

# The Identification and Regulation of Expropriation in International Investment Law

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## Abstract:

This essay focuses on the concept of expropriation within the framework of international investment law. Expropriation has evolved from direct state appropriation of foreign investors' property to indirect expropriation, a more covert measure without the transfer of ownership. This essay distinguishes between direct and indirect expropriation, explores the meaning of expropriation through key cases, and evaluates the challenges tribunals face in legal practices. Finally, this essay examines the role of fair and equitable treatment (FET) standards and compensation mechanisms. With an effective regulation of expropriation, the author believes that a balance between state sovereignty and investor protection can be achieved.

**Keywords:** expropriation; international investment law; investment protection

## Introduction

International investment is no doubt an effective way to promote capital flow and economic growth. On the national level, many countries have loosened their domestic policies to attract foreign investments. On the global level, a few principles have been introduced in international legal system to protect foreign investors, whose rights are easily to be restricted or infringed by host states. The right of property is particularly noticeable, for it is regarded as the most important right of foreign investors (Gavriil, 2024). Besides Gavriil, many other scholars have also emphasized the inviolability of property rights. For example, Dunn (1928) interpreted the minimum standard of treatment of foreigners as "the security of the person from injury or restraint, and the preservation of private property" (p.176, as cited in Broude & Henckels, 2021, p.95). The protection of property was further extended by the European Convention on Human Rights (ECHR) in article 1 of its first protocol, where legal persons were officially provided with the equivalent property rights as natural persons. Similarly, international investment agreements (IIAs) also assure aliens that their investments overseas would not be negatively affected by expropriation or other measures tantamount to expropriation (Gavriil, 2024).

Although foreign investors are entitled to inviolable property rights, sometimes such rights are not valued. For instance, a number of international dispute settlement cases are associated with land and real estate, which are recognized as immovable properties. Unfortunately, few studies have been conducted in this field to explore the impli-

cation indirect expropriation has on contracting parties (Thiel, 2018). Given the research gap in areas related to expropriation, this article aims to address two issues to lay the foundation for future studies: (1) what kinds of action can be classified as expropriation; (2) how to guarantee a healthy investment environment by limiting the exercise of expropriation.

## The Concept of Expropriation

Expropriation refers to "a deprivation of property in an individual case directed at a transfer of property from one person to another in order to achieve an objective of public interest" (Thiel, 2018, p.783). Expropriation was once the focus of international disputes before its central position was replaced by standards such as national treatment and most-favored-nation (MFN) treatment (Schreuer, 2013). Nowadays, "no expropriation without compensation" has become a generally acknowledged principle in international economic law. Even with the existence of compensation, expropriation is still a major concern to most foreign investors, as the amount of compensation is often inappropriate compared with the benefits governments deprive from foreign companies. As a result, the conclusion of many bilateral investment treaties (BITs) and multilateral investment treaties (MITs) was accompanied by the need of capital-exporting countries to seek protection from expropriation from developing countries (Gavriil, 2024). Investors can resort to these treaties when they are faced with expropriation in a foreign state.

Since protection against expropriation plays a significant role of international investment law (Schreuer, 2013), it is

necessary to determine the exact scope of an expropriation so that each state can fulfill their responsibilities well. Expropriation can usually be divided into two categories, direct and indirect expropriation. Direct expropriation happens in a situation where a state takes away the property of foreign investors without offering reasonable compensation (Wellhausen, 2019). In other words, the ownership of property would shift from investors to host states with the completion of direct expropriation. While this enables host states to have the full control of the property, recent years have witnessed a decline on the number of direct expropriation (Johns et al., 2019). An important reason is that many states avoid being involved with extreme measures that could get them into trouble (Schreuer, 2013). In contrast, increasing states choose to expropriate in an indirect manner. The definition of indirect expropriation is not as clear as that of direct expropriation. However, it is possible to distinguish them from each other. Typically speaking, indirect expropriation, or so-called “creeping expropriation”, does not change the ownership of property but jeopardize the value of investment or disable foreign investors to use their property to earn expected profits (Simões, 2017). Even though the property still belongs to investors, the damage they suffer can be destructive because they have lost the actual control of their property and cannot carry out investment activities normally. Therefore, indirect expropriation should be strictly regulated in case that it does harm to foreign investments.

To sum up, the primary distinction between direct and indirect expropriation is whether the behavior changes the ownership of property. Both direct and indirect expropriation are challenges to foreign investors’ property rights, and the fight against arbitrary expropriation is in fact a fight “against the adverse exercise of state sovereignty” (Gavriil, 2024, p.2). The ideal circumstance is that sufficient compensation is ensured before expropriation. In the meantime, legislators should be careful with extending the definition of expropriation, as this would arise conflicts between international investment law and host states’ autonomy (Thiel, 2018).

### Indirect Expropriation in Case Study

In real legal practice, indirect expropriation not only threatens foreign investors but also bothers tribunals, because tribunals often find it difficult to make a ruling without clear guidance from law. The German Basic Law, for instance, does not provide for the definition of an indirect expropriation (Thiel, 2018). Consequently, cases concerning indirect expropriation largely fall into discretion. In addition, states are allowed to regulate foreign investments for the consideration of public interest although

such regulation may lead to detrimental outcomes for foreign investors (Schreuer, 2013). This further justifies indirect expropriation and makes it even harder for tribunals to tell the exercise of regulatory power from indirect expropriation than simply defining the latter. So far, many attempts have been made to draw a separating line, but these attempts failed to be convincing enough to finish the endless discussion on this topic (Thiel, 2018). This article will refer to several relevant cases in order to gain insights into the identification of indirect expropriation.

First and foremost is the famous *Metalclad* case. In *Metalclad v. Mexico*, the Metalclad company’s claim that the Mexican government conducted indirect expropriation was supported by the court. The tribunal held that following the North American Free Trade Agreement (NAFTA), actions that were not direct expropriation but had “the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property” also constituted expropriation (Johns et al., 2019, p.931). Thus, the Mexican government shall compensate the company for the deficit owing to its intervening behavior. A similar opinion was seen in *Tecmed v Mexico*, in which the tribunal recognized the refusal to renew the operating permit for a landfill as an indirect expropriation as well (Thiel, 2018).

On the other hand, not all tribunals agreed with the claimants as above. In some other cases, tribunals were strict with the standard of expropriation and ruled adverse to foreign investors. The *Charanne and Construction Investments v. Spain* case can serve as a typical example. According to Simões (2017), this case included two foreign companies as claimants which were shareholders of an electric company in Spain. The claimants asserted that Spain had gone beyond non-compensable regulation and had breached the prohibition of indirect expropriation. The tribunal found out that during the two companies’ investment, Spain deliberately changed the regimes in the photovoltaic solar electricity industry, which affected the interest of the claimants. However, the tribunal argued that Spain’s act was not expropriation as it did not have a “substantial” impact on the belongings of property.

What could be inferred from these cases is that with the decrease in direct expropriation over the past few decades, appellants have more chances to win a case if they accuse host states of indirect expropriation instead of a direct one. However, just as Johns et al. (2019) pointed out, the threshold of indirect expropriation is rising, and claimants usually have to rely their hope on uncertainty caused by the absence of related legal statutes. From the judge’s perspectives, there are some existing doctrines they can and have probably learned from to write a persuasive verdict.

## Prevalent Criteria of Expropriation

One of the most frequently used theories to identify expropriation is the sole effect doctrine. As its name suggests, this doctrine emphasizes the specific effect governments have on foreign investors by taking regulatory measures, rather than the causes behind these measures or policies (Gavriil, 2024). The sole effect doctrine was adopted by the tribunal in *Metalclad v. Mexico* to prove the government's indirect expropriation. The government refused to approve an environmental permit for the Metalclad company, which resulted in the company's failure to construct a landfill as planned (Johns et al., 2019). This obviously had an unneglectable influence on the operating activities of the company, so the tribunal awarded compensation corresponding to the expropriation.

Another doctrine favored by many tribunals is the police power doctrine. Unlike the sole effect doctrine which prioritizes foreign investors' benefits, the police power doctrine focuses on states' legitimate rights to control industries that are closely connected with public interests. Under this doctrine, states are not obliged to pay compensation as long as their measures are taken out of public interests and are non-discriminatory (i.e., obeying national treatment and MFN treatment) (Gavriil, 2024). The police power doctrine was adopted in investor-state disputes such as *Methanex Corp v United States*. When tribunals draft their sentences with the help of this doctrine, they often exclude public welfare from expropriation and put the burden of proof on foreign investors (Schreuer, 2013). If investors cannot prove that the state or government has made a commitment to the involved issue, then the state is free from punishment for expropriation. Interestingly, despite the fact that the sole effect doctrine and the police power doctrine are opposite theories, they are both popular in the jurisprudence of indirect expropriation and have together formed a "fragmented and frequently contradictory body of jurisprudence" (Olynyk, 2012, p.254, as cited in Johns et al., 2019). This means both doctrines contribute to the development of international investment law, but the contrariness between them has made the law more complex than it was.

## Expropriation and Fair and Equitable Treatment

Fair and equitable treatment (FET) is also an important treatment standard apart from protection against expropriation. It is evoked in many cases, particularly where the investor is not sure whether they will meet the threshold of expropriation. It can be very useful when there is no expropriation, but the state has treated the investor in a bad way. The breach of FET and indirect expropriation

are analogous when the former standard is "massive and long-lasting" (Thiel, 2018, p.783). In *British Caribbean Bank v. Belize*, the tribunal illustrated that the difference between expropriation and FET was that protection against expropriation highlighted foreign investors' property rights, while FET mainly considered the purpose, context, and impact of governmental action (Broude & Henckels, 2021). In other words, the treatment investors enjoy from FET is more of personal or human rights and is far away from property rights.

## Compensation for Expropriation

Against the backdrop of worldwide decolonization after World War II, many newly independent states (NIEO) started to ask for rights to appropriate without compensation. They complained that the amount of money they needed to pay for expropriation was more than they had in hand. Nevertheless, the European states and the US ignored their request and insisted that NIEO offer full compensation for expropriations. In 1938, Gordon Hull, the US Secretary of State, proposed that expropriation must be accompanied by "prompt, adequate, and effective" compensation. His view coincidentally survived as the well-known "Hull Formula" which is now used in a great deal of treaties and contracts. "Prompt" demands host states pay the compensation immediately after expropriation. "Adequate" requires the compensation to be enough to cover the costs or expenses that companies have made. Moreover, the compensation has to be effective, indicating investors will be put in a position that they would have been in if the expropriation never happened. The "Hull Formula" has become a customary rule of international law (Gavriil, 2024), and it has been written into legal documents like the Energy Charter Treaty (Simões, 2017).

## Conclusion

Although traditional direct expropriations are no longer the center of international economic law, many forms of indirect expropriations have emerged and deserve our attention. This article has discussed the definition of expropriation, analyzed some highly relevant cases, and introduced two dominant doctrines to determine whether a governmental behavior consists of expropriation. This article also talked about the relationship between expropriation and FET and the golden rule "Hull Formula" in terms of compensation. In summary, this article is an overview of expropriation in a legal sense, with the hope that more researchers will look into this concept in the foreseeable future.

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