Tippets, Abbett, McCarthy, Stratton v. TAMS-AFFA*, Award No. 141-7-2, (Jun. 22, 1984) (reprinted in 6 Iran-U.S. Cl. Trib. Rep. 219, 226 (1986)).

122. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, paras. 3, 9 (Jul. 14, 2006).

123. Treaty with Argentina Concerning the Reciprocal Encouragement and Protection of Investment, U.S.-Arg., art. IV(1), Nov. 14, 1991, S. TREATY DOC. No. 103-2 (1993).

124. *Azurix*, at paras. 38, 41.

125. *Id.* at paras. 43, 82-83, 92, 144, 277.

126. *Id.* at para. 308.

> Azurix did not lose the attributes of ownership, at all times continued to control [its Argentine subsidiary] and its ownership of 90% of the shares was unaffected. No doubt the management of [Azurix's Argentine subsidiary] was affected by the Province's actions, but not sufficiently for the Tribunal to find that Azurix's investment was expropriated.[128]

In this respect, the *Azurix* tribunal's notion of the control element of expropriation closely parallels that of the *Feldman* tribunal, in which a NAFTA panel held that a loss of control in a regulatory expropriation case must approach the level of a direct physical taking.[129] This quasi-physical concept of control also appears in the *CMS Gas Transmission Co.* award, which dealt with Argentina's regulation of its natural gas pipeline industry.[130] Interestingly, the idea of control appearing in *CMS Gas* and *Azurix* can be traced to the NAFTA case of *Pope & Talbot*, demonstrating the influence of NAFTA *lex specialis* on larger customary international law.[131] Finally, the narrow notion of loss-of-control communicated by the *Azurix* panel plainly reflects the earlier *Santa Elena* award, where that tribunal indicated a partial loss of control (even quasi-physical control of the *Pope & Talbot* variety) was insufficient to find that expropriation had occurred.[132]

Furthermore, the *Azurix* arbitrators, like those in the *Santa Elena* case, attributed a time element to the loss of control and did so with greater clarity.[133] The *Azurix* tribunal held that "[w]hen considering multiple measures," a determination of expropriation "will depend on the duration of their cumulative effect."[134] Although the tribunal stated that "[t]here is no specific time set un-

127. *Id.* at para. 322.

128. *Id.*

129. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 152, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002). Interference with the day-to-day operations of an investment should be imagined as a quasi-physical taking, in that management's oversight of the ordinary operations of an investment (such as a factory) is equivalent to physical possession of the investment. Without the ability to direct the day-to-day operations of an investment, or select the personnel who operate the investment, one can hardly be said to hold even physical possession of the investment in question.

130. *See* CMS Gas Transmission Co. v. Argentina, ICSID (W. Bank) Case No. ARB/01/8, Final Award, para. 263, 44 I.L.M. 1205 (2005).

131. *See id.* at para. 263; *Pope & Talbot*, at para. 100. *See also Feldman*, at para. 152.

132. *See Santa Elena*, at paras. 78, 81.

133. *See Azurix Corp.*, at para. 313. *See also Santa Elena*, at para. 77 (citing Tippets, Abbett, McCarthy, Stratton v. TAMS-AFFA (Award No. 141-7-2, Jun. 22, 1984)) (reprinted in 6 Iran-U.S. Cl. Trib. Rep. 219, 226 (1986)).

134. *Azurix Corp., at* para. 313.

der international law for measures constituting creeping expropriation to produce that effect," it agreed with previous arbitral decisions that a single measure (rather than a "creeping" set of measures) would not be expropriatory if it only caused the property to be "out of the control of the investor for a year."[135]

3. Identifying Regulatory Expropriation: Disappointment of Investor Expectations

After convincing an arbitral panel that they have suffered a loss of control over their property, foreign investors alleging regulatory expropriation must further demonstrate the disappointment of certain expectations regarding the investment. The importance of investor expectations in determining regulatory expropriation is recognized by scholars and arbitrators alike. For example, Thomas Wälde and Abba Kolo believe:

> Investors are ready, and can be expected to be ready, to accept the regulatory regime in situations in which they invest. Investment protection rather turns around the issue of unexpected change with an excessive detrimental impact on the foreign investor's prior calculation, and the—in domestic politics natural—favouring of national competitors.[136]

This concern for unforeseen regulatory changes causing an "excessive detrimental impact on the foreign investor's prior calculation"[137] has also received considerable emphasis in awards interpreting the customary international law of regulatory expropriation. The *Santa Elena* tribunal took investor expectations into account when it determined that expropriation occurred on the date that the property could no longer "be used for the development purposes for which it was originally acquired."[138] Investor expectations assumed a role of parallel importance in the *Azurix* award, where the complainant and respondent battled over their meaning and centrality.

The complainant in *Azurix* argued that investor expectations could be generated either by affirmative government action, by prevailing norms, or even originate from the contract itself, and

135. *Id.* (citing Wena Hotels Ltd. v. Egypt, ICSID (W. Bank) Case No. ARB/98/4, Committee Decision on Application for Annulment, 41 I.L.M. 933 (2002)).

136. Thomas Wälde & Abba Kolo, *Environmental Regulation, Investment Protection and 'Regulatory Taking' in International Law*, 50 INT'L & COMP. L.Q. 811, 819 (2001).

137. *Id.*

138. *Santa Elena*, at para. 81.

that a violation of such expectations might alone constitute expropriation provided the result was the deprivation of some economic benefit.[139] In contrast to Azurix's argument, the Argentine government presented a novel theory of its own, claiming that investor expectations are not an element of expropriation at all, but are instead a part of measuring compensation.[140] The investor's notion that relevant expectations could be generated by prevailing norms or stem from the contract itself (in addition to originating from affirmative government representations) is particularly interesting in that it runs counter to NAFTA's *Metalclad* and *Feldman* cases.[141] In these awards, NAFTA tribunals determined that investor expectations only assumed importance in a determination of regulatory expropriation where state officials made specific representations to the foreign investors.[142] In the end, the *Azurix* tribunal refused to remove investor expectations from the calculus of regulatory expropriation and remained ambivalent as to whether prevailing norms (and not just statements by government officials) could serve as acceptable generators of investor expectations.[143] It may be inferred from the tribunal's decision that action taken by government officials undermining the terms of the contract can violate investor expectations originating from the contract, but disappointment of investor expectations alone is an insufficient basis for a finding of expropriation.[144]

Unlike *Azurix*, where the matter of regulatory expropriation became pertinent due to provisions in the United States-Argentina BIT, the regulatory expropriation claim in *Revere Copper and Brass, Inc. v. Overseas Private Investment Corp.* was based on an indemnity contract between Revere, an American company investing in Jamaica, and the Overseas Private Investment Corporation (OPIC), an arm of the United States government.[145] Under the terms of the contract, OPIC agreed to insure Revere against any expropriatory action by the Jamaican government that prevented the investor "from effectively exercising its fundamental rights with respect to the Foreign Enterprise" or which inhibited the investor "from exercising effective control over the use or disposition

---

139. *Azurix Corp.*, at paras. 286-87.

140. *See id.* at para. 302.

141. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, paras. 148-49, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002); *Metalclad Corp.*, para. 89.

142. *See Feldman*, paras. at 148-49; *Metalclad Corp.*, at para. 89.

143. *See Azurix Corp.*, at paras. 316, 320-22.

144. *See id.* at paras. 320-22.

145. *See* Revere Copper and Brass, Inc. v. Overseas Private Inv. Corp., Award, Aug. 24, 1978, 56 I.L.R. 258, 261 (1980).

of substantial portion of its property."[146] Revere was engaged in bauxite mining to supply its aluminum production, and had entered Jamaica via an agreement with Jamaican officials who promised to fix certain taxation and royalty levels for bauxite mining.[147] Following a change in government, the new Jamaican administration imposed a special bauxite levy on foreign investors such as Revere, which ultimately led the company to shut down its Jamaican operation.[148] In response, Revere filed suit against OPIC to recover the depleted value of its investment, alleging that the loss resulting from the Jamaican government's regulatory actions fell within OPIC's policy coverage for expropriation.[149] Initially, the arbitral tribunal recognized that Revere was "still in possession of its plant" and that it shut down the plant "not because the Government had physically intervened in the affairs of [Revere] so as to prevent it from using or disposing of its property."[150] Nevertheless, the tribunal concluded that the actions of Jamaican officials deprived Revere of effective control over its property, and were therefore expropriatory.[151]

The tribunal drew a link between the actions of the Jamaican government and the loss of effective control by returning to the element of investor expectations. In its opinion, the tribunal stated:

> Control in a large industrial enterprise, such as that conducted by [Revere] in Jamaica, is exercised by a continuous stream of decisions.. . . .
>
> Rational decisions require some continuity of the enterprise. In a large enterprise like the present one, with the [government agreement] gone, decisions simply become gambles. Risks are inherent in all such decision making, but without the [government agreement] the odds cannot be calculated. There is no way in which rational decisions can be made. What the Government did yesterday, it can do tomorrow or next week or next month. . . . This is the antithesis of the rational decision making that lies at the heart of control.[152]

---

146. *Id.* at 261-62.
147. *Id.* at 261-63.
148. *See id.* at 269.
149. *Id.* at 268-69.
150. *Id.* at 270.
151. *Id.* at 291.
152. *Id.* at 292.

In essence, the tribunal declared that the Jamaican government's promise not to alter the tax or royalty scheme for bauxite mining created certain expectations for the future in Revere. These expectations gave Revere the power to make rational business decisions, which is a central basis of control (according to the tribunal) in a business enterprise. When the government reneged on its promise and changed its tax regulatory structure, Revere's expectations were disappointed and it was left without the ability to make rational decisions, causing it to lose control of its enterprise. This loss of control resulted in the expropriation of the investment.

Overall, the decision of the *Revere* tribunal to break down the wall between the control element of expropriation and the investor-expectations element of expropriation is revolutionary, even if it has not been repeated in subsequent arbitrations. By eliminating the tripartite division to expropriation which has taken form in both NAFTA law, customary international law, and the law of the ECT, *Revere* gives a heightened effect to investor expectations and increased power to foreign investors alleging regulatory expropriation. However, later awards, such as *Azurix*, have declined to ratify the *Revere* approach in its entirety, by refusing to hold that violations of investor expectations may by themselves constitute regulatory expropriation.[153]

4. Identifying Regulatory Expropriation: Deprivation of Value

The third element of regulatory expropriation is the showing of some diminishment in the value of the investment caused by governmental regulatory action. Yet in customary international law and in most BITs, it remains an open question as to the extent of loss which a foreign investor must prove in order to cross this final hurdle on the path to demonstrating an expropriatory taking. Generally, just as in the existing NAFTA jurisprudence, ICSID tribunals interpreting BIT provisions and customary international law tend to find that regulatory deprivation has occurred where government environmental regulation has totally wiped out the value of an investment.[154] Wälde and Kolo are aware of this basic rule, when they stipulate that an environmental regulation "which effectively or *totally* renders the investment/property [of a foreign investor] without *any* economically beneficial use or imposes on the owner a special sacrifice in favour of the community at large is

---

153. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, paras. 320-22 (Jul. 14, 2006).

154. *See, e.g., Pope & Talbot,*at para. *102. See also, Revere Copper and Brass, Inc.* at 269.

compensable."[155] Many disputes, of course, lie in the grey area where government regulation has damaged the investment, without leaving it totally valueless or depriving the investor of all beneficial use.

If a tribunal basing its decision on the combination of a non-specific BIT expropriation provision and customary international law is faced with a dispute in which government regulations have deprived the foreign investor of less than the total value of its investment, the tribunal will hold that expropriation has occurred only if the investor has suffered a "substantial deprivation," or the regulations have had a "devastating effect" on the investment.[156] In the *CMS Gas* award, the tribunal provided that there must be a "substantial deprivation of the fundamental rights of ownership," and declined to find that expropriation had occurred, partly on the grounds that "the value of shares of a comparable company has been increasing" since the government implemented its regulatory measures.[157] Although *CMS Gas* borrows the "substantial deprivation" description from *Pope & Talbot*, the tribunal's confusing language tends to obscure whether the "substantial deprivation" standard applies to the control element or the value element of regulatory expropriation.[158] However, the reference to the *value* of the shares of comparable companies suggests that the "substantial deprivation" standard was, in fact, meant to apply to the value prong of the expropriation test.[159]

The *Azurix* award also deals with value prong of the test for expropriation, though in a more circumspect manner.[160] The tribunal in this case reasoned that actions by the Argentine government did not breach either international law or the agreement between the complainant and Argentina, when it stated that "[w]ere this not the case, the Tribunal would agree that the breaches . . . would have had a devastating effect on the financial viability of the Concession . . . ."[161] Although the *Azurix* taking was more or less a complete one, the tribunal's reference to government actions having a "devastating effect" on the value of an investment is useful language which may be applied to expropriations resulting in a

---

155. Wälde & Kolo, *supra* note 136, at 827 (emphasis added) (citing Agins v. Tiburon, 447 US 255 (1980)).

156. *See* CMS Gas Transmission Co. v. Argentina, ICSID (W. Bank) Case No. ARB/01/8, Final Award, para. 259, 44 I.L.M. 1205 (2005) [hereinafter CMS Gas]; *Azurix Corp.*, at para. 321.

157. *CMS Gas*, at para. 259.

158. *See* Pope & Talbot, Inc. (U.S.) v. Canada, Interim Award, para. 102, 40 I.L.M. 258 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

159. *See id.*

160. *See Azurix Corp.*,at para. 321.

161. *Id.*

deprivation of less than 100% of the value of an investment. In summation, the value deprivation element of regulatory expropriation under customary international law and the law of bilateral investment treaties does not differ all that much from the NAFTA standard reviewed above. A total deprivation of value, like in *Metalclad*, appears to always fulfill the necessary requirement, while partial deprivations of value must be either "substantial" in nature, or of "devastating effect."

B. Elements of Proper or "Legal" Regulatory Expropriation Under Customary International Law

1. Introduction to Proper Regulatory Expropriation Under Customary International Law

This analysis breaks down regulatory expropriation under customary international law, along with the arbitral awards applying this law to the interpretation of expropriation provisions set out in BITs, into two main phases. First, the complainant must show that expropriation via governmental regulatory action has occurred. This involves a demonstration of some loss of control over the investment, the disappointment of certain investor expectations regarding the investment, and a substantial or total loss in the value of the investment. If the foreign investor can overcome the first hurdle and convince a tribunal that an expropriation has occurred, it must continue on to the second step, which involves proving to the tribunal that the regulatory expropriation was not in accordance with international law or the terms of an applicable BIT. This is not to imply, of course, that governments cannot expropriate or nationalize, provided they fulfill the legal requirements to be discussed below.[162]

Most bilateral investment treaties, as well as § 712 of the Restatement (Third) on Foreign Relations Law, set out four main requirements in order for an expropriation (once one has been identified) to occur properly. The 1998 Costa Rica-Canada BIT is a good example.[163] Article 8(1) of the Costa Rica-Canada BIT provides:

> [i]nvestments of investors of either Contracting Party shall not be nationalized, expropriated or sub-

---

162. *See* Kuwait v. American Indep. Oil Co. (Aminoil), 21 I.L.M. 976, paras. 86, 143 (1982).

163. *See* Agreement Between the Government of the Republic of Costa Rica and the Government of Canada for the Promotion and Protection of Investments, art. VIII(1), Costa Rica-Can., Mar. 18, 1998, 1999 Can. T.S. No. 43, *available at* http://www.treaty-accord.gc.ca/ViewTreaty.asp?Treaty_ID=101533.

> jected to measures having an effect equivalent to nationalization or expropriation . . . in the territory of the other Contracting Party, except for a public purpose, under due process of law, in a non-discriminatory manner and against prompt, adequate and effective compensation. Such compensation shall be based on the fair market value of the investment expropriated immediately before the expropriation or at the time the proposed expropriation became public knowledge, whichever is earlier.[164]

In a similar manner, Article 4(1) of the Jamaica-Argentina BIT states that expropriatory measures must be taken "in the public interest, on a non-discriminatory basis and under due process of law," and that the foreign investor must receive "payment of prompt, adequate and effective compensation."[165]

The United States, as the world's major capital-exporting country, has taken great care in crafting a model BIT to serve as a template for all its international investment agreements. The current U.S. Model BIT appeared in 2004 and is a product of the Office of the United States Trade Representative and the Department of State working in tandem.[166] Under the terms of the U.S. Model BIT:

> 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).[167]

Therefore, as is required by customary international law, and repeated in the text of numerous BITs, a proper or "legal" regulatory expropriation under international law must be for a public pur-

---

164. *Id.*

165. Agreement between the Government of Jamaica and the Government of the Argentine Republic on the Promotion and Reciprocal Protection of Investments, art. 4(1), Feb. 8, 1994, *available at* http://www.sice.oas.org/bits/jamarg_e.asp.

166. U.S. Model BIT, *supra* note 8.

167. *Id.* art. 6.

pose, non-discriminatory in nature, occur through due process, and in the end, the foreign investor must receive some form of compensation.

2. Proper Regulatory Expropriation Under Customary International Law: The Public Purpose Element

Of the four requirements for proper regulatory expropriation under international law, the public purpose element has been the subject of the most heated debate. While there is general agreement among international legal scholars and across arbitral tribunals that regulatory actions resulting in expropriation must be taken for the public good, the effect of such a finding is highly disputed once this public purpose element has been invoked. On one side, it is argued that as long as a regulation is passed for a public purpose, the enacting government need not pay compensation to the foreign investor even if the regulation results in a total deprivation of value. A position similar to this one was taken by the NAFTA tribunal in the *Methanex* and *S.D. Myers* cases.[168] On the other side, it is argued that even if a regulation is enacted for a public purpose, this prong of the expropriation test does not trump the requirement that compensation be rendered to foreign investors where government regulation has damaged or totally destroyed the value of their investments. The NAFTA awards adopting the latter approach include *Metalclad, Feldman,* and *Pope & Talbot.*[169]

Influential sources such as the Restatement (Third) on Foreign Relations Law and the 2004 United States Model BIT support the proposition that under customary international law, regulations resulting in harm to an investment's value do not necessitate compensation by the government to the foreign investor provided they were enacted for a public purpose. For example, the comments to § 712 of the Restatement provide that "[a] state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police

168. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, para. 311 (Jul. 14, 2006) (explaining *S.D. Myers*); Methanex Corp. v. United States, Final Award, pt. IV, ch. D, para. 7, 44 I.L.M. 1345 (2005) (NAFTA Ch. 11 Arb. Trib. 2005).

169. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 98, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002); Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, para 111, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000); Pope & Talbot, Inc. (U.S.) v. Canada, Interim Award, para. 99, 40 I.L.M. 258 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

power of states . . . ."[170] In addition, Annex B to the U.S. Model BIT severely circumscribes the requirement of compensation for regulations enacted for a public purpose.[171] The drafters of the U.S. Model BIT believed that "[e]xcept 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 expropriations."[172] Under this approach, almost all environmental regulations would fall, by definition, under the public purpose rubric, and as a consequence the enacting government would owe no compensation to the foreign investor no matter how much the regulation in question affected the value of the foreign investment. Although this view of the public purpose prong necessitates the removal of all environmental regulations from the customary international law of expropriation, some scholars have shown themselves to be quite comfortable with this outcome. Indeed, the International Institute for Sustainable Development (IISD) and the World Wildlife Federation (WWF) argue that "any environmental law worth adopting will affect business operations," and thus environmental measures should be excepted from the rule requiring compensation for expropriations.[173]

In spite the significance of the position adopted by the Restatement and the U.S. Model BIT on the issue, three recent influential arbitral awards have taken a different tack to the public purpose question under customary international law. Of the three, the *Santa Elena* award presents the most convincing response to those arguing for a public purpose *carte blanche* to expropriation, or the exceptionality of environmental regulations as suggested by the IISD and WWF. *Santa Elena* provides that

> While an expropriation or taking for environmental reasons may be classified as a taking for a public purpose, and thus may be legitimate, the fact that the Property was taken for this reason does not affect either the nature of the measure of the compensation to be paid for the taking. That is, the purpose of protecting the environment for which the Property

170. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 712 cmt. g (1987).

171. *See* U.S. Model BIT, *supra* note 8, Annex B, § 4(b).

172. *Id.*

173. International Institute for Sustainable Development & World Wildlife Federation, *Private Rights, Public Problems: A Guide to NAFTA's Controversial Chapter on Investor Rights* 32 (Int'l Inst. for Sustainable Dev. 2001), *available at* http://www.iisd.org/pdf/trade_citizensguide.pdf.

> was taken does not alter the legal character of the taking for which adequate compensation must be paid. The international source of the obligation to protect the environment makes no difference.[174]

The tribunal continued, concluding that

> Expropriatory 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.[175]

The *Santa Elena* tribunal, which issued its award in 2000, has not been alone in refusing to give special treatment under the international law of expropriation to regulations enacted for a public purpose. In *Azurix*, the respondent government, citing *S.D. Myers*, claimed that "[p]arties to [the Bilateral Treaty] are not liable for economic injury that is the consequence of *bona fide* regulation within the accepted police powers of the State."[176] The *Azurix* tribunal rejected outright the *S.D. Myers* approach as "contradictory" and held that just because a regulation was passed for a legitimate public purpose did not excuse the state from paying compensation when the value of an investor's property was damaged.[177]

ADC Affiliate Ltd. v. Hungary ("*ADC*") is the last, and most recent, of the three main awards in which arbitrators have come out against a public purpose *carte blanche*.[178] The complainants in the *ADC* award, decided in 2006, rested their claim for expropriation on Article 4 of the Cyprus-Hungary BIT, which required compensation in instances of "any [governmental] measure depriving . . . directly or indirectly . . . investors . . . of their investment."[179] ADC Affiliate Ltd., a Cypriot company, had originally partnered with the Hungarian Air Traffic and Airport Administration (ATAA) to

174. *Compañía del Desarrollo de Santa Elena, S.A. v. Costa Rica*, ICSID (W. Bank) Case No. ARB/96/1, Final Award, para. 71, 39 I.L.M. 1317 (2000).
175. *Id.* at para. 72.
176. *Azurix Corp.*, *at* para. 278.
177. *Id.* at paras. 310-11.
178. *See* ADC Affiliate Ltd. v. Hungary, ICSID (W. Bank) Case No. ARB/03/16, Award, para. 432, (Oct. 2, 2006), *available at* http://www.worldbank.org/icsid/cases/pdf/ARB0316_ADCvHungary_AwardOctober2_2006.pdf.
179. *Id.* at paras. 295, 426.

renovate, build, and operate several terminals at Budapest's main airport. However, in the middle of the lease period, the Hungarian Ministry of Transport eliminated the ATAA via a regulatory decree (referred to as a "ministerial order"), thereby voiding ADC Affiliate Ltd.'s agreement with the ATAA.[180] The regulatory decree was passed thanks to authority granted by the Hungarian Parliament's 2001 amendments to the Air Traffic Act, which also made impossible any further partnerships "of the type previously performed by the Project Company."[181] In reviewing Hungary's defenses to the complainant's expropriation claim, the *ADC* tribunal remarked:

> [A] treaty requirement for "*public interest*" requires some genuine interest of the public. If mere reference to "*public interest*" can magically put such interest into existence and therefore satisfy this requirement, then this requirement would be rendered meaningless since the Tribunal can imagine no situation where this requirement would not have been met.[182]

Yet the tribunal made what was perhaps its most important point regarding the ability of a state to regulate in the public interest, and the consequences of such regulation, when it held that "while a sovereign State possesses the inherent right to regulate its domestic affairs, the exercise of such right is not unlimited and must have its boundaries."[183]

In general, even while due deference must be offered to the academic position taken in the comments to § 712 of the Restatement (Third) on Foreign Relations and by Annex B to the 2004 U.S. Model BIT regarding the public purpose element, the weight of arbitral jurisprudence appears to the contrary. *Santa Elena*, *Azurix*, and *ADC Affiliate Ltd.* all indicate that even if a regulation (environmental or otherwise) resulting in an expropriation is enacted for the genuine benefit of the public, this does not excuse the state from its obligation under customary international law to compensate the foreign investor for its losses. It remains to be seen whether the 2004 changes in the U.S. Model BIT—particularly the addition of Annex B—may alter the present vector of customary international law dealing with the public purpose element.

180. *See id.* at paras. 80, 94-95, 116, 176, 186, 191.
181. *Id.* at para. 181.
182. *Id.* at para. 432.
183. *Id.* at para. 423

3. Proper Regulatory Expropriation under Customary International Law: The Compensation Element

Even when foreign investors and capital-importing states agree that all three elements of expropriation are present, controversy often arises over the amount of compensation owed to the foreign investor. Developing states in the 1970's asserted that the quantum of compensation in instances of expropriatory regulation should be determined based on the domestic law of the regulating state, to the chagrin of foreign investors.[184] This position, obviously favorable to the capital-importing states, was adopted in the General Assembly's 1974 Charter of Economic Rights and Duties, which was largely influenced by the developing New International Economic Order of the time.[185] In contrast to the announced policy of the capital-importing states, the capital-exporting states proceeded to back the "Hull formula," which required "prompt, adequate and effective compensation" when expropriation was identified.[186]

Unlike the public purpose element of "legal" or "proper" expropriation, which remains the subject of substantial debate, the controversy over the compensation element of regulatory expropriation has been definitively resolved in favor of the capital-exporting countries. The Trade Unit of the Organization of American States, in *Investment Agreements in the Western Hemisphere: A Compendium*, provides that "most [investment] agreements use the Hull formula" and that only in very few cases (Brazil-Venezuela, Ecuador-Paraguay, Peru-Paraguay BITs) is the more general formula of "just compensation" used.[187] Naturally, a wide variety of methods for valuing an expropriated investment fall under the Hull formula's requirement of "prompt, adequate, and effective compensation," with the arbitral tribunal making the ultimate choice as to which method is to be used. Nevertheless, many recent awards have rendered effective compensation to foreign investors based on the "fair market value" of the property prior to the date of expropriation.[188]

---

184. *See* Been & Beauvais, *supra* note 15, at 47.

185. *See id.* Wälde & Kolo, *supra* note 136, at 811-12.

186. Patrick M. Norton, *Back to the Future: Expropriation and the Energy Charter Treaty*, in THE ENERGY CHARTER TREATY: AN EAST-WEST GATEWAY FOR INVESTMENT AND TRADE 373 (Thomas Wälde ed., Kluwer L. Int. 1996).

187. *See* Organization of American States, Trade Unit, *Investment Agreements in the Western Hemisphere: A Compendium* parts II(D)(1), II(E)(2)(c) (1999), *available at* http://2005.sice.oas.org/cp_bits/english99/main.asp.

188. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, para. 438 (Jul. 14, 2006); *ADC Affiliate Ltd.*, at para. 501.

For instance, the fair market value concept of property valuation is expressly provided for in the US-Argentina BIT and was quickly put to use by the tribunal in *Azurix* once it determined expropriation had taken place.[189] In the words of the tribunal, "in assessing fair market value, a tribunal would establish that value in a hypothetical context where the State would not have resorted to [expropriatory] maneuvers but would have fully respected the provisions of the treaty and the contract concerned."[190] In essence, the tribunal is looking back at the value of the investment at the time prior to when the expropriatory action occurred.[191]

The fair market value requirement also appears in the Cyprus-Hungary BIT, which lies at the heart of the *ADC Affiliate Ltd. v. Hungary* case.[192] Article 4(2) of the BIT provides that "[t]he amount of compensation must correspond to the market value of the expropriated investments at the moment of expropriation."[193] However, in contrast to *Azurix*, the *ADC* tribunal chose not to apply the BIT standard of fair market value prior to expropriation. This was because the regulatory action in *ADC* constituted "unlawful" or improper expropriation, and thus the BIT (which "only stipulates the standard of compensation that is payable in the case of a lawful expropriation," i.e., expropriation carried out for a public purpose, etc.) did not apply.[194] The tribunal, in looking beyond the BIT to the origins of the law of expropriation, instead adopted the test set out in the *Chorzów Factory* award, where the Permanent Court of International Justice held:

> [R]eparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed. [195]

Employing the *Chorzów Factory* test led the *ADC* tribunal to grant the complainants the market value of the investment at the time of the award rather than at the moment prior to expropriation, mainly because the value of the investment had increased follow-

189. *See Azurix Corp.*, at para. 419.
190. *Id.* at para. 417.
191. *Id.* at para. 438.
192. *See* ADC Affiliate Ltd. v. Hungary, ICSID (W. Bank) Case No. ARB/03/16, Award, (Oct. 2, 2006), *available at* http://www.worldbank.org/icsid/cases/pdf/ARB0316 _ADCvHungary_AwardOctober2_2006.pdf.
193. *Id.*. at para. 295.
194. *Id.* at para. 481.
195. *Id.* at para. 484 (citing Chorzów Factory, Claim for Indemnity (Ger. v. Pol.) 1928 P.C.I.J. (ser. A) No. 17).

ing the expropriation.[196] As a result, the foreign investors received more than they otherwise might have under the compensation provisions of the BIT.

The *ADC Affiliate Ltd. v. Hungary* arbitration, while intriguing due to its reliance on the *Chorzów Factory* case, raises as many questions as it seeks to answer. For example, even though the vast majority of BITs apply the fair market value standard only to the pre-expropriation value of the investment, the *ADC* tribunal implies that these collective BIT provisions do not represent customary international law on the matter.[197] But even in choosing to utilize the *Chorzów Factory* standard over the standard set out in the Cyprus-Hungary BIT, the tribunal remarks that the "application of [this] restitution standard . . . has led to use of the date of the expropriation as the date for the valuation of damages."[198] In reality, then, it seems that the tribunal (which acknowledges the *ADC* case as *sui generis*) has invented its restitutionary approach out of whole cloth.[199] In the wake of *ADC*, academics and arbitrators must closely monitor future cases where the value of the expropriated investment increases following the date of expropriation, in order to determine whether damages in these cases will now be the fair market value of the post-expropriation investment, or the fair market value of the pre-expropriation investment.

4. Proper Regulatory Expropriation Under Customary International Law: The Elements of Non-Discriminatory Treatment and Due Process of Law

The last two elements of proper regulatory expropriation include the requirement that the regulation in question be non-discriminatory and that it be enacted through due process of law. Because these two elements, in the regulatory expropriation paradigm, do not involve considerations all that different from those present in the normal expropriation context, their appearance in this analysis will be rather brief. As in the previous explanation of the compensation element of proper regulatory expropriation under international law, the *ADC Affiliate Ltd. v. Hungary* award serves as a helpful guide to the due process and non-discrimination prongs.

In *ADC*, the claimants argued that because all foreign investors were prohibited from operating the airport under the provi-

196. *See id.* at paras. 495-96, 499.
197. *See id.* at paras. 483-84.
198. *Id.* at para. 496.
199. *See id.* at para. 497.

sions of the Ministry of Transport's regulatory directive, the anti-discrimination standard in Article 4 of the Cyprus-Hungary BIT (covering "measures depriving, directly or indirectly, investors . . . of their investments") was violated.[200] The Hungarian government denied that its actions were discriminatory, reasoning that because ADF Affiliate Ltd. was the only foreign investor involved in the airport project, the Ministry of Transport's regulatory decree and the related amendments to the Air Traffic Act did not achieve any real "singling out" or discrimination against foreign investors.[201] Eventually, the tribunal held that it could not "accept the Respondent's argument that as the only foreign parties involved in the operation of the Airport, the Claimants are not in a position to raise any claims of being treated discriminately."[202] The tribunal continued, holding that "in order for a discrimination to exist, particularly in an expropriation scenario, there must be different treatments to different parties."[203] The tribunal took the view that there was indeed discrimination in the effect of the government's regulation, because ADC Affiliate Ltd. had been treated differently from the "Respondent-appointed operator" that took over control of the airport from ADC.[204] Overall, this goal of demonstrating "different treatments to different parties" through expropriatory regulation is at the core of the discrimination prong.[205]

In addition to its non-discrimination analysis, the *ADC* tribunal also examined due process considerations relating to the Hungarian government's expropriatory actions. In its memorial to the arbitrators, ADC alleged that the Hungarian government's actions, such as Parliament's amendments to the Air Traffic Act and the Ministry of Transport's regulatory decree, violated due process because ADC received no reasonable notice of the change in government policy.[206] Furthermore, ADC claimed that due process was denied because the foreign investor was not presented with the "opportunity to seek judicial review" of the government's actions through a "fair hearing" before an "impartial adjudicator."[207] The tribunal accepted ADC's due process arguments without reservation, opining that

---

200. *Id.* at paras. 295, 411.
201. *See id.* at para. 397.
202. *Id.* at para. 441.
203. *Id.* at para. 442.
204. *Id.*
205. *Id.*
206. *See id.* at para. 376.
207. *Id.*

> *"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. In general, the legal procedure must be of a nature to grant an affected investor a reasonable chance within a reasonable time to claim its legitimate rights and have its claims heard.[208]

This expansion of due process by the *ADC* tribunal, which went beyond requiring states to accept outside input in enacting the regulation to include giving foreign investors some judicial route to challenge the legality of the expropriatory regulation itself, is a vital tool which foreign investors will certainly take advantage of in the future.

Beyond these conventional "notice and a hearing" requirements that have become almost dogmatic in American procedural due process review, the *ADC* award also states that due process was violated because Hungary "failed to establish a connection between the '*need to transform the ATAA*' and the deprivation of the Claimants investments in the Airport Project."[209]

This statement by the tribunal appears to introduce a substantive due process-style inquiry into the due process prong of proper "legal" regulatory expropriation, and is reminiscent of the U.S. Supreme Court's statement in *Penn Central Trans. v. New York* that a regulation can "constitute a 'taking' if not reasonably necessary to the effectuation of a substantial public purpose."[210] It remains uncertain as to whether or not this substantive due process requirement introduced by the *ADC Affiliate Ltd.* award will take root in the customary international law of regulatory expropriation.

208. *Id.* at para. 435.
209. *Id.* at para. 437.
210. Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 127 (1978).

IV. CHRONOLOGICAL ANALYSIS OF REGULATORY EXPROPRIATION IN THE JURISPRUDENCE OF THE ENERGY CHARTER TREATY

A. *Introduction to Energy Charter Treaty Article 13*

In comparison to the customary international law of expropriation captured in numerous BITs, the Energy Charter Treaty (ECT) is a relatively recent arrival on the international legal scene. The ECT is a multilateral investment treaty opened for signature in 1994,[211] which came into effect four years later in 1998.[212] Article 2 of the ECT sets out the purpose of the treaty, which is to create "a legal framework in order to promote long-term cooperation in the energy field, based on complementarities and mutual benefits, in accordance with the objectives and principles of the Charter."[213] The ECT, like NAFTA, provides a dispute resolution mechanism whereby investors may take advantage of either the ICSID dispute resolution apparatus, or alternatively those of UNCITRAL or the Stockholm Chamber of Commerce.[214] James Loftis and Mark Beeley explain that the treaty, while still influential in the international legal realm, suffers from two main limitations.[215] First, even though the ECT "expressly prohibits reservations," some signatory countries have attempted to exempt themselves from assorted treaty provisions through various understanding and declarations contained in the ECT's many annexes and protocols.[216] Another weakness "is the limited scope of the signatories themselves,"[217] for while most of Europe and Japan have ratified the ECT, notable energy-exporting states (such as those in the Middle East) have yet to even sign.[218] Other major powers, such as the United States and Canada, maintain observer status while Russia, a signatory to the treaty, continues to delay ratification which would fully subject it to the treaty's standards.[219]

Fortunately, for those foreign investors doing business in ratifying countries, the ECT provides substantial investment safe-

211. Craig Bamberger, *An Overview of the Energy Charter Treaty*, in THE ENERGY CHARTER TREATY: AN EAST-WEST GATEWAY FOR INVESTMENT AND TRADE 1 (Thomas Wälde ed., Kluwer L. Int. 1996).

212. James L. Loftis & Mark J. Beeley, *The Rise of Energy Charter Treaty Arbitration*, Global Arbitration Review – European Arbitration Review 7 (2007), http://www.velaw.com/pdf/resources/LoftisBeeleyEnergytreatycharter1106.pdf.

213. ECT, *supra* note 8, at art. 2.

214. *See id.* art. 26(1),(4).

215. Loftis & Beeley, *supra* note 212 at 9.

216. Craig Bamberger, *supra* note 211, at 2. *See also* Loftis & Beeley, *supra* note 212 at 9.

217. Loftis & Beeley, *supra* note 212 at 10.

218. *Id.* at 7.

219. *See id* at 7.

guards in addition to its hefty trade provisions. Thomas Wälde, one of the leading experts on the treaty, writes that

> The ECT's investment regime has been largely adopted from NAFTA Chapter XI and U.K. bilateral investment treaties (BITs). It often codifies therefore--in a "progressive direction," contrary to positions taken by the "Third World" and its proponents during the "New International Economic Order" (NIEO) period--customary international law.[220]

Wälde concludes that the ECT is "possibly the most advanced text in terms of extensive investor protection."[221]

As Wälde correctly notes, the ECT is packed full of investor protections. These can be found in Part III of the ECT, and include "fair and equitable treatment" and "minimum treatment under international law" rules (Article 10(1)), a "national treatment" rule for investors (Article 10(3),(7)), and a "due process" requirement (Article 10(12)).[222] The ECT also contains wide-ranging provisions protecting investors in cases of government expropriation. These provisions are bundled together in Article 13 of the ECT, which provides:

> Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation . . . except where such Expropriation is:
> (a) for a purpose which is in the public interest;
> (b) not discriminatory;
> (c) carried out under due process of law; and
> (d) accompanied by the payment of prompt, adequate and effective comp-ensation.[223]

The ECT, in referring to "measures having effect equivalent to nationalization or expropriation," is obviously intended to address acts of regulatory expropriation, along with more traditional types of physical takings, although this was not definitively stated until

---

220. Thomas W. Wälde, *Energy Charter Treaty-based Investment Arbitration*, TRANSNAT'L DISP. MGMT, Jul. 2004, at 1, 6, *available at* http://www.transnational-dispute-management.com.
221. *Id.*
222. *See* ECT, *supra* note 8, arts. 10(1), (3), (7), (12).
223. *Id.* art.13.

the *Nykomb* award.[224] In fact, Article 13 of the ECT closely resembles its cousin, Article 1110 of the NAFTA treaty, which also prohibits signatories from "tak[ing] . . . measures tantamount to nationalization or expropriation" without meeting the four elements of proper expropriation.[225] Todd Weiler and Thomas Wälde, in their comparison of the ECT and NAFTA jurisprudence, note that neither multilateral treaty could afford to ignore the issue of regulatory expropriation, as "[i]t is one of the several disciplines with which modern treaties seek to impose good-governance rules on economic regulation."[226]

Although on its face it might appear that the ECT heavily skews towards the side of foreign investors, consequently disfavoring state regulation, this is in fact not the case. Particularly in the area of environmental regulation, the ECT presents a much more level playing field for states than most BITs. Article 19 of the ECT provides that "each Contracting Party shall strive to minimize in an economically efficient manner harmful Environmental Impacts occurring either within or outside its Area from all operations within the Energy Cycle in its Area."[227] Other, more specific Article 19 obligations include "tak[ing] account of environmental considerations in the policy process," having particular regard to energy efficiency, renewables, cleaner fuels and pollution-reducing technologies, and promoting transparency with regard to environmentally significant investments.[228] Crucially, the impact of Article 19 of the ECT remains somewhat circumscribed by Article 27(2), which removes disputes regarding the "application or interpretation" of Article 19 from the purview of the ECT's dispute resolution mechanisms.[229] Nonetheless, it would be a mistake to deduce from this limitation that the environmental aspects of the ECT present in Article 19 have no role to play in Article 13 disputes centered on expropriation via environmental regulation. According to Kolo and Wälde:

> [T]he environmental obligations [of the ECT] may be relied upon by an international tribunal in interpret-

224. *See* Nykomb Synergetics Tech. Holding AB v. Latvia, Award, § 4.3.1 (Stockholm Chamber of Com. Inst. Dec. 16, 2003), 2003 WL 24045555 (APPAWD). *See also* Todd Weiler & Thomas Wälde, *Investment Arbitration under the Energy Charter Treaty in the light of new NAFTA Precedents: Towards a Global Code of Conduct for Economic Regulation*, TRANSNAT'L DISP. MGMT., Feb. 2004, at 1, 29, *available at* http://www.transnational-dispute-management.com.

225. *See* ECT, *supra* note 8, art. 13(1); NAFTA, *supra* note 8, art. 1110.

226. Weiler & Wälde, *supra* note 224, at 29.

227. ECT, *supra* note 8, art. 19(1).

228. *Id. See also* Bamberger, *supra* note 211, at 19.

229. *See* ECT, *supra* note 8, art. 27(2).

> ing other provisions of the treaty (e.g. the expropriation or sanctity-of-contract provisions). Since the distinction between 'normal' regulation and a compensable 'regulatory taking' is not easy and requires a balancing process, the environmental standards recognized in a treaty are suitable to serve as factors to be taken into account in such balancing process. They help to define the legitimacy of environmental policies underlying national regulation.[230]

Kolo and Wälde are not alone in writing that Article 19 could be influential in future regulatory expropriation disputes under the ECT, as Craig Bamberger also believes that "the absence of [Article 19] ECT dispute resolution does not eliminate the possibility that it might be cited in dispute resolution concerning other articles."[231] Together with Article 18(1) of the Charter, which promises to "recognize state sovereignty and sovereign rights over energy resources . . . subject to the rules of international law," Article 19 offers state respondents the ability to counter some investor claims of regulatory expropriation, although it is not certain to what extent.[232]

B. Article 13 Jurisprudence

The publicly available jurisprudence of the ECT, in contrast to that of the NAFTA treaty, remains rather paltry. As of January 2007, only two final awards on the merits have been rendered, along with one award on jurisdiction.[233] Although both awards involved claims of expropriation, the arbitral tribunals rejected the complainant's allegations in each instance.[234] The *Nykomb Synergetics Technology Holding AB v. Latvia* award, delivered in 2003, is the earlier of these two awards, and the first award rendered under the ECT since it came into force in 1998.[235] In *Nykomb*, the complainant, a Swedish company, entered into a business agreement through its Latvian subsidiary with Latvenergo, a Latvian state-owned enterprise, to sell electricity for redistribution over the

230. Wälde & Kolo, *supra* note 136, at 817.
231. Bamberger, *supra* note 211, at 20.
232. ECT, *supra* note 8, arts. 18-19. *See* Wälde, *supra* note 220, at 12.
233. *See* Loftis & Beeley, *supra* note 212.
234. *See* Petrobart Ltd. v. Kyrgyz Republic, No. 126/2003, Arbitral Award, § VIII(8) (Stockholm Chamber of Com. Inst. Mar. 29, 2005), *available at* http://www.investmentclaims.com/decisions/Petrobart-kyrgyz-rep-Award.pdf.; Nykomb Synergetics Tech. Holding AB v. Latvia, Award, § 4.3.1 (Stockholm Chamber of Com. Inst. Dec. 16, 2003), 2003 WL 24045555 (APPAWD).
235. *See Nykomb*.

Latvian power grid along with the heat generated by the powerplant which was to be piped to a neighboring municipality.[236] Following the construction of the complainant's cogeneration plant, built to provide the heat and electricity contracted for, a dispute broke out between the complainant (Nykomb) and Latvenergo regarding the price Latvenergo was paying for Nykomb's electricity.[237] Originally, foreign investors like Nykomb were induced into investing in Latvia by government provisions granting builders of cogeneration power plants the ability to charge twice the average tariff for electricity, which was typically fixed below market levels due to heavy government regulation of the energy industry in addition to cheap imported electricity.[238] Moreover, this special tariff rate had been guaranteed in the contract between the complainant's Latvian subsidiary and Latvenergo.[239] Nevertheless, various laws and regulations enacted by the Latvian government following Nykomb's entry into the Latvian energy market resulted in the "gradual limitation and eventually the abolishment of the double tariff as a mandatory incentive prescribed by statute."[240] As a result of the Latvian government's legal and regulatory actions and Latvenergo's subsequent refusal to pay the agreed-upon double tariff rates, Nykomb initiated arbitration on the grounds that several provisions of the ECT had been violated.[241] Among Nykomb's claims was that Latvia had engaged in regulatory expropriation in such a way as to violate Article 13 of the ECT.[242]

In its expropriation argument, Nykomb asserted that the behavior of the Latvian government and Latvenergo, its state-owned power monopoly, constituted indirect expropriation.[243] From the complainant's point of view, "[b]y taking away a substantial part of [Nykomb's] income from sales [Latvia] makes the enterprise not economically viable and the Claimant's investment worthless."[244] After considering Nykomb's argument, the tribunal rejected its expropriation claim, responding:

> The tribunal finds that "regulatory takings" may under the circumstances amount to expropriation or the equivalent of an expropriation. The decisive fac-

236. *See id.* § 1.1.
237. *See id.*
238. *See generally id.*
239. *See id.* § 3.3.
240. *Id.* § 3.5.10.
241. *See id.* § 4.3.
242. *See id.*
243. *Id.* § 4.3.1.
244. *Id.*

> tor for drawing the border line towards expropriation must primarily be the degree of possession taking or control over the enterprise the disputed measures entail. In the present case, there is no possession taking of [Nykomb] or its assets, no interference with the shareholder's rights or with the management's control over and running of the enterprise - apart from ordinary regulatory provisions laid down in the production license, the off-take agreement, etc.[245]

The *Nykomb* tribunal's comments on regulatory expropriation are noteworthy on two grounds. First, in stating that "regulatory takings may . . . amount to expropriation or the equivalent of an expropriation," *Nykomb* set an important precedent for including regulatory expropriations within the coverage of Article 13 of the ECT.[246] Second, the *Nykomb* tribunal's focus on the control element of expropriation, and in particular its refusal to recognize expropriation without some "possession taking of [Nykomb] or its assets" by the Latvian government or "interference with . . . management's control" over the investment,[247] sets a strict regulatory expropriation control standard under the ECT resembling that of *Azurix* or *Feldman*, rather than the more-inclusive standard of *Metalclad*.[248] This development in the regulatory expropriation law of the ECT is critical and marks a retreat away from expansive notions of investor's rights for a legal regime which was once believed to be more favorable to investors than NAFTA itself.[249]

In 2005, roughly two years after *Nykomb*, the second full award on the merits based on the ECT emerged.[250] *Petrobart Ltd. v. Kyrgyz Republic* grew out of the dealings between Petrobart, a Gibraltar-based company, and KGM, a utility company controlled by the

245. *Id.*

246. *See id.*

247. *Id.*

248. *See* Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, para. 322 (Jul. 14, 2006); Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 152, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002); Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, para 103, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).

249. *But see* Thomas Wälde & Kaj Hobér, *The First Energy Charter Treaty Arbitral Award*, TRANSNAT'L DISP. MGMT., Oct. 2004, at 15, *available at* http://www.transnational-dispute-management.com (Rejection of expropriation claim by *Nykomb* tribunal was only a compromise due to the "political character of this tribunal").

250. *See* Petrobart Ltd. v. Kyrgyz Republic, No. 126/2003, Arbitral Award, § II (Stockholm Chamber of Com. Inst. Mar. 29, 2005), *available at* http://www.investment claims.com/decisions/Petrobart-kyrgyz-rep-Award.pdf.

Kyrgyz government.[251] Petrobart had initially contracted to supply gas to KGM, but KGM soon found itself unable to pay due to "a series of restructurings that removed the state energy company's assets."[252] KGM eventually slipped into bankruptcy, with most of its operations and assets having been taken over by the newly created state-owned companies of Kyrgyzgaz and Munai.[253]

Because both Gibraltar, as part of the United Kingdom, and the Kyrgyz Republic are signatories to the ECT, Petrobart Ltd. chose to pursue ECT arbitration through the Stockholm Chamber of Commerce, following extended litigation in the Kyrgyz courts and one failed attempt at UNICTRAL arbitration.[254] Among the various allegations against the Kyrgyz Republic, Petrobart asserted that governmental regulatory action, such as presidential orders "transfer[ing] . . . KGM's assets but not its liabilities," in conjunction with interference in the local Kyrgyz courts that delayed Petrobart from seizing the assets of the bankrupt KGM, amounted to "measures equivalent to expropriation in circumstances which are not in conformity with Article 13(1) of the Treaty."[255] The tribunal declined to accept Petrobart's regulatory expropriation argument, holding that "the measures taken by the Kyrgyz Government . . . although they had negative effects for Petrobart, were [not] directed specifically against Petrobart's investment or had the aim of transferring economic values from Petrobart to the Kyrgyz Republic."[256]

While the *Petrobart* tribunal's discussion of regulatory expropriation was rather limited, the tribunal's decision to emphasize governmental measures having the "aim of transferring economic value," over measures depriving the foreign investor of control, appears a reconsideration of *Nykomb*'s narrow construction of Article 13(1)'s treatment of regulatory expropriation.[257] Even so, because *Petrobart Ltd.* is only the second of two full awards issued under the ECT, it is impossible to tell whether this award represents a larger movement in the ECT's regulatory expropriation jurisprudence away from *Nykomb*, and towards acceptance of the broader *Metalclad* "use" paradigm in identifying acts of regulatory expropriation. Regardless, the ECT should be "constructed in alignment with the emerging NAFTA and BIT jurisprudence."[258]

---

251. *See id.*
252. Loftis & Beeley, *supra* note 212, at 8. *See also Petrobart Ltd.*, § II.
253. *See Petrobart Ltd.*, § II.
254. *See id.* §§ II, V; Loftis & Beeley, *supra* note 212, at 8.
255. *Petrobart Ltd.*, § VII(1)(C)(g).
256. *Id.* § VIII(8).
257. *See id.* § VIII(8).
258. Wälde, *supra* note 220, at 10.

Given the approach of the *Feldman* (NAFTA) and *Azurix* (U.S.-Argentina BIT) arbitral tribunals, this rule-of-thumb suggests that *Nykomb*'s focus on physical possession and management *control*, rather than on the *use* of the investment, remains the appropriate standard for identifying regulatory expropriation under the ECT.[259]

V. IN DEFENSE OF REGULATORY EXPROPRIATION: RESPONDING TO CRITIQUES OF REGULATORY EXPROPRIATION

A. Economic Critique of Regulatory Expropriation

This analysis of the current state of regulatory expropriation under NAFTA, various BITS and accompanying customary international law, along with the arbitral jurisprudence of the Energy Charter Treaty, has shown that in spite of the differences among these legal regimes, there is also an important point of common agreement in that all three recognize the existence of regulatory expropriation. Peaking around the time of the *Metalclad* decision, however, a number of scholars began to question whether a doctrine of regulatory expropriation was desirable from a policy perspective.[260] While some have attacked regulatory expropriation as a whole, others have attempted to carve out state-enacted environmental regulations from the coverage of the law of regulatory expropriation.[261]

Vicki Been, in her article *Does an International "Regulatory Takings" Doctrine Make Sense?*, identifies three central justifications for a regulatory expropriation rule, and then subsequently attempts to rebut these justifications.[262] These economic and equitable justifications for an international legal rule of regulatory expropriation highlighted by Been in her piece are accurate and helpful, even if her critique suffers from substantial weaknesses. First, Been discusses the theory of cost-internalization, whereby compensation in instances of regulatory expropriation by sovereign states is justified on the grounds that requiring governments to

259. *See* Feldman v. United Mexican States, ICSID (W. Bank) Case No. ARB(AF)/99/1, Award of the Tribunal, para. 152, 42 I.L.M. 625 (2003) (NAFTA Ch. 11 Arb. Trib. 2002); Azurix Corp. v. Argentine Republic., ICSID (W. Bank) Case No. ARB/01/12, Award, para. 322 (Jul. 14, 2006).

260. *See, e.g.*, Been, *supra* note 9, at 49-50; Howard Mann & Konrad von Moltke, *Working Paper: NAFTA's Chapter 11 and the Environment -Addressing the Impacts of the Investor-State Process on the Environment* 47 (Int'l Inst. for Sustainable Dev. 1999), *available at* http://www.iisd.org/publications/pub.aspx?id=409.

261. *See* Been & Beauvais, *supra* note 15, at 142; Mann & von Moltke, *supra* note 260, at 47.

262. *See* Been, *supra* note 9, at 49-50.

pay for the regulations they enact (and thus "internalize" the cost of these regulations) results in more efficient regulation.[263] This is to say that governments will not regulate where the cost of enacting the regulation exceeds the benefits of that regulation. Been attacks the cost-internalization approach, arguing that

> [b]ecause politicians and bureaucrats do not maximize profits, having to expend funds to cover a compensation award will not necessarily have any effect on their decision, unless those expenditures make it harder for the decision-makers to achieve whatever it is that they do try to maximize. In other words, unless compensation awards transmit political, rather than market-based, incentives, those awards may do little to discourage inefficient regulation.[264]

Been's critique of the cost-internalization justification for regulatory expropriation suffers from her decision to draw an artificial distinction between political and market-based incentives. Although Been may be correct in stating that governments are not necessarily interested in maximizing profits (i.e., the size of the government treasury) alone, she is mistaken in assuming that just because governments do not attempt to generate "profits," that they are not interested in the economically efficient allocation of the revenues that they do acquire.

Essentially, Been misconstrues the incentives that drive government. In reality, there is a logical imperative for governments to provide the maximum possible level of services for the amount of revenues they collect. For instance, if a government is subject to an arbitration award that diverts funding for public services, this will have the "market-based effect" of decreasing the pool of funding available for government programs (i.e., social services, infrastructure development, etc.), which will result in a political effect of decreased support for the government. If support for the government drops too low, then a new party will be elected, or in non-democratic systems, the citizens may overthrow the presiding regime. Clearly, the "political incentive" is closely tied to the "market-based effect" of the government's expropriatory activity. Although government is not as efficient as private industry at the allocation of resources available to it, to suggest that forcing states to pay compensation does not have a significant effect on govern-

263. *See id.*
264. *Id.* at 51.

mental behavior, as is the only possible conclusion from Been's argument, is difficult to accept.

Been and Joel Beauvais attempt to counter the above response to Been's cost-internalization critique, by claiming that even if a constituent "chooses to vote for the candidate who promises to prevent regulations that would trigger [international] compensation requirements, a constituent will then have to monitor the behavior of the candidate she elects" to guarantee the government does not engage in expropriatory conduct.[265] Yet, in reality, a constituent need not monitor government officials in order for the threat of a regulatory expropriation award to have an effect on government behavior. In short, taxpayers do not have to know that the decrease in services they enjoy is tied to a regulatory compensation award in order to vote politicians out of office. Simple recognition that their standard of living has diminished under the current regime should be sufficient. Governing elites are well aware of this dynamic, and adjust their expropriatory actions accordingly.

The second basis for the doctrine of regulatory expropriation is tagged by Been as the "insurance rationale."[266] A rule of compensation for the expropriatory actions of states is justified on these grounds because skittish foreign investors will normally refuse to invest capital outside of their home countries, fearing that losses occurring abroad caused by governmental expropriation will otherwise remain unaddressed.[267] Here, Been asserts that investors should not be able to demand arbitration for expropriatory actions because there already exists a system of government-provided political risk insurance, namely OPIC, made available through the American government, and MIGA, through the World Bank.[268] Thus, "compensation should not be paid when an investor had the opportunity to purchase insurance against the risk, and chose not to do so."[269]

Been's effort at penalizing foreign investors who are too "cheap" to purchase political risk insurance by eliminating the legal doctrine of regulatory expropriation is founded on a misunderstanding of how the insurance system operates. Clearly, Been has forgotten that once an insurance company pays out a claim to a policy holder, it normally becomes subrogated to that claim, and may attempt to recover against the offending party. Few private (or public) insurance companies would remain solvent, if they were

265. Been & Beauvais, *supra* note 15, at 95.
266. *See* Been, *supra* note 9, at 50.
267. *See* Been & Beauvais, *supra* note 15, at 109-11.
268. Been, *supra* note 9, at 56-57.
269. *Id.* at 57.

to pay out time and again claims in the millions or billions of dollars without attempting to recover some of their losses. The request for arbitration in the 2004 *United States v. India* case, where OPIC took over the claims of GE, Bechtel, Enron, and Bank of America against the Indian government, after paying out $110 million on political risk insurance policies, is an excellent example of the subrogation principle at work.[270] Although OPIC and the Indian government eventually settled, OPIC's arbitration request, which alleged (among other wrongs) expropriatory action by the Indian government, was obviously a determining factor in the final outcome of the dispute.[271]

As for governmental political risk insurance programs in particular, it is doubtful that capital-exporting states will continue to support these programs if capital-importing states are allowed to expropriate property through regulation without being subject to a compensation requirement under international law. Although the investor may emerge whole thanks to insurance payments, the government insurer becomes that much poorer, while those taxpayers backing the government insurance scheme are the ones who ultimately bear the monetary cost. Under Been's system, it would be foreign taxpayers (those who subsidize the government political risk insurer) who ultimately pay for the capital importing-state's regulation. This is hardly a fair or economically efficient way to arrange matters.

The third rationale for an international regulatory takings doctrine moves out of the economic and into the equitable realm. Beavais and Been describe this "fairness rationale" as including:

> [T]heories [which] would require that foreign investors receive compensation either whenever they are burdened by regulations imposed by levels or types of governments whose processes do not afford the advantages of pluralist politics, or whenever particular kinds of foreign investors or foreign investors as a class are 'singled out' by regulations and are unable to protect themselves against legislative or regulatory change in normal political processes.[272]

---

270. *United States. v. India*, Request for Arbitration, paras. 1, 20, 37, Nov. 4, 2004, *available at* http://www.opic.gov/insurance/claims/ awards/documents/GOI110804.pdf.

271. *Id.* para. 37; Sucheta Dalal, *How the Dabhol Deal was Swung by the Government*, INDIAN EXPRESS (Oct. 9, 2005),*available at* http://www.indianexpress.com/res/web/pIe/full_story.php?content_id=79717.

272. Been & Beauvais, *supra* note 15, at 104.

The "fairness rationale" for regulatory expropriation also reflects Frank Michelman's seminal academic work, *Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law*, in which the concept of demoralization costs for uncompensated takings is introduced.[273] Been criticizes the fairness justification for regulatory expropriation in asserting that arbitral tribunals have no right to "review the balance legislatures have struck between the interests of investors and those of broader society,"[274] and in arguing that fairness theories "ignore the role that the availability of exit plays in disciplining government regulators."[275]

Been's focus on the lack of democratic legitimacy of arbitral awards, and her attempt to place the primacy of the legislature ahead of any determination of regulatory expropriation by an arbitral tribunal, is incorrect in three respects. First, Been seems to forget that arbitral panels do not have the power to overturn regulatory decisions of the government in issuing an award requiring compensation for regulatory expropriation, nor in doing so are they second-guessing legislative judgments. Rather, panels can only impose costs on the government which ensure that affected foreign investors receive back the fair value of their investments, when the government takes action in a manner depriving investors of that value. Second, Been overlooks the fact that governments also struck another "balance" which subjected them to the customary international law of expropriation, in deciding to open their doors to foreign investors, and in signing numerous BITs and other multilateral agreements in order to attract foreign investment. Third, it may be that government action ending in regulatory expropriation is not the result of any careful legislative decision weighing individual property rights against the public good, but is rather the self-interested determination of a small ruling clique to benefit a select few. After all, many capital-importing nations are not democracies, and to excuse the controlling elites in these countries of the few legal restraints upon them would be disastrous for foreign investors.

As for the threat of capital flight, Been seems to believe that "[c]ompetition from other jurisdictions for new investment will discipline the host jurisdiction's propensity to change its regulations"

273. *See* William A. Fischel, REGULATORY TAKINGS: LAW, ECONOMICS, AND POLITICS 141, 144-45 (Harvard. U. Press 1995) (citing Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law*, 80 HARV. L. REV. 1165).
274. Been, *supra* note 9, at 62.
275. *Id.* at 60.

in a manner damaging to foreign investors.[276] Yet even if the host state discovers that it is suffering from underinvestment following its initial expropriatory act and changes its future behavior, this does nothing to make whole the party who was deprived of the value of its investment. Finally, Been's arguments against the "fairness rationale" for regulatory expropriation also gloss over the many revolutions and regime changes which have carried ideologically-motivated governments into power who are unconcerned with attracting foreign investment, and who view foreign economic involvement in their countries with a hostile eye. Hugo Chavez's recent decision to expropriate Venezuela's foreign-owned power and telecommunications utilities,[277] along with Evo Morales's efforts to nationalize Bolivia's natural gas sector,[278] are part of a new wave of expropriations which fall into this category.

B. Environmental Critique of Regulatory Expropriation

Given the many holes in Been's sweeping attack on regulatory expropriation in its entirety, some scholars have instead theorized that only a certain area of governmental control, such as environmental regulation, should be exempt from the international regulatory takings doctrine. Muthucumaraswamy Sornarajah, author of *The International Law of Foreign Investment*, warns of a "definite clash . . . between the protection of the environment and the protection of foreign investment," stating:

> The progressive evolution of the right to a clean environment as a human right and as a norm incorporating higher values may lead to an inflexible right for the state to interfere in order to protect the environment and to regard this interference as not amounting to a taking which is not compensable.[279]

Because international law does not yet recognize an unlimited right for states to engage in environmental regulation without compensating foreign investors for resulting regulatory expropriation, Howard Mann and Konrad von Moltke, of the International Institute for Sustainable Development (IISD), suggest that multi-

---

276. *Id.* at 61.

277. *See* Jose de Cordoba, David Luhnow & Sara Silver, *State Control of Firms Brings Risk for Chavez*, WALL ST. J., Jan. 11, 2007, at A7.

278. *See* Juan Forero, *U.S. Aid Can't Win Bolivia's Love as New Suitors Emerge*, N.Y. TIMES, May 14, 2006, at sec. 1, p. 4.

279. Muthucumaraswamy Sornarajah, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 125 (2nd ed. 2004).

lateral investment treaties like NAFTA risk "freezing the development of sound environmental regulations, as well as other public welfare protection measures."[280] Lauren Godshall goes further, implying that the doctrine of regulatory expropriation could cynically be "turned into a tool for foreign investors to extract huge settlements from [governments attempting to protect the environment] under expansive claims of expropriation."[281]

As a remedy for these phantom threats, the IISD has created its own *IISD Model International Agreement on Investment for Sustainable Development.*[282] Although Article 8 of the IISD Model Agreement does include certain provisions protecting investors from expropriatory actions of the state, a significant exception is written into that article, which provides:

> [*B*]*ona fide*, non-discriminatory regulatory measures taken by a Party that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, do not constitute an indirect expropriation under this Article.[283]

This attempt to exclude environmental regulation from the general international legal doctrine of regulatory expropriation is furthered in Articles 20 and 25 of the Model Agreement, which state that parties to the agreement promise not deviate from environmental protective measures simply to encourage foreign investment,[284] and that host states have an inherent right "to take regulatory or other measures to ensure that development in their territory is consistent with the goals and principles of sustainable development."[285] In sum, for Sornarjah, Mann, Godshall, and others of this persuasion, arbitral awards like the *Santa Elena* decision, in which a tribunal held that "the purpose of protecting the environment for which the Property was taken does not alter the legal character of the taking for which adequate compensation must be

---

280. Mann & von Moltke, *supra* note 260, at 47.

281. Lauren Godshall, Note, *In the Cold Shadow of Metalclad: The Potential for Change to NAFTA's Chapter Eleven,* 11 N.Y.U. ENVTL. L.J. 264, 315 (2002).

282. *See generally* Howard Mann et al., *IISD Model International Agreement on Investment For Sustainable Development* 12, 14 (Int'l Inst. for Sustainable Dev. 2005) *available at* http://www.iisd.org/publications/pub.aspx?id=685.

283. *Id.* art. 8(I).

284. *Id.* art. 20.

285. *Id.* art. 25(B).

paid," are an anathema which require an immediate change in international law.[286]

Although this picture of a "freezing [of] the development of sound environmental regulations" due to the implementation of the international legal principle of regulatory expropriation is a compelling one, it is also highly inaccurate.[287] In spite of Godshall's allegations that investor-protection mechanisms such as Article 1110 of the NAFTA treaty and Article 13 of the ECT were "being hijacked by private corporations in arbitration proceedings to . . . coerce national governments into settlements for vast sums of money,"[288] Kaj Hobér and Thomas Wälde, writing several years after the hysteria surrounding the *Metalclad* award passed, determined that

> As in many if not all NAFTA cases and in many BIT-based cases, it is rather small or middle-sized entrepreneurial investors with limited prior experience in, and exposure to the risk of, international operations who get caught in the net of changes in government, domestic political volatility, xenophobic resentment of foreigners and the exclusion of foreign companies . . . linking domestic politics and local business.[289]

For these small and medium-sized investors, the compensation requirement that applies in instances of regulatory expropriation is a vital lifeline that allows them to recover their investment in an unpredictable developing state, where government regulations may be enacted for a combination of factors, both self-serving and for the public good.

In contrast to the unfounded worries of Godshall and Mann, the *Nykomb* award, where a Swedish investor constructed a highly efficient co-generation power plant, serves as an example of a dispute in which an environmentally friendly foreign investor was confronted with the "'environment-unfriendly' strategies of the ex-Soviet state electricity monopoly."[290] Indeed, one of the reasons the Latvian government was unwilling to pay the agreed-upon double tariff for energy provided by the foreign investors, was because it was receiving cheap energy from Russian power plants operating

286. *Compañía del Desarrollo de Santa Elena, S.A. v. Costa Rica*, ICSID (W. Bank) Case No. ARB/96/1, Final Award, para. 71, 39 I.L.M. 1317 (2000).
287. Mann & von Moltke, *supra* note 260, at 47.
288. Godshall, *supra* note 281, at 265.
289. Wälde & Hobér, *supra* note 249, at 18.
290. *Id.* at 19.

with almost no environmental controls.[291] In reality, *Nykomb* is "the reverse image of the scenario of a big-investor wishing to downgrade the environment against a domestic community upholding national environmental aspirations painted as a rule by the NGO commentators."[292]

Even as many foreign investors are attempting to make a profit while meeting high environmental standards set by host governments, there is also a dark side to environmental regulation which did not appear in the *Nykomb* case. In some instances, governments have used environmental regulation as a sort of "Trojan horse" to allow them to selectively chip away at the value of foreign investments in their country for the purpose of benefiting domestic competitors, or appeasing anti-foreigner populist sentiments.[293] Kolo and Wälde explain that "[b]ecause of the moral high ground it occupies, concern over the environment provides a convenient platform for even the most unlikely bedfellows to challenge the emerging institutions of the global economy under environmental, human rights, protectionist, nationalist and sovereignty-based, statist and communitarian headings."[294]

Nowhere is Kolo and Wälde's warning proven more fully than in the *Metalclad v. Mexico* award.[295] Although the tribunal identified a number of expropriatory actions in this award, the most egregious by far was the decision of the governor of the Mexican state of San Luis Potensi to create a "Natural Area for the protection of rare cactus" which just happened to encompass the Metalclad site.[296] The effect of the governor's environmental decree was to permanently bar operation of the landfill.[297] In issuing the special environmental decree, the governor, of course, was in no way concerned about the preservation of any rare plants which might happen to have been in the area, but was rather caving in to the "NIMBY-ism" of residents living in San Louis Potensi who opposed the landfill.[298]

A prime example of the abuse of environmental regulation, in which a capital-importing country has used its regulatory powers to intentionally expropriate the investment of a foreign business, is that of the Sakhalin-2 dispute discussed briefly in the introduc-

291. *See id.*
292. *Id.* at 18.
293. *See* Wälde & Kolo, *supra* note 136, at 812.
294. *Id.*
295. *See* Metalclad Corp. v. United Mexican States, ICSID (W. Bank) Case No. ARB/(AF)/97/1, Award of the Tribunal, paras. 59, 109, 40 I.L.M. 36 (2001) (NAFTA Ch. 11 Arb. Trib. 2000).
296. *Id.* at para. 59.
297. *Id.* at para. 109.
298. *See generally id.* at para. 46.

tion. The Sakhalin-2 story begins in 1994 when Royal Dutch Shell, a global energy company incorporated in the United Kingdom, signed an agreement with the Russian government to exploit a vast oil and natural gas field discovered in eastern Siberia.[299] Under the terms of the agreement, Shell and its Japanese partners (Mitsui and Mitsubishi) had the right to recover the billions of dollars in engineering costs spent in preparing Sakhalin-2, before the Russian government could receive its share of the oil and gas profits from the project's production sharing agreement.[300] By 2006, Sakhalin-2 had become the "largest foreign investment project in Russia,"[301] but with oil and natural gas prices at all-time highs, the government began reconsidering its initial bargain with Shell and its co-investors.

Instead of taking over the concession by an expropriation decree, Russia sought a renegotiation of the terms of the investment agreement by pressuring Shell on the environmental performance of the project.[302] The government appointed Oleg Mitvol, Deputy Head of Inspection for the Russian Natural Resources Ministry, to investigate alleged environmental breaches committed in the course of construction on and around Sakhalin island.[303] The Russian government's sudden and unexpected interest in the environmental merits of the project was a pleasant surprise to environmentalists opposed to the drilling. "We are prepared to be prostitutes with anyone if the end result is protection of the environment," stated Igor Chestin, head of the Russian branch of the World Wildlife Fund, while speaking about Sakhalin-2.[304]

Having already spent $12 billion on the project, Shell refused to renegotiate the 1994 agreement, arguing that the construction of Sakhlain-2 was being performed within the bounds of Russia's environmental laws.[305] In response to Shell's attempts to enforce the terms of the initial bargain, the Russian Ministry of Natural Resources revoked a key environmental permit for the project, halting construction in its tracks and threatening to add billions of dollars more in costs.[306] In addition, Mitvol threatened to open a criminal case against Shell for the "destruction of the forest" which

299. *See* Andrew E. Kramer, *Moscow Gets Further Concession From Shell; 3 Foreign Partners at Sakhalin-2 Project Lose Upfront Payment*, INT'L HERALD TRIB., Dec. 29, 2006, at 1.

300. *Id.*

301. Myers, *supra* note 4, at 5.

302. Parfitt, *supra* note 1.

303. *See* Tony Halpin, *Russia Accuses Shell of Damaging Sakhalin Forests*, THE TIMES (London), Sep. 21, 2006, at 56.

304. Parfitt, *supra* note 1.

305. *Id.*

306. *See* Parfitt, *supra* note 1.

supposedly occurred during the construction of pipelines on Sakhalin island.[307] Finally, in December 2006, Shell, Mitsui, Mitsubishi, and the government reached an accord, under which the companies agreed "not [to] recoup their costs upfront," which had the effect of "giving the government a bigger take without formally renegotiating the production sharing agreement."[308] Moreover, Shell and its foreign partners agreed to give Gazprom, an energy company controlled by the Russian government, a 50% plus one share stake in the private side of the venture.[309] As a result of the new agreement, "Mitsui's share drops from 25% to 12.5%, and Mitsubishi's from 20% to 10%," while Shell's share drops from 55% to 27.5%.[310] According to the *International Herald Tribune*, a short time after the new agreement was announced, President Vladimir Putin "declared instantaneously that the project's environmental problems 'could be considered resolved.'"[311]

While Shell chose not to pursue arbitration in this case, perhaps hoping to avoid endangering its remaining investments in Russia or maybe because Russia is not a signatory to the investor-friendly ECT, the facts plainly show that the actions of the Russian government constituted regulatory expropriation. In revoking a crucial environmental permit and threatening to criminally prosecute Shell and its partners under Russian environmental laws, the Russian government managed to force the project's foreign investors to renegotiate the terms of an investment agreement, and unwillingly hand over majority control of an investment which was previously 100% foreign-owned. Altogether, the Sakhalin-2 dispute is an excellent model of expropriatory action masquerading as environmental regulation. This is also precisely the kind of government behavior which will inevitably become more prevalent if environmental regulation is removed from the scope of regulatory expropriation. Already, Shell's decision not to seek compensation for the expropriation of its investment has emboldened the Russian government, which is now threatening to withdrawal the environmental licenses from Total's Kharyaga project, and BP's Kovykta field.[312] The lesson of Sakhhalin-2 is that a broader approach to regulatory expropriation is warranted in order to protect foreign investors, who may be wary of losing other investments in a country if their initial claim of regulatory expro-

307. *See* Halpin, *supra* note 303, at 56.
308. Kramer, *supra* note 299, at 1.
309. *See Shell's Sakhalin Rout Shines Light on Others*, *supra* note 3.
310. *Id.*
311. Myers, *supra* note 4, at 5.
312. *See Shell's Sakhalin Rout Shines Light on Others*, *supra* note 3.

priation fails—the precise opposite of what Been, Mann, von Moltke, Sornarajah, and Godhsall have advocated.

VI. CONCLUSION

The jurisprudence of NAFTA, customary international law as captured in various BITs, and the Energy Charter Treaty points to three unique but intertwined strands of thought on regulatory expropriation. Generally, there seems to be agreement amongst tribunals interpreting international law in each of these three areas that a finding of regulatory expropriation requires a showing by the foreign investor of some loss of control or use of the investment, the disappointment of certain expectations regarding the investment, and a diminishment of value due to government regulatory action. However, there is discernable disagreement as to how the first element of the three-prong regulatory expropriation test should be measured, or even whether it is *control* or *use* that matters.

On the one hand, although the law is still developing, it seems that NAFTA tribunals have taken a bifurcated approach to the control/use element of regulatory expropriation. As was stated earlier, *control* and *use* under NAFTA jurisprudence appear to constitute two separate standards by which regulatory expropriation can be determined. On the other hand, the post-*Nykomb* jurisprudence of the ECT indicates acceptance of the narrower *control* approach to regulatory expropriation, with a focus on quasi-physical expropriation and interference with management's power over the day-to-day operations of the investment. This parallels the holding in *Azurix* (a case based on customary international law and the US-Argentina BIT), rather than the more-inclusive NAFTA standard of *Metalclad.*

Moving beyond the control-use dichotomy, there are other large swathes of commonality among the jurisprudential approaches to regulatory expropriation in NAFTA, customary international law, and in the ECT. All three strands accept that proper or "legal" expropriation can only take place if the state enacting the expropriatory regulation does so for a public purpose, in a non-discriminatory manner, in accordance with due process, and if compensation for the foreign investor's losses is paid. Also, in spite of the efforts of some NGOs and scholars, the general trend across these three categories of regulatory expropriation law seems to be a rejection of the public purpose *carte blanche* for government regulations, even if such regulations are for the protection of the environment.

In arguing for special public purpose or environmental exceptions to the doctrine of regulatory expropriation, Been, Mann, von Moltke, Sornarajah, and Godhsall have all offered compelling reasons for why the international law of regulatory expropriation should be relaxed or eliminated. However, in a world where environmental regulation has increasingly become just another weapon in the arsenal of governments who seek to renege on previous commitments for diverse political and economic reasons, the doctrine of regulatory expropriation has become even more vital to foreign investors than in the past. This is not to disparage valid environmental regulation, but like anything else worthwhile, preserving the environment is an important goal involving substantial costs which should be shared by all citizens, rather than being passed off to comparatively powerless foreign investors.

Unfortunately, the actions of the Russian government in the Sakhalin-2 incident prove that environmental regulation serves as a useful curtain to shield what is in reality the fleecing of foreign investors. Furthermore, the widespread abuse of environmental regulations in such a manner is certain to generate increased resistance against *valid* attempts to protect increasingly fragile ecosystems in capital-importing states. But given Russia's victory in the Sakhalin-2 dispute, it is likely that environmental (and other) regulations will be used more frequently in upcoming years to pressure foreign investors, necessitating further study of the law of regulatory expropriation. Whether or not the future development of regulatory expropriation in NAFTA, customary international law, and the ECT, will take the more expansive route of *Metalclad*, which would help protect against further Sakhalin-like incidents, or will instead stick to the narrower path of *Azurix/Nykomb*, remains to be seen.