Regulatory Expropriation, Investment Protection and International Law: When Is Government Regulation Expropriatory and When Should Compensation Be Paid?

by

Andrew Paul Newcombe

A thesis submitted in conformity with the requirements
for the degree of Master of Laws
Graduate Department of Faculty of Law
University of Toronto

© Copyright by Andrew Newcombe 1999

Abstract of Thesis

Regulatory Expropriation, Investment Protection and International Law: When Is Government Regulation Expropriatory and When Should Compensation Be Paid?

by

Andrew Newcombe

Master of Laws, 1999
Faculty of Law, University of Toronto

Investment protection obligations in bilateral investment agreements and the investment chapter of the *North American Free Trade Agreement* provide that states must pay compensation for measures tantamount to expropriation. The scope of this obligation is controversial because international law has failed to develop clear rules for determining when a government measure is expropriatory. This thesis analyzes the international law governing expropriation and the scope of foreign investment protection under international law. It argues that states should have significant autonomy in the regulation of foreign investment, even if regulation significantly impairs the value of an investment. An international minimum standard of investment protection should require compensation for appropriations of property, national treatment, respect for state contracts and protection against arbitrary and opportunistic state conduct. The thesis then analyzes the scope of expropriation under Chapter Eleven of the NAFTA and the effect of international investment obligations on domestic regulatory authority.

Acknowledgments

I thank Professor Michael Trebilcock, Faculty of Law, University of Toronto for supervising the writing of this thesis. From our initial meeting to the final draft, Professor Trebilcock's suggestions, insights and encouragement were invaluable. I would also like to thank Jon R. Johnson of Goodman Phillips & Vineberg and Julie A. Soloway, Research Fellow, Centre for International Studies for providing many useful sources, their insights and ideas on trade and investment law and their encouragement. I thank the Graduate Programme, Faculty of Law, University of Toronto for providing financial support my studies and Julia Hall of the Graduate Programme Office for the assistance she provided throughout the year. Finally, my decision to pursue my LL.M. was supported by my wife, Jennifer Champion, to whom I owe the deepest thanks and appreciation. This thesis would not have been possible without her support and encouragement.

Table of Contents

INTRODUCTION

A prevalent theme in discussions of trade and investment liberalization is the concern with the loss of sovereignty and regulatory authority over national economies. This concern was evident, for example, in the concerted opposition by numerous non-governmental organizations to the negotiation of the *Multilateral Agreement on Investment* (the "MAI") at the Organisation for Economic Co-operation and Development. Critics of the MAI and trade investment liberalization point to the Government of Canada's settlement with US based Ethyl Corporation in July 1998 as proof of their claims that the liberalization of trade and investment is a threat to national sovereignty and results in reduced protection for the environment and public health. In 1997 Ethyl Corporation claimed $250 million (US) in damages from Canada under Chapter Eleven (Investment) of the *North American Free Trade Agreement* (the "NAFTA") in response to the Canadian government's ban on the import and export of MMT, a gasoline additive. Ethyl Corporation claimed the ban violated the national treatment, performance requirements and expropriation provisions in Chapter Eleven. While the merits of Ethyl Corporation's claim were not unassailable, the Government of Canada chose to settle with Ethyl Corporation rather than to proceed with investor-state arbitration under Chapter Eleven of the NAFTA. The claim by Ethyl

Corporation and its settlement raises important questions about the impact of investment obligations on domestic regulatory authority.

Significant investment liberalization has occurred in the 1990's resulting in a numerous treaties with investment protection provisions, including the NAFTA and the Energy Charter Treaty. The number of bilateral investment treaties ("BITs") more than doubled between 1990 and 1997, to over 1500. The number and scope of treaties governing foreign direct investment continues to increase and, as the result of investor-state arbitration provisions in many of these treaties, so does the potential that state regulation that affects property rights may breach international investment obligations.

In this thesis I focus on one controversial aspect of international investment policy and investment protection, namely, the meaning and scope of expropriation in international law. This area will become increasingly important as investors continue to launch claims under Chapter Eleven of the NAFTA and under similar provisions in BITs. Chapter Eleven provides that Canada, the US and Mexico may expropriate or take measures tantamount to expropriation only if the measure is for a public purpose, is non-discriminatory and the state party pays the required compensation. One of the controversial issues in Ethyl Corporation's claim was whether the Canadian government's ban on the import and export of MMT was a measure tantamount to expropriation of Ethyl Corporation's investment in Canada. It is also an area that requires considerable clarification in international law.

Expropriation cases in international law have traditionally involved confiscations or seizures of property, the nationalization of key industries held by foreign interests or the cancellation of state-granted natural resource concessions. In contrast, a number of claims under the NAFTA are based on a conception of expropriation that is doctrinally similar to "regulatory takings" in US Fifth Amendment jurisprudence. A "regulatory taking", or what I will refer to as a "regulatory expropriation", arises where government legislation or a regulatory measure deprives a property owner of the use or benefit of property, limits or prohibits the transfer or disposition of property or has the effect of destroying the value of property, but where the state does not

acquire title to the property in question. Regulatory expropriations, therefore, differ from typical cases of expropriation, such as the taking of property for a highway or other public projects.

While courts in many states, especially in those states with constitutional protection of property rights, have considered the distinction between expropriation and regulation and have developed a jurisprudence on when regulation is expropriatory, there are few sources in international law governing the distinction between regulation and expropriation of property. Given the experience of Chapter Eleven claims under the NAFTA, the expanding network of BITs and the potential for a multilateral framework for the treatment of foreign investment to be negotiated in the future, potentially under the auspices of the World Trade Organization, it is important to clarify the extent to which a state is responsible for economic injuries to a foreign investor when it exercises sovereign powers that affect the investor's property.[1] This is particularly important in the domain of social regulation, for example regulation to protect the environmental and health, since this form of regulation may significantly affect the economic viability of an investment and is at the core of domestic regulatory authority.

The thesis is divided into five chapters that treat distinct but interrelated issues. Chapter One explores the diverse rationales for why governments should or should not compensate property owners when government regulation impairs the value of property rights. The purpose of the chapter is not to develop a theory of property rights or a framework for compensation for regulatory expropriation. Rather, I argue that there is significant disagreement about the optimal compensation policy for expropriation claims. The Chapter begins with a review of US Fifth Amendment jurisprudence. It examines how the US Supreme Court has distinguished between regulation and "takings" of property and analyzes the doctrinal rationales used to justify compensation and non-compensation. I then focus on how some US property law scholars have analyzed the "regulatory takings question" as a question of transitions in property rights. The chapter reviews the substantial economic literature analyzing the incentive effects of compensation versus no-compensation and under what circumstances compensation for

[1]It is important to note that the thesis is concerned with the body of international law that regulates state treatment of property (or 'investments" as defined in the NAFTA and BITs) of foreign nationals and not the state's treatment of the property of its own nationals.

expropriation is economically efficient. I conclude that there are sound rationales supporting compensation where the government acquires a well-recognized and crystallized property interest, but that claims for compensation are not as compelling where they are based on losses of economic value or a deprivation of property rights resulting from general social regulation.

The sources of international law are reviewed in Chapter Two in order to assess whether, and under what circumstances, international law obliges states to pay compensation for regulatory expropriation. The paucity of sources demonstrates that international law has failed to develop clear rules to determine what government measures amount to expropriation. Customary international law is unclear and BITs and other international treaties typically refer to an uncertain and vague international law to determine what amounts to an expropriation. Rather than clarifying the scope of expropriation under international law, international investment instruments incorporate vague standards to be applied by investor-state arbitration tribunals. While the scope of expropriation under international law remains vague, there is considerable authority to suggest that international law generally requires compensation where the state has either directly or indirectly acquired property from a foreign national and there is no justification under the state's police power for the acquisition. My review concludes that there is no duty in customary international law for states to adopt the least restrictive measures available when regulating property rights in the public interest and that states generally exercise broad discretion under their police powers to regulate uses of property. In these cases state responsibility does not arise under international law for the effect of such regulation on the value of a foreign investor's property.

Chapter Three draws on the analysis in Chapters One and Two to develop a framework for how international law should treat claims of regulatory expropriation. I argue that the development of a legal framework for the treatment of foreign investment, including the treatment of claims for regulatory expropriation, is best founded on a policy that views the level of investment protection as instrumental to the maximization of global social welfare resulting from foreign investment flows. Investment protection is primarily an instrument of economic policy and reference solely to the respect for property rights does not serve as a compelling basis for the development of international law on investment protection. I argue that states should have

significant autonomy in the regulation of foreign investment, even if regulation significantly interferes with property rights or the value of the investment. I then propose a framework for an international minimum standard of investment protection that would require compensation for appropriations of property, cancellation of state contracts and breaches of a minimum standard of treatment. In addition, foreign investors would be protected from discriminatory acts through a national treatment requirement.

Chapter Three also addresses the complex interrelationship between international investment law and international trade law. A state measure may be primarily aimed at trade in goods, for example, an import restriction, but have a considerable impact on investment. A paradigmatic example is the Canadian government's ban on the import and export of MMT which, according to Ethyl Corporation's Chapter Eleven claim, would have destroyed Ethyl Corporation's investment in Canada. In such cases, what rules – international trade law, international investment law or both – should apply? A framework is required to determine the applicable law and jurisdiction in cases of overlap and this in turn depends on the future institutional structure for international investment law.

Claims under Chapter Eleven of the NAFTA have been extremely controversial, particularly because six of the claims have involved environmental regulation. The Chapter Eleven claims, and the investment protection provided in Chapter Eleven, are viewed by many environmental organizations and opponents of investment liberalization as an assault on the ability of governments to regulate investment, a vindication of the rights of investors over the public interest and proof that trade and investment liberalization constrains the ability of governments to regulate in the public interest. These claims and the controversy over the proposed MAI have created interest in the scope and impacts of international investment law. Chapter Four analyzes the scope of the expropriation provisions of Chapter Eleven and claims of expropriation under the NAFTA. I argue that the scope of expropriation in Chapter Eleven is not broader than customary international law and that, on this basis, the claims of regulatory expropriation made to date under Chapter Eleven should not be successful. However, given the uncertainty and vagueness of international expropriation law, an international tribunal may give a wider interpretation to the expropriation provisions than I argue is warranted. Since the scope of the

obligations in Chapter Eleven is unclear, the meaning of expropriation in Chapter Eleven should be clarified.

The final chapter compares Canadian expropriation law with international law and assesses the impact of Chapter Eleven and international expropriation law on domestic regulatory authority. A comparison of Canadian and international law confirms the views and concerns expressed by other commentators, namely, that international law requires compensation for expropriation in areas that Canadian law does not. Government liability for expropriation under Canadian law arises where the government appropriates property from a person while international law focuses on whether the government measure in question deprives a person of property. As a result government measures that are not expropriatory under Canadian law may give rise to a claim of expropriation under international law. By providing for investor-state arbitration for breaches of Chapter Eleven of the NAFTA, limits domestic regulatory authority in ways that Canadian law does not. These limits are potentially broader than the framework for investment protection that I propose in Chapter Three. As a result, more explicit rules are needed to clarify when state responsibility for regulatory expropriation arises.

A Note on Terminology

Throughout this thesis I use the term "regulatory expropriation" to refer to non-traditional claims of expropriation where, as the result of some type of government action or regulation, a person is deprived of the value of his or her property. This is to be distinguished from more traditional forms of expropriation, for example where title to property is transferred to the government, the property is seized or the government otherwise takes physical possession of the property. In these cases, not only is the property owner deprived of the value of property but there is also a corresponding acquisition of property by the state. In US constitutional jurisprudence, takings of property by the state through regulatory measures are referred to as "regulatory takings". I prefer the term "regulatory expropriation" in order to distinguish between state responsibility for regulatory expropriations under international law and regulatory takings under US constitutional jurisprudence. International legal authorities have referred to "regulatory expropriation" in many different ways, including: indirect expropriation, de facto expropriation, creeping expropriation, measures tantamount to expropriation, wealth deprivation and regulatory takings.

In discussing international expropriation law, I use the terms “property”, “property rights” and “property interests” to refer to the property interests or investments of foreign investors. International investment agreements use the defined term “investment” to provide an extensive definition of the property interests that are to receive investment protection since the meaning of “property” under customary international law is not without doubt. I use the term foreign national and alien interchangeably.

1. RATIONALES FOR COMPENSATION POLICY FOR REGULATORY EXPROPRIATION

Introduction

Regulatory expropriation – or, as it is called in the United States, regulatory takings, occurs where a government's regulatory action deprives a person of property rights. The right to compensation for regulatory is riddled with paradox. While a government will typically compensate property owners for a direct expropriation of an insubstantial piece of property, such as a sliver of a half acre lot required to widen a municipal road, it is unusual for a government to explicitly compensate property owners for significant reductions in property value resulting from common types of regulatory changes, such as land use zoning. In general, most states do not provide compensation for the effects of regulatory changes resulting from legislative, executive and judicial decisions, even though such changes may cause losses as, or more, severe than outright expropriation. This chapter examines the diverse rationales for why governments should or should not compensate property owners when government regulation interferes with

property rights.[1] The purpose of this chapter is not to propose an optimal compensation policy for regulatory expropriation or to develop doctrinal rules to implement that policy. Rather, I argue that there is significant disagreement about the optimal compensation policy for expropriation claims. In the later chapters, I draw on this analysis to develop a framework for how international law should treat claims of regulatory expropriation.

In order to provide a context for an analysis of international expropriation law, I first review the doctrinal development of US regulatory takings jurisprudence. Examining why a particular state compensates its citizens for government measures that affect property rights is a useful way of exploring the potential policy rationales for an international minimum standard of treatment for property and whether there are reasons to treat the property of foreign nationals differently from that of a state's citizens. In the second section, I provide an overview of traditional justifications for property rights and then examine how different perspectives on US takings jurisprudence reflect divergent conceptions of the right to property and, more fundamentally, differences in political philosophy and conceptions of justice. In the third section, I examine utilitarian and economic analyses of regulatory expropriation and compensation, focusing on Michelman's seminal article, “Property, Utility, and Fairness: Comments on the Ethical Foundations of ‘Just Compensation’ Law”, Kaplow's work on legal transitions, and economic analyses of compensation for expropriation. In the final section, I describe how regulatory expropriation often involves transitions in property rights regimes, and I examine the role of political institutions in establishing policy for regulatory transitions. I conclude that there are sound rationales supporting compensation where the government acquires a well-recognized and crystallized property interest, but that claims for compensation are not as compelling where they are based on losses of economic value or a deprivation of property rights resulting from general social regulation.

[1] I analyze only incidental losses resulting from government measures and not policies of intentional redistribution, i.e. taxation. Clearly, compensation for losses caused by intentional redistribution is inconsistent with a policy of redistribution.

1.1 Regulatory Takings and Just Compensation in US Law

The Takings Clause in the Fifth Amendment to the US Constitution provides that "nor shall private property be taken for public use, without just compensation". The Fourteenth Amendment, applicable to individual states, provides that "No state shall deprive any person of life, liberty or property, without due process of law".[2] Even though there is no explicit compensation requirement for takings in the Fourteenth Amendment, individual states are required to pay compensation for takings as a result of the due process clause in the Fourteenth Amendment [3] and, often, under state constitutions. The constitutional protection of property rights under the Fifth and Fourteenth Amendments has led to extensive US jurisprudence on government measures that affect property rights. While the US is not unique among nations in its constitutional protection of property rights, I have chosen US caselaw for a number of reasons. First, the US courts have explicitly struggled with how to make a principled legal distinction between takings and regulation for over 75 years. New forms of social regulation have forced the US Supreme Court (the "Court") to create doctrinal rules for distinguishing between takings and regulation. Second, many commentators have analyzed US takings law extensively, and their analyses provide valuable insights into the policy rationales for and against compensation and the deficiencies and inconsistencies in the doctrinal tests that the Court has developed. Third, because of the political and economic influence of US investment interests and the participation of the US in disputes regarding the protection of foreign property, US takings law has had a significant influence on discussions of the international minimum standard in international expropriation law. [4] Indeed, the influential *Restatement (Third) of the Foreign Relations Law of the United States* takes the view that, for the purpose of determining whether there has been an expropriation, international law draws a similar line to that drawn in US jurisprudence.[5] US takings law regularly sets the baseline for discussions of international

---

[2]This review of US takings law does not consider the US Supreme Court jurisprudence of the Lochner era in which a constitutional requirement of substantive due process under the Fourteenth Amendment was used to invalidate laws affecting property rights. See *Lochner* v. *New York* 198 U.S. 45 (1904).

[3]*Chicago, B. & Q.R. Co*. v. *City of Chicago*, 166 U.S. 226 (1897).

[4]M. Sornarajah, *The International Law of Foreign Investment* (Cambridge: Cambridge University Press, 1994) at 294.

[5]American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (Washington: American Law Institute Publishers, 1987) at §712, Reporters' Note 6 [hereinafter Third Restatement]. Also see D. Schneiderman, "NAFTA's Takings Rule: American Constitutionalism Comes to Canada" (1996) 46 U.T.L.J. 499 in

expropriation law. An analysis of regulatory expropriation in international law is deepened by an analysis of US takings law.

US takings caselaw in the nineteenth century focused on the distinction between government appropriation of property that requires compensation and government regulation of property based on the state's police powers that does not require compensation.[6] Case authority recognized that a taking does not require a formal transfer of title. A taking may occur where the government obtains some benefit in the course of pursuing a public project.[7] *Mugler* v. *Kansas*[8] provides a classic statement of the government's authority to regulate in the public interest under its police power.[9] In *Mugler*, the State of Kansas prohibited the manufacture, sale and consumption of alcohol. Brewers challenged the legislation as a taking of their breweries and inventory. The Court denied the claim and held that:

> A prohibition simply upon the use of property for purposes that are declared by valid legislation to be injurious to the health, morals, or safety of the community, cannot, in any just sense be deemed a taking or an appropriation of property for the public benefit. Such legislation does not disturb the owner in the control or use of his property for lawful purposes, nor restrict his right to dispose of it, but is only a declaration by the State that its use by any one, for certain forbidden purposes, is prejudicial to the public interests.[10]

Prior to *Pennsylvania Coal Co*. v. *Mahon*,[11] it was generally thought that the Fifth Amendment only required compensation in cases of direct appropriation of property by the government or a practical ouster of possession.[12] However, in the classic US regulatory takings case, *Pennsylvania Coal*, Justice Holmes held that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking",[13] thereby explicitly

---

which Schneiderman argues that US takings law may be imported into Canada through Chapter Eleven of NAFTA. Schneiderman's argument is discussed in Chapters Four and Five.

[6]See generally E. Freund's classic distinction between harm-prevention and benefit-extraction in *The Police Power: Public Policy and Constitutional Rights* (Chicago: Callahan, 1904).

[7]See *Pumpelly* v. *Green Bay Co.*, 80 U.S. (13 Wall.) 166 (1871). In *Pumpelly*, the Court held that the government must pay compensation to owners whose lands it had flooded on the basis that the government was using the property for its own purposes.

[8]123 U.S. 623 (1887) [hereinafter *Mugler*].

[9]This is commonly called the state's police power and, in the case of regulating nuisances, is also referred to as the noxious use doctrine.

[10]*Supra* note 8 at 668-69.

[11]260 U.S. 393 (1922) [hereinafter *Pennsylvania Coal*].

[12]*Lucas* v. *South Carolina Coastal Council*, 112 S. Ct. 2886 (1992) per Justice Scalia at 2892 [hereinafter *Lucas*].

[13]*Supra* note 11 at 415.

recognizing claims for regulatory takings. *Pennsylvania Coal* arose as the result of the *Kohler Act*, a Pennsylvanian statute that prohibited the mining of coal that caused the subsidence, within city limits, of any structure used for human habitation. Mr. Mahon, and others like him, held a property deed that conveyed the surface rights but reserved, in express terms, Pennsylvania Coal's right to remove all coal under the surface of the conveyed property. The deed provided that the grantee waived all claims for damages arising from the removal of coal.

While Justice Holmes acknowledged that government could not function if it could not diminish property values to some extent without the payment of compensation, he held that limits must be placed on the state's police powers, otherwise property rights would disappear. According to Holmes, whether or not a regulation amounts to a taking is a question of degree, depending on a case by case judgment that cannot be determined by general propositions. Holmes found that the effect of the *Kohler Act* constituted a taking of Pennsylvania Coal's property. In making this finding he considered a number of factors including the diminution in the property's value, whether the purpose of the prohibition was to protect public safety and whether there was an average reciprocity of advantage (a balancing of benefits and burdens). He concluded that the state's police power could not justify the destruction of previously existing property rights. Implicit in his reasons is the argument that Mr. Mahon acquired only the surface rights to his property and that the state could not effectively take away Pennsylvania Coal's property and give it to Mr. Mahon without the payment of compensation.

In a forceful dissent, Justice Brandeis held that: (1) restrictions imposed to protect public health, safety or morals (the traditional police powers) are not takings; (2) the *Kohler Act* prohibited a noxious use of property; and (3) the prohibition was valid even if it deprived the owner of the only use to which the property could be put profitably. Brandeis noted the interpretive difficulties with the diminution in value test if property rights are separated into different interests. He asked rhetorically whether an owner who sold the air rights 100 feet above the surface would be entitled to compensation for zoning restrictions, and if not, why a sale of the undersurface rights should bar the state's power to prohibit mining that causes subsidence. He also held that where public safety is imperiled, the power of contract cannot prevail against the exercise of the police power.

Pennsylvania Coal and the regulatory takings cases that followed it have been subject to extensive academic analysis. J.L. Sax' article "Takings and the Police Power"[14] was the first contemporary attempt to critically analyze US takings jurisprudence and to develop a framework for determining when compensation should be paid. Sax argues that the Court traditionally adopted two approaches to takings. The earlier approach was formalistic and focused on whether there was an appropriation of property or a regulation of a use of property that was harmful. This relied on a formalistic definition of "taking" (an invasion or appropriation by the state) and "property" (the abatement of a noxious use is not a taking of property, since there is no property right to noxious uses).[15] The second approach, typified by *Pennsylvania Coal*, focused on whether the regulation goes too far because of the nature of the loss suffered and the extent of the economic harm inflicted by the regulation. Sax reviews the jurisprudence and finds inconsistencies in the Court's takings jurisprudence. First, he argues that the invasion and appropriation tests have not caught instances of government takings.[16] Second, while the noxious use doctrine (abatement of nuisances) focuses on who created a "harm", regulation depriving a person of property right may result from the state having to resolve the inconsistency between perfectly innocent and independently desirable uses, rather than an inherently harmful use. For example, in *Miller* v. *Schoene*, the State of Virginia passed legislation allowing the destruction of red cedar trees to protect neighbouring apple orchards because a rust fungus grew in cedars, that, while perfectly benign for cedars, harmed apple trees.[17] The Court held that this did not constitute a taking. Third, he argues that the diminution of value test is inconsistent with the purpose of the Takings Clause and creates an unworkable definitional problem in trying to determine the property interest that has been diminished. Is the diminution in question determined with respect to total coal productivity in Pennsylvania Coal's holdings or the amount of coal that cannot be removed as a result of the *Kolher Act*? The basis for quantifying diminution in value continues to be a source of controversy. In *Lucas*, Justice Scalia remarks

---

[14]J.L. Sax, "Takings and the Police Power" (1964-5) 74 Yale L.J. 36 [hereinafter Sax (1964)].

[15]*Ibid.* at 39.

[16]See *infra* note 20.

[17]276 U.S. 272 (1928). Although Sax does not explicitly refer to Coase, his analysis of reciprocity of harm appears to draw on Coase's classic analysis of nuisance law in "The Problem of Social Cost" (1960) 3 J. L. & Econ. 1.

that the rhetorical force of the diminution in value rule is greater than its precision because the rule does not make clear the property interest against which the loss of value is to be measured.[18]

Sax' solution is to differentiate between the kinds of private economic loss resulting from government activity by focusing on the role the government plays in each case. Sax distinguishes between the role of government as a participant and enterpriser in acquiring and enhancing public goods and the role of government as mediator in the process of competition among economic claims:

> ...The precise rule to be applied is this: when an individual or limited group in society sustains a detriment to legally acquired existing economic values as a consequence of government activity which enhances the economic value of some government enterprise, then the act is a taking, and compensation is constitutionally required; but when the challenged act is an improvement of the public condition through resolution of conflict within the private sector of the society, compensation is not constitutionally required.[19]

Sax acknowledges certain caveats to this general rule. First, compensation may come in many forms such as reciprocal benefit (in-kind compensation) and incidental benefits. Second, he acknowledges that takings cases do not allow for one universal rule to cover all circumstances. For example, under his formulation, taxes could conceivably fit into the government's enterprise role, but general taxation measures would be exempt. Under his framework, property owners affected by the noise of airplanes and those whose airspace is invaded by over-flights would be equally entitled to compensation because the activity in question enhances the economic value of a government enterprise (the airport). Likewise, in *United States* v. *Central Eureka Mining Company*,[20] where the US War Production Board shut down privately owned gold mines to induce experienced miners to pursue other essential war work, compensation should have been paid because the government effectively regulated the gold mines out of business in order to induce a shift of labour to favour war production. But Sax would side with Justice Brandeis' reasons in *Pennsylvania Coal* that the *Kohler Act* was not a taking because a government enterprise was not enhanced.[21]

---

[18]*Lucas*, *supra* note 12 at 2895.

[19]*Supra* note 14 at 67.

[20]*United States* v. *Central Eureka Mining Company*, 357 U.S. 155 (1958). The Court denied compensation in the case.

[21]In *Keystone Bituminous Coal Ass'n* v. *DeBenedictus*, 480 U.S. 470 (1987) the Court upheld legislation similar to that in *Pennsylvania Coal*.

In his subsequent work on takings, Sax revised his framework of analysis from a focus on the nature of the government action to the nature of the use of property. Sax maintains that where government regulates a property use that creates a spillover (an externality), then the regulation enforces a public right and the government should not pay compensation. But where government regulates a property use that creates no externalities, then compensation should be paid. Sax revised his framework because of his concern that environmental regulation, such as wetlands protection, would be categorized as enhancing public goods and, therefore, a taking. In his later works, Sax generally advocates a non-compensation policy for claims of environmental regulatory expropriation.[22]

In "Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law",[23] Michelman also argues that the Court's doctrinal rules for compensation were unsatisfactory. Michelman finds that the Court awards property owners compensation in four types of cases. First, the state is required to pay compensation where the state uses or occupies property. Michelman argues that this requirement breaks down on analysis because there is no principled difference between the state acquiring a restrictive covenant over a property and imposing a restrictive zoning regulation. Affirmative occupancy may have the same effect on the property owner as a negative restraint on use.[24] Second, the Court focuses on the impact of government measures on property. Michelman argues that requiring compensation only for significant impacts is arbitrary because of the artificial cut-off. Why should the state pay compensation for a 90% devaluation in property but not a 50% devaluation? And as Justice Brandeis had argued in *Pennsylvania Coal*, once property interests are divisible, a taking can be defined based on the property interest that the government measure affects. Third, the Court draws a distinction based on government action that is a gain or benefit to the public. Michelman argues this simply ignores the question of why, if there is an overall benefit to society, the losers are not compensated. Finally, the Court considers whether the property owner

[22]See J.L. Sax, "Takings, Private Property and Public Rights" (1971) 81 Yale L.J. 149, J.L. Sax, "Property Rights and the Economy of Nature: Understanding *Lucas v. South Carolina Coastal Council*" (1993) 45 Stan. L. Rev.1433 and J.L. Sax, "Takings Legislation: Where It Stands and What is Next" (1996) 23 Ecol. L. Q. 496.

[23]F.I. Michelman, "Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law" (1967) 80 Harv. L. Rev. 1165.

is prohibited from conducting an activity considered harmful to other people. Michelman argues that non-compensation on the basis of harmful uses is not a principled basis for non-compensation. For example, in the case of a restriction on a property owner placing roadside billboards on his or her property, the distinction between preventing harms (distractions to drivers) and securing benefits (safety) cannot be sustained. Michelman's framework for analyzing compensation for takings is examined in detail in Section 1.3.1.

In *Penn Central Transportation Co.* v. *New York City*,[25] the Court affirmed that takings cases are essentially ad hoc, factual enquiries. In cases of regulatory takings, the Court will examine a number of factors including: the nature and purpose of the government activity; the economic impact of the regulation; and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations. In *Penn Central*, Penn Central claimed that New York City's *Landmarks Preservation Law* was a taking because heritage designation prevented the development of a multistory office building over the site of Grand Central Terminal. The Court denied the claim and held that the law did not prevent Penn Central from realizing a reasonable return on its investment and that, since the city made pre-existing air rights transferable to other development parcels in the vicinity, any financial burden was mitigated. A minority of three justices held that there was a taking since Penn Central was deprived of the use of the airspace above Grand Central Terminal.

Seventy years after *Pennsylvania Coal*, the US Supreme Court reviewed its takings jurisprudence in *Lucas* v. *South Carolina Coastal Council*,[26] a case involving a restriction on development in an ecologically sensitive coastal zone. The State of South Carolina had enacted the *Beachfront Management Act*, among other things, to protect the South Carolina coast from erosion and to preserve South Carolina's beaches. As a result of the legislation, Mr. Lucas was prohibited from erecting any permanent habitable structure on two residential lots that he had purchased for $975,000. Lucas had intended to build single-family residences on the parcels, similar to the houses on the immediately adjacent lots. The trial court found that, as a result of

---

[24]*Ibid.* at 1187.
[25]438 U.S. 104 (1978) [hereinafter *Penn Central*].
[26]*Supra* note 12.

the prohibition on building, Lucas' two parcels were rendered valueless. Justice Scalia, for the majority, held that, in addition to the requirement that government must compensate a property owner when it appropriates property, two other distinct categories of regulatory action are compensable without a case-specific inquiry into the public interest served by the regulation. First, where the regulation compels a property owner to suffer a physical invasion of the owner's property; and second, where the regulation denies all economically beneficial or productive use of land. In the second case, where land is to remain in its natural state, Justice Scalia held that it is likely that private property is being used for some form of public service. He held that "when the owner of real property has been called upon to sacrifice *all* economically beneficial uses in the name of the common good, that is, to leave his property economically idle, he has suffered a taking."[27]

Justice Scalia reviewed previous decisions that relied on the police power to prohibit harmful or noxious uses of property. He noted the difficulty in distinguishing between harm-preventing regulation and benefit-conferring appropriations. The preservation legislation in question could be interpreted as either preventing Lucas from harming South Carolina's ecological resources or as conferring the benefit of an ecological preserve. Since a harm-preventing justification can be formulated in every case, Scalia notes acerbically that a harm based test "amounts to a test of whether the legislature has stupid staff".[28] Holding that the harm/benefit test is subject to abuse, Justice Scalia suggests a new test with nuisance law as the baseline for evaluating government action:

> Where the State seeks to sustain regulation that deprives land of all economically beneficial use, we think it may resist compensation only if the logically antecedent inquiry into the nature of the owner's estate shows that the proscribed use interests were not part of his title to begin with...
>
> ... that title is somehow held subject to the "implied limitation" that the State may subsequently eliminate all economically valuable use is inconsistent with the historical compact recorded in the Takings Clause that has become part of our constitutional culture.[29]

---

[27] *Ibid.* note 12 at 2895.
[28] *Ibid.* note 12 at 2898.
[29] *Ibid.* note 12 at 2899-2900.

Therefore, the state can regulate nuisances, but any state-defined nuisance prohibition must be in accordance with the principles of nuisance law. Scalia held that it is unlikely that common law principles would have prevented the erection of a habitable structure on the land, but the question was one of state law to be tried on remand. The state would have to identify the principles of property and nuisance law that prohibited Lucas' use of the property.[30]

In *obiter*, Scalia noted that because the state has traditionally exercised a higher degree of control over personal property, a property owner is more aware that a regulation may render personal property economically worthless, especially where the property's only economic use is sale or manufacture for sale.[31] For example, in *Andrus* v. *Allard*,[32] regulations under the *Eagle Protection Act* and the *Migratory Bird Treaty Act* permitted the possession and transportation of certain bird parts but prohibited commercial transactions in the same parts. The prohibition was upheld under the Takings Clause even though it significantly affected the owners of "pre-existing avian artifacts" (i.e. headdresses). In *Andrus*, the Court held that where an owner possesses a full bundle of property rights, the destruction of one strand is not a taking because the aggregate must be viewed in its entirety. The prohibition on the sale of lawfully acquired property did not effect a taking.[33]

Justices Blackmun and Stevens vigourously dissented from the majority's decision in *Lucas*. Justice Blackmun held that the decision was contrary to two premises that were unassailable prior to the decision: first, that the state has the power to prevent any use of property it finds to be harmful to its citizens; and second, that state legislation is entitled to a presumption of

---

[30]Fischel followed the subsequent proceedings and found that the state purchased the parcels from Mr. Lucas and that it planned to resell them for development. One of the neighbouring parcel owners offered to buy one parcel for $315,000 and keep it undeveloped in order to protect his view. The state refused this offer and sold the parcels to a developer for $785,000 or $392,500 each. Fischel poignantly remarks that "when its own money was on the table, the state was unwilling to forgo $77,500 to preserve one of the lots whose previous value of $600,000 to the owner it had denied was a compensable loss" in *Regulatory Takings: Law, Economics and Politics* (Cambridge: Harvard University Press, 1995) at 61 [hereinafter *Regulatory Takings*]. The decision by the trial judge that the parcels were valueless is questionable. Maintaining the property undeveloped was clearly not valueless to surrounding landowners. The difficulty was that Lucas lacked any bargaining power with his neighbours who had already obtained a de facto scenic easement over the properties.

[31]*Supra* note 12 at 2899.

[32]444 U.S. 51 (1979) [hereinafter *Andrus*].

[33]*Ibid.* at 66-68. But see Section 1.4, below, as to whether *Andrus* is still a precedent.

constitutionality.[34] Blackmun finds that Lucas did not contest that the building prohibition was necessary to protect people and property from storms, high tides and beach erosion. Blackmun rejects the categorical rule that compensation is payable where the owner is prevented from any economically beneficial use of the owner's property and relies on previous decisions, including *Penn Central*, that hold that a diminution in property value, by itself, cannot establish a taking. He holds that land use regulation that destroys recognized real property interests is justified in order to protect the health, safety, morals or general welfare of the community.[35] Blackmun further rejects the categorical rule requiring compensation, except where the prohibited use is a common law nuisance, by arguing that the Court has never required that a prohibited activity amount to a common law nuisance. Rather, the Court has relied on legislative judgments of what constitutes harm. Blackmun suggests that common law nuisance principles do not provide an objective value-free basis for upholding regulation anymore than a legislative determination of harm. The harm-preventing determination by the state is similar to the nuisance determination by a court as both depend on a determination of whether the use is harmful.

A takings case in 1998 demonstrates the significant disagreement among members of the Court on the scope of the Takings Clause and reveals the potential impact on social regulation of a broad interpretation of the Takings Clause. In *Eastern Enterprises* v. *APFEL*,[36] four justices held that a former coal producer's statutory liability to pay the health benefits of retired miners is a taking.[37] The other five justices (the majority on the takings issue) held that the requirement to pay the benefits was not a taking.[38] Justice Kennedy, one of the five in the majority on the takings issue, nevertheless held the legislation was unconstitutional under the Due Process Clause. As a result, five justices in total held the legislation was unconstitutional. Eastern Enterprises challenged the constitutionality of the *Coal Industry Retiree Health Benefit Act of 1992* (the "Coal Act") under which Eastern was responsible to pay for the health benefits of over 1000 miners whom it had employed prior to 1965. Eastern had been a coal producer until 1965

[34]*Supra* note 12 at 2905.

[35]*Supra* note 12 at 2910-2911.

[36]*Eastern Enterprises* v. *APFEL*, 118 S. Ct. 2131 (1998) [hereinafter *Eastern*].

[37]O'Connor J.'s opinion joined by Rehnquist, C.J., and Scalia and Thomas, JJ.

[38]Stevens, Souter, Ginsburg and Breyer, JJ. joined in two dissenting opinions. Justice Kennedy wrote separate reasons.

and contributed to an industry-wide multiemployer benefit plan established for miners. It transferred its coal operations to a subsidiary in 1965 and sold the subsidiary to a third party in 1987. Justice O'Connor held there was a taking under the three factor test in *Penn Central*. On the economic impact of the regulation, O'Connor found that Eastern had not negotiated or contributed to the multiemployer plan after 1965. It was only in the later plans that the industry committed to funding lifetime health benefits for retirees and their family members. When Eastern employed the miners, retirement and health benefits were far less extensive, were unvested and were subject to alteration. Eastern was therefore forced to bear the burden of paying for non-negotiated lifetime benefits for many of its former employees. The evidence suggested Eastern's payments could range between $50 and $100 million. Second, O' Connor held that the Coal Act substantially interfered with Eastern's reasonable investment-backed expectations, because it attached new legal consequences to the employment relationship between Eastern and its employees between 1946 and 1965.[39] Finally, O'Connor found that the nature of the government activity was unusual because it imposed retroactive liability and forced Eastern to bear a burden unrelated to any commitment it undertook.

In three sets of reasons, the majority of five on the takings question held that the Coal Act did not effect a taking because the Coal Act only imposed a general liability on Eastern to pay benefits into a benefit fund. The majority held that in all previous takings cases a specific property right or interest had been the subject of the takings claim. Second, the majority held that the Takings Clause operates as a conditional limitation permitting government to take property provided it pays compensation. In this case, the constitutionality of the Coal Act turned on the legitimacy of Congress' judgment, rather than on the availability of compensation. Finally, the four justices in the minority (on the disposition of the case) held that the miners had a legitimate expectation of health benefits and that it was not unfair for Congress to require Eastern to pay the health care costs of retired miners who had worked for Eastern before 1965.

[39]The Court had held in previous decisions that an employer's statutory liability under a multiemployer benefit plan should reflect some proportionality to its experience with the plan. See O'Connor's reasons *supra* note 36 at 2149.

1.2 The Liberal Conception of Property and the Takings Clause

The central question that this chapter addresses is why and under what circumstances should property owners be compensated for government measures that have the effect of depriving the owner of property rights. While US takings jurisprudence clearly requires that the government pay compensation for certain deprivations of property, the jurisprudence and academic commentary suggest various rationales for compensating deprivations of property and for distinguishing between non-compensable government regulation and takings for which just compensation is due. In this section I examine the rationales for compensation under the Takings Clause by focussing on the conceptions of property rights and political theory that underlie the Takings Clause.

While an in-depth discussion of property rights theory is beyond the scope of this thesis, identification of the most prominent theories is useful in understanding rationales for compensation.[40] Theses theories can roughly be divided into several groups. The first group of theories focuses on natural rights and desert. For example, Nozick argues there is a natural right to property.[41] Locke's labour theory maintains that property rights arise as a product of a person's labour. For example, one can acquire property rights through creating, husbanding, demarcating or defending certain property. Through labour a natural right to property is created. As discussed below, American legal scholar Richard Epstein is an influential contemporary proponent of the Lockean conception of property and the state. The second group of theories provides a utilitarian justification for property rights. Utilitarian analysis of property rights, associated with Bentham and other utilitarians, asserts that property rights are solely instrumental in maximizing social welfare by ensuring that people can form settled expectations about the future enjoyment of products.[42] Economic analysis of property rights adopts a utilitarian or instrumental justification of property rights according to which their primary

[40]See Michelman *supra* note 23 at 1202 to 1213.
[41]See Waldron, *supra* note 45 for an assessment of various property rights justifications.
[42]See Michelman *supra* note 23 at 1211.

function is to guide incentives to achieve a greater internalization of externalities.[43] Finally, property rights are also justified as a requirement for ethical human development.[44]

The classical liberal conception of property embodies the exclusive right to possession, use and disposition.[45] The right to possession generally includes the right to exclude. While there is general agreement that property includes these three basic legal rights, takings jurisprudence essentially concerns the breadth and limits of these rights. Carol Rose argues that the tension in US takings law arises from different conceptions of the purpose of property rights within the liberal tradition.[46] The Lockean, Madisonian and Benthamite tradition focuses on stringent property protection. This collides with the civic republican tradition that views property as instrumental to democratic participation. In the civic republican tradition, property fosters the independence and civic participation of citizens in a self-governing community.[47] The civic republican does not focus on the wealth-preservation, wealth or productivity maximization function of property rules. Radin makes a similar distinction between the liberal conception of property under which property acts as a protected space from government intrusion and is protected because it is a pre-existing and pre-political natural right (the Lockean conception), and the republican tradition where the central concern is the preservation of self-government. For the republican, property protection is primarily instrumental in ensuring the independence of citizens. These approaches lead to very different questions when rules for takings are evaluated. The liberal asks - is the one being exploited by the many? While the republican asks - will this action undermine our commitment to self-government?[48]

1.2.1 US Takings Jurisprudence and the Liberal Conception of Property

---

[43]H. Demetz, "Toward a Theory of Property Rights" (1967) 57 Am. Econ. Rev. Pap. & Proc. 347.

[44]See Hegel, *Philosophy of Right*, trans. T.M. Knox (Oxford: Oxford University Press, 1967). For a modern version of a personality theory of property see M.J. Radin, *Reinterpreting Property* (Chicago: The University of Chicago Press, 1993).

[45]See generally T. Honore, "Ownership" in A.G. Guest (ed.) *Oxford Essays in Jurisprudence* (London: Oxford University Press, 1961) and J. Waldron, *The Right to Private Property* (Oxford: Clarendon Press, 1988).

[46]C.M. Rose, "*Mahon* Reconstructed: Why the Takings Issue Is Still a Muddle" (1984) S. Cal. L. Rev. 561.

[47]*Ibid.* at 591 - 593.

[48]M.J. Radin, "The Liberal Conception of Property: Crosscurrents in the Jurisprudence of Takings" in M.J. Radin, *Reinterpreting Property* (Chicago: The University of Chicago Press, 1993) [hereinafter *Reinterpreting Property*]at 142 - 143.

Radin argues that the liberal conception of property is incompletely realized in US takings jurisprudence but that there is a trend in recent cases toward a greater realization of the conception. The trend in US takings jurisprudence supports Radin's claim. Court decisions, such as Justice Scalia's decision in *Lucas*, reflect a reinvigorated rights-based theory of property. The Court recently held that where government requires dedication of land as a condition of development approval there must be a rough proportionality between the harm caused by the new land use and the benefit obtained from the condition, otherwise a taking occurs.[49] And *Eastern Enterprises* demonstrates a division in the Court on the Takings Clause that mirrors the liberal and republican conceptions of property.

The property rights movement in the US,[50] of which legal scholar Richard Epstein is an influential proponent, advocates reinvigorated property rights protection to check the powers of the welfare state. In his well-known work, *Takings: Private Property and the Power of Eminent Domain*,[51] Epstein adopts a Lockean contractual framework for analyzing takings that assumes that individual liberty and property exist prior to the state. Contracting citizens, acknowledging that any one of them could block a necessary public project or extract substantial rents in order to allow their property to be used for a public project, agree that the state may expropriate their property. Property owners, therefore, forsake property rule protection for liability rule protection

[49]See *Dolan* v. *City of Tigard*, 512 U.S. 379 (1994). The City of Tigard had enacted a Community Development Code requiring new development facilities to dedicate land for pedestrian pathways and a Master Drainage Plan requiring that property owners along a floodplain pay for part of the cost of improvements to the floodplain. The plan noted that increases in impervious surfaces exacerbate flooding problems. Ms Dolan applied to redevelop an existing commercial site adjacent to the floodplain. The plans would have doubled the size of her store and included plans to pave a 39-space parking lot. The City required Ms Dolan to dedicate approximately 10% of her property for flood control and a pedestrian/bicycle pathway as a condition for approving a building permit. The majority held that the requirement for a floodplain easement could not be upheld because it amounted to a permanent recreational easement upon her land for purposes broader than flood control. With respect to the pedestrian/bicycle pathway, the majority held that the City had simply found the pathway could offset some of the congestion caused by the development but had not made any effort to quantify how the pathway could offset the traffic demand.

[50]See M.W. Cordes, “Leapfrogging the Constitution: The Rise of State Takings Legislation” (1997) 24 Ecol. L. Q. 187 for a discussion of the property rights movement and statutory requirements for compensation for takings in the legislation of US states.

[51]R.A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (Cambridge: Harvard University Press, 1985) [hereinafter *Takings*].

through a constitutional requirement that if the state takes any of a person's bundle of property rights, then the state must pay just compensation for the property taken.[52]

Epstein argues that any government interference with the use or enjoyment of property must be compensated, unless the restriction is based on the state's police powers. As the state has no more authority to deprive a person of property without compensation than a private individual, the police power is only as broad as the common law of nuisance. Epstein uses private law as the measure of public rights. This is essentially the position that Justice Scalia adopts in *Lucas*. While adopting a strict compensation requirement for takings, Epstein acknowledges that restrictions on the rights of others often serve as a form of implicit, in-kind compensation. For example, zoning restrictions in a residential neighbourhood may be justified by the average reciprocity of advantage received by residential landowners. But he views US takings jurisprudence as sanctioning impermissible takings in areas such as rent control and welfare payments because the government is acting in a wealth distribution role. According to Epstein, the purpose of the Takings Clause is to protect private property from acts of wealth distribution by the state. He argues that "the requirement of just compensation for government takings should constitute a powerful and useful check on the growth of the state, which if consistently applied would effectively clip the wing of the modern welfare state"[53] and that "[t]he state power to force private owners to surrender property against their will undercuts the inviolate nature that private property typically enjoys as between private parties."[54]

The Court has characterized the right to exclude others as "one of the most essential sticks in the bundle of property rights that are commonly characterized as property."[55] In *Lorretto* v. *Teleprompter Manhatten CATV Corp.*,[56] the Court reviewed legislation permitting a cable operator to install cable equipment on rental buildings without the owner's permission, but with payment of compensation. The purpose of the legislation was to ensure that tenants had access to low cost cable. Teleprompter installed a half-inch diameter cable on Lorretto's building and

---

[52]R.A. Epstein, "Takings" in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 3 (New York: Stockton Press, 1998) 561 at 563.

[53]*Ibid.* at 561.

[54]*Ibid.* at 563.

[55]*Kaiser Aetna* v. *United States* , 444 U.S. 164 (1979) at 176.

two cable boxes on the roof of the building and paid nominal compensation of $1. The cable companies had previously compensated property owners at a standard rate of 5% of the gross cable revenues realized from the property. The equipment on the roof occupied approximately one-eighth of a cubic foot of space. The majority held that a permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve. The dissent in *Loretto* analyzed the case under the three factors in *Penn Central* and found that there was no taking.

The categorical rule in *Loretto* has significant consequences for many types of regulation. In *Ruckelshaus* v. *Monsanto Co.*,[57] the Court held that the Environmental Protection Agency's disclosure of a trade secret could frustrate reasonable investment-backed expectations and amount to a taking. The right to exclude others is the very nature of a trade secret, and unauthorized disclosure could amount to a taking. The Court held that once others have access to a trade secret, the property interest and value of the property right is effectively lost.

In addition, the categorical rule in *Loretto* may have significant implications for deregulation in network industries. In *Deregulatory Takings and the Regulatory Contract*,[58] Sidak and Spulber argue that as the value of intellectual property and information-based assets grow, the Takings Clause will be applied to protect these assets. For example, they argue that with respect to network industries such as communications and electricity "[m]andatory interconnection and unbundling constitute a government-ordered, physical invasion of the property of the incumbent regulated firm."[59]

---

[56]458 U.S. 419 (1982) [hereinafter *Loretto*].

[57]467 U.S. 986 (1984) [hereinafter *Ruckelshaus*].

[58]J.G. Sidak & D.F. Spulber, *Deregulatory Takings and the Regulatory Contract* (Cambridge: Cambridge University Press, 1997).

[59]Sidak & Spulber, *ibid.* at 232. There is some judicial authority for this argument. Sidak & Spulber, *ibid.* at 8 note that "[i]n 1994 U.S. Court of Appeals for the District of Columbia overturned a Federal Communications Commissions rule - as exceeding the agency's authority - that ordered unbundling of the local loop and physical or virtual collocation of competitor's transmission equipment on the premises of the incumbent local exchange carrier." See also *Bell Atlantic Tel. Cos.* v. *FCC*, 24 F.3d 1441 (D.C. Cir. 1994) at 1445 noting that the FCC's order of physical collocation "directly implicates the Just Compensation Clause of the Fifth Amendment."

Radin argues that the categorical rule in *Loretto*, which prohibits any balancing of the public interest served by the invasion, in effect raises the right of exclusion to constitutional status. The means for doing this is "conceptual severance":

> To apply conceptual severance one delineates a property interest consisting of just what the government action has removed from the owner, and then asserts that that particular whole thing has been permanently taken. Thus, this strategy hypothetically or conceptually "severs" from the whole bundle of rights just those strands that are interfered with by the regulation, and then hypothetically or conceptually construes those strands in the aggregate as a separate whole thing.[60]

Radin also argues that the Court may be moving toward a categorical rule on the right of alienation because Chief Justice Rehnquist and Justices Scalia and Powell have indicated that the decision in *Andrus* (prohibition on the sale of eagle feathers) is to be limited to its facts.[61] Conceptual severance is a movement away from the principle Justice Brennan formulated in *Penn Central* that:

> "Takings" jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated. In deciding whether a particular government action has effected a taking, this Court focuses rather both on the character of the action and the nature and extent of the interference with rights in the parcel as a whole.[62]

In *Eastern*, where the government imposed retroactive liability for payments of employee medical benefits, O'Connor takes the opposite approach to conceptual severance. Rather than finding a taking of a specific property interest, O'Connor interpreted the Taking Clause as prohibiting a taking of a conceptual unity – Eastern's wealth. In O'Connor's view, the statutory requirement for Eastern to pay health benefits was a taking of Eastern's property. Such an interpretation of the Takings Clause moves the US one step closer to Epstein's vision of the Takings Clause.

1.2.2 US Takings Jurisprudence and the Republican Conception of Property

In contrast to the liberal conception of property, civic republicanism subordinates private interests to the pursuit of the public welfare.[63] Sax argues that the purpose of the Takings Clause

---

[60]Radin, *Reinterpreting* Property, supra note 48 at 127 -128.
[61]See *Hodel* v. *Irving*, 481 U.S. 704 (1987).
[62]*Supra* note 25 at 130-131.
[63]Sax (1993), s*upra* note 22 at 1453.

is not to preserve the economic status quo, or wealth, but to prevent arbitrary and unfair government. The protection afforded by the Takings Clause is therefore most properly viewed as a guarantee against unfair, arbitrary or tyrannical government, rather than value diminution.[64] Michelman, who previously focused on demoralization costs which he saw to arise from systematic exploitation, now characterizes the harm that the Takings Clause is designed to prevent as a corruption of the public commitment to the values of self-government by ensuring the independence of the property owning citizenry.[65] And Rose argues that the civic republican is indifferent to accumulation of property or wealth; the importance of property rests in the independence it provides for citizens to exercise the autonomous judgment necessary for self-rule.[66] Unlike the more static conception of property evoked by Justice Scalia in *Lucas* or Justice Marshall in *Loretto*, property in this conception is a multitude of existing and evolving interests that may conflict, as in *Miller*, where the government required cedar trees to be cut down to protect apple orchards and the regulation was held not to be a taking.[67] In the civic republican tradition these conflicts are balanced primarily through the political process and the Takings Clause serves as a bulwark against arbitrary government.

1.2.3 Corrective Justice and Expropriation

The requirement to pay compensation for property that has been taken or destroyed has strong foundations in principles of corrective justice.[68] Under common and civil law, where a private individual takes, uses or destroys another's property without lawful justification, the property owner is entitled to compensation in order to rectify the wrong done. Corrective justice requires that each person gets what is due to them and that the person is put back in the same position he or she would have been but for the wrongful action, with neither profit nor loss.[69] Corrective justice would require that, where the state appropriates property that enhances public good, the

---

[64]Sax (1964), *supra* note 14 at 57 and 64.

[65]As discussed by Radin, *Reinterpreting Property*, *supra* note 48 at 241.

[66]C.M. Rose, "'"Takings" and the Practices of Property: Property as Wealth, Property as "Propriety" in C. Rose, *Property & Persuasion: Essays on the History, Theory and Rhetoric of Ownership* (Boulder: Westview Press, Inc., 1994).

[67]See *supra* note 17 for details of the case.

[68]See generally, "Corrective Justice" in E.J. Weinrib, *The Idea of Private Law* (Cambridge: Harvard, 1995).

[69]Aristotle, Nicomachean Ethics in R. McKeon, ed., *The Basic Works of Aristotle* (New York: Random house, 1941) Book V, Ch. 1.

citizen is compensated for the loss in order that the gain the state has acquired is restored.[70] In cases of deprivation of property where there is no corresponding acquisition by the state, a requirement for compensation would depend, as in the case of a private individual destroying property, on whether there is a lawful justification for the action.

1.3 Utilitarian and Economic Analysis of Compensation

1.3.1 Michelman's Framework of Demoralization and Settlement Costs

Extensive utilitarian and economic analysis of US takings law began with Michelman's analysis in "Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law",[71] in which he develops a framework for justifying when it is appropriate for the government to pursue public goals while leaving the associated costs disproportionately concentrated upon one or a few property owners.[72] To answer this question, Michelman adopts a utilitarian theory of property where property rights are instrumental and subordinate to the goal of maximizing social welfare.[73] Property rights are useful because they provide secure expectations about the future enjoyment of a person's productive efforts. Under utilitarian ethics, a government project that has positive net benefits is desirable even if it has severe distributive impacts on a property owner. The decision to pay compensation depends on the settlement costs required to pay compensation compared to the demoralization costs of not paying compensation. Demoralization costs include the total of: (1) the property owner's and their sympathizers' feelings of unfairness at the property owner bearing the disproportionate burden of an uncompensated loss; (2) the losses in productivity resulting from the government project; and (3) societal disincentives to engage in productive activity because of the fear of future losses. Demoralization is a "special kind of suffering on the part of people who have grounds for feeling themselves the victims of unprincipled exploitation".[74] Settlement costs are the value of the amount of time, effort and resources required to reach settlements adequate to

[70]Taxes would be a general exception from this framework.

[71]*Supra* note 23.

[72]*Supra* note 23 at 1165.

[73]*Supra* note 23 at 1213. Michelman refers to "efficiency" or "an efficient process", "which maximizes the total amount of welfare, of personal satisfaction, in society, and not all satisfaction is material." *Supra* note 23 at 1173. Also see below at section 1.3.3(c).

avoid demoralization costs. Michelman proposes that the proper utilitarian standard for compensation is to require compensation whenever demoralization costs exceed settlement costs.[75] Michelman argues that the utilitarian standard is also consistent with Rawlsian principles of fairness. The goal of compensation policy is to maintain an assurance that the costs and benefits of collective decisions will balance out over time and to forestall the evils associated with unfair and discriminatory treatment.[76]

Michelman argues that the utilitarian framework for comparing demoralization and settlement costs assists in explaining the judicial and administrative expediency of doctrinal takings rules. The framework suggests that the categorical requirement for compensation for physical invasion identifies clearly compensable cases. In cases of physical invasions, settlement costs will be low because the extent and nature of the taking can be easily determined, there is no need to trace the remote consequences of the government's act and the number of affected parties is typically low.[77] Michelman argues that the physical invasion test is a rather blunt instrument and draws an arbitrary line. It provides a simple way to identify compensable takings but requires compensation where losses may be quite insignificant. But the rule can be justified as there is a clear disproportionate burden on the property owner and "[p]hysical possession doubtless is the most cherished prerogative, and the most dramatic index, of ownership of tangible things."[78]

The diminution of value test focuses on whether or not the government measure in question practically deprives the claimant of some distinctly perceived, sharply crystallized investment-backed expectation. Where an investment-backed expectation is destroyed, demoralization costs will generally be high. For example, a ban on existing uses, as opposed to potential uses, would

---

[74]*Supra* note 23 at 1230.

[75]*Supra* note 23 at 1215.

[76]*Supra* note 23 at 1214-1225.

[77]Fischel notes that the physical invasion rule can be defended because in most cases settlement costs are low compared to settlement costs of a regulation of similar magnitude. However, there are older US cases that provide an exception to the physical invasion rule. For example, Fischel notes that government can destroy property in order to stop the spread of an urban fire (the conflagration rule) or to prevent property from falling into enemy hands. Fischel justifies these exceptions on the basis that it is not economically efficient to compensate when the destruction is inevitable and it is unlikely government that will "over-regulate" in this area if there is no compensation. In addition, in both cases, the property can be viewed as potentially harmful. See Fischel, *Regulatory Takings*, *supra* note 30 at 357-9.

[78]*Supra* note 23 at 1228.

defeat a distinctly crystallized expectation, while a ban on a potential use destroys market value.[79] Michelman maintains that the diminution in value test suffers from a number of flaws. It requires that we think of property as several discrete things or bundles of rights, rather than a total amount of wealth, that we find that the deprivation of one mentally circumscribed thing from the total bundle is especially demoralizing, and that we believe a compensation tribunal can make this determination.[80] With respect to the harm/benefit test, Michelman adopts a Coasian analysis of harm and argues that the harm-prevention/benefit-extraction test is illusory as long as a government measure is justified on the basis of efficiency. He argues that anti-nuisance measures can be justified by considerations of corrective justice but that public benefit measures can only be justified with reference to efficiency.[81] This distinction is problematic given Michelman's analysis of the difficulty of distinguishing between public benefits and the abatement of nuisances. According to Michelman, a prohibition on erecting billboards on the side of a highway could be classified either as preventing a harm (a nuisance) or providing a public benefit (safetey). In cases where a government measure can be reasonably categorized as either an anti-nuisance measure or as a public benefit measure, on Michleman's own terms the measure can be justified either under principles of corrective justice or efficiency.

Michelman acknowledges the difficulty of making fairness (based on utilitarian or Rawlsian principles) a simple, easily stated formula, but maintains that a workable, impersonal judicial rule is required to approximate in a useful number of cases the result fairness would dictate.[82] He suggests that an approach consistent with his framework would provide that:

> compensation is due only where there has been either (a) a physical occupation or (b) a nearly total destruction of some previously crystallized value which did not originate under clearly speculative or hazardous conditions.[83]

1.3.2 Economic Analysis of Legal Transitions

All changes in government policy impose gains and losses on investments made before the government action.[84] Investments include not only monetary commitments but any action

---

[79] *Supra* note 23 at 1233.
[80] *Supra* note 23 at 1234.
[81] *Supra* note 23 at 1199 and 1236.
[82] *Supra* note 23 at 1250.
[83] *Supra* note 23 at 1250.

undertaken with settled expectations and long-term consequences. There can be both human and capital investments, such as forming an attachment to a particular community, education, starting a business, research and development or building a factory.[85] Expropriation is only one potentially severe example, among many situations, where a change in government policy imposes gains and losses on investments. In order to evaluate whether compensation should be paid in the case of expropriation, it is useful to examine changes and transitions more broadly to examine why, when and how the impacts of policy changes on investments should be compensated or mitigated.[86]

In "An Economic Analysis of Legal Transitions",[87] Kaplow argues that the "central feature of any transition situation is the existence of uncertainty concerning future government policy prior to the government action".[88] Transition concerns are ubiquitous.[89] Legal changes affecting investments could include utility rate regulation, deregulation, local land use planning, product bans and liability laws, changes to tariffs and customs, tax changes, government regulation of industry, changes to corporate and bankruptcy laws and changes to the common law. The market response to new competition is to shift economic values; the market accommodates changes in tastes and technologies with shifts in the value of resources. As there is typically no proprietary claim to market share, shifts in market value are a pecuniary externality to an investor.[90] Kaplow argues that since uncertainty governing government policy is equivalent, in economic terms, to general market uncertainty, market mechanisms, principally insurance and diversification, should be used to allocate the risk of uncertain government action.[91] Therefore, an analysis of legal transitions should begin with the effects of transition policy on risk and incentives, rather than on an investor's reliance and expectations. Kaplow argues that the common argument for compensation, the reliance and investment-backed expectations of

---

[84]See L. Kaplow, "An Economic Analysis of Legal Transitions", *infra* note 87.

[85]*Ibid.*

[86]J. Quinn & M.J. Trebilcock in "Compensation, Transition Costs, and Regulatory Changes" (1982) 32 U.T.L.J. 117 for analysis of the role compensation plays in transitions.

[87]See L. Kaplow, "An Economic Analysis of Legal Transitions" (1986) 99 Harv. L. Rev. 511.

[88]*Supra* note 84 at 512.

[89]See Kaplow, *supra* note 87 at 517 and J.L. Knetsch, *Property Rights and Compensation* (Toronto: Butterworths, 1983).

[90]Knetsch, *ibid.*at 104-107.

[91]Kaplow, *supra* note 87 at 520.

investors, is circular because of the implicit assumption that it is reasonable to expect laws never to change. Kaplow argues that expectations and reliance are a matter of degree; the probability of the imposition of the risk affects the appropriate transition policy. Second, even if there are investment-backed expectations, whether the investor has a normatively compelling claim to the fulfillment of the expectation is open to question.[92] The majority and minority decisions in *Lucas* can be interpreted as a difference in opinion in whether Lucas had a normatively compelling claim to the fulfillment of his development plans where the development may have contributed to environmental damage. The reasonableness of investment-backed expectations and the possibility of regulatory transitions is discussed at the end of this section.

Kaplow argues that government does not generally mitigate market risks because market mechanisms are efficient risk allocators. Kaplow favours market mechanisms for risk allocation because it is socially desirable for investors to account for the prospect of government reform in their decision making, compensation insulates investors from the downside risk of investments and compensation creates moral hazards because investors may over-invest in investments for which compensation is available. Therefore, as a matter of economic efficiency, compensation for expropriation is unwise. Compensation achieves full risk spreading but encourages over-investment, while a non-compensation policy preserves appropriate investment incentives but provides no protection against risk.[93]

While Kaplow generally favours insurance and diversification of risk through market mechanisms, he acknowledges that the risk of expropriation involves unique circumstances. Since there is a low probability of expropriation, the administrative costs of arranging private insurance may impede the establishment of an efficient insurance market for expropriation. If there is no insurance, a non-compensation policy will ensure appropriate and efficient incentives but may not allow risk spreading. On the other hand, compensation spreads risks but eliminates incentives to invest efficiently. Kaplow suggest that a form of compulsory insurance paid through property taxes could be devised under which the “insurance premium” would be tailored

[92]Kaplow, *supra* note 87 at 524.
[93]*Supra* note 87 at 593 -594.

to additional investments in the land and the probability of expropriation.[94] Compulsory insurance may be required because of adverse selection problems. Adverse selection may occur where the probability of loss differs significantly among individuals who are aware of the differences and insurance companies are unable to detect those differences at sufficiently low cost.

1.3.3 Economic Analysis of Compensation - How Do Property Owners React to Incentives and Risks

There is a voluminous economic literature on compensation for expropriation.[95] From an economic perspective, the role of compensation policy is to ensure efficient allocation of resources. Much of the economic analysis of expropriation, such as Kaplow's, has focused on the incentive effects of compensation. Efficient allocation requires that property owners have the proper incentives to make efficient property use decisions and government has the proper incentives to make efficient regulatory decisions. The difficulty is that these two objectives may conflict.[96] If compensation is always paid, property owners may over-invest in risky ventures with the knowledge that, if government policy changes, they will be insured through government compensation.[97] However, not paying compensation creates a threat of over-regulation because governments may not consider the social cost of government action if it does not have to compensate property owners.[98]

---

[94] See Kaplow, *supra* note 87 at 543-545.

[95]See, for example, M.B. Johnson, "Planning with Prices: A Discussion of Land Use Regulation Without Compensation" in B. Siegan, ed., *Planning Without Prices* (Lexington: Lexington Books, 1977), J.L. Knetsch, *Property Rights and Compensation*, *supra* note 89, L. Blume & D. Rubinfeld, "Compensation for Taking: An Economic Analysis" (1984) 72 Cal. L. Rev. 569, L. Blume, D. Rubinfeld & P. Shapiro, "The Taking of Land: When Should Compensation Be Paid?" (1984) 99 Q. J. Econ. 71, W.A. Fischel & P. Shapiro, "A Constitutional Choice Model of Compensation for Takings" (1989) 9 Int'l Rev. L. & Econ. 115, V. Been, "'Exit' as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine" (1991) 91 Col. L. Rev. 473, N. Mercuro, ed., *Taking Property and Just Compensation: Law and Economics Perspectives of the Taking Issue* (Boston: Kluwer Academic Publishers, 1992), B. Hermalin, "An Economic Analysis of Takings" (1995) 11 J.L. Econ. & Org. 64, W.A. Fischel, *Regulatory Takings*, *supra* note 30, B. Yandle, ed., *Land Rights: The 1990's Property Rights Rebellion* (Lanham: Rowman & Littlefield Publishers, Inc., 1995), T. Miceli & K. Segerson, *Compensation for Regulatory Takings: An Economic Analysis with Applications* (Greenwich: JAI Press, 1996), D. Cohen and B. Radnoff, "Regulation, Takings, Compensation, and the Environment: An Economic Perspective" in C. Tollefson, ed., *The Wealth of Forests: Markets, Regulation, and Sustainable Forestry* (Vancouver: UBC Press, 1998).

[96]T.M. Miceli & K. Segerson, "Compensation for Regulatory Takings" in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 1 (New York: Stockton Press, 1998) at 360 - 363.

[97]See Kaplow, *supra* note 87, Blume, Rubinfeld & Shapiro, *supra* note 95 and Miceli & Segerson (1996), *supra* note 95.

[98]See Johnson, *supra* note 95, Epstein, *supra* note 95 and Yandle, *supra* note 95.

If a government plans to build a dam that will flood adjacent land, it can either pay for the land with tax dollars or it can expropriate the land without compensation. From this perspective, compensation for expropriation can be viewed as a question of who should be taxed to pay for the land - taxpayers or the landowner. The same decision applies to government acquisition of labour, goods and capital - government could either pay for what it acquires through general taxation revenue or it could seize without compensation. Optimal taxation theory suggests that taxes should be imposed on goods for which the supply is inelastic, in other words, taxes that do not change a person's behaviour through tax avoidance.[99] There are sound economic reasons why a state pays for the goods and services it acquires. If it did not pay, goods and services would not be forthcoming (they would exit the jurisdiction) and productive investment would be discouraged.[100] Also, since goods and services are mobile, unlike sunk investments in real property, goods and services can normally be removed without cost from the property to be expropriated.[101] The mobility of goods and services induces governments to pay compensation. Mobility and the costs of exiting a jurisdiction are considered below and are also examined in Chapter Three with respect to foreign investment.

(a) Moral Hazard

Economic analyses of compensation often point to the effect of moral hazard on settlement costs. Compensation may induce investors to change their behaviour in order to obtain compensation, resulting in inefficient behavior because of excessive development and increased settlement costs.[102] For example, investors may subdivide or enhance their properties in order to increase expropriation awards.[103] However, in cases of social regulation, moral hazard may also support the argument *for* compensation. Dana argues that the absence of a compensation requirement encourages property owners to accelerate development in order to avoid regulatory losses from

---

[99]W.A. Fischel, "Eminent Domain and Just Compensation" in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 2 (New York: Stockton Press, 1998) at 34 and R. Posner, *Economic Analysis of Law*, 5th ed. (New York: Aspen Law & Business, 1998) at 63.

[100]Fischel (1998), *ibid.* at 34 -35.

[101]Blume, Rubinfeld, & Shapiro, *supra* note 95.

[102]Blume, Rubinfeld & Shapiro, *supra* note 95.

[103]Fischel (1998), *supra* note 99 at 39.

further preservation regulation.[104] Therefore, rather than moral hazard resulting from compensation, Dana argues there is a moral hazard problem resulting from not compensating property owners. In the context of natural preservation, the issue is whether the social costs of accelerated development outweigh the costs of a compensation regime.[105] Natural preservation regulation has several well defined characteristics: landowners know that undeveloped land is subject to future development controls; the political process to obtain ecological protection is usually gradual; losses may be large; and regulation is typically non-retroactive (natural preservation legislation does not typically require landowners to restore habitats that have already been destroyed).[106] The race to develop imposes efficiency losses as resources are allocated to early development when they could be used more efficiently elsewhere. Second, society loses the option to preserve land in its natural state.[107] A policy of non-compensation creates incentives for owners of heritage building and apartment buildings to destroy the buildings to avoid restrictive heritage designation for the former and stringent rent controls for the latter. Similarily, Knetsch has argued that if compensation is not offered for the taking of scarcity rents (i.e. archeological ruins and heritage houses), the owner has no incentive (other than personal utility or a sense of duty) to care for property. Without compensation, there is little incentive for the owner to not use the property in a way that is potentially harmful to the public use.[108] Given current planning and regulatory requirements and the need for some type of regulatory approval to proceed with development, it is unlikely that the potential for accelerated development is a significant enough risk to warrant a blanket policy of compensation. The success of development projects often requires some form of governmental co-operation. Strategic behaviour on the part of developers may equally suggest a policy of log-rolling and lobbying for implicit or explicit compensation through other forms of development approval or governmental benefits. While there may be isolated cases of strategic development to avoid restrictive legislation, in cases of urgent public interest governments are apt to act quickly to stop harmful actions.

---

[104]D. Dana, "Natural Preservation and the Race to Develop" (1995) 143 U. Pa. L. Rev. 655 at 656.
[105]*Ibid.* at 656.
[106]*Ibid.* at 685.
[107]*Ibid.* at 692 - 693.
[108]Knetsch, *supra* note 89 at 67.

(b) Fiscal Illusion

Economic analyses of compensation often point to the effect of fiscal illusion if the state does not have to pay for expropriation. Fiscal illusion occurs when government does not have to fully account for the costs that it does not directly bear. Posner provides the following example that illustrates the potential economic inefficiency resulting from fiscal illusion.[109] Assume the government has the choice between two building projects. The government can build a tall narrow building with construction costs of $10 million on a small lot that costs $1 million, for a total cost of $11 million. Or it can build a low wide building with construction costs of $9 million on a larger lot that costs $3 million, for a total cost of $12 million. The cheaper alternative for society is the tall narrow building. But if the government does not have to pay compensation for the larger lot, it will be cheaper for it to build the wider building, even though this is a less efficient use of resources.

According to Kaplow, the fiscal illusion argument relies on the assumption that decision makers exhibit a bias towards discounting costs more than they discount benefits. But since the decision makers do not bear the ultimate costs and benefits of decisions, one cannot assume decision makers will have a bias in discounting either way.[110] As Cohen and Radnoff note, the direction of bias in discounting costs and benefits will depend on the allocation of the costs and benefits and the composition of the affected groups.[111] In addition, Cohen argues that even if fiscal illusion exists, internalizing the cost of regulation will not necessarily result in efficient regulation because of the unique nature of government. For example, Cohen argues that governments are not as subject to capital markets as firms and that government can externalize losses across taxpayers.[112]

A related concern is that self-interested behaviour by government actors may distort efficient compensation policies. As noted above, Kaplow argues that decision makers do not bear the

---

[109]*Supra* note 99 at 64.

[110]Kaplow, *supra* note 87 at 566-570.

[111]Cohen & Radnoff, *supra* note 95 at 318.

[112]D. Cohen, "Regulating the Regulators: The Legal Environment of the State" (1990) 40 U.T.L.J. 213 and Cohen & Radnoff, *supra* note 95 at 318.

direct costs of their decisions and therefore should not exercise a bias in discounting costs and benefits. But public decision makers are likely to exercise a degree of personal or institutional self-interest in decision making. In their analysis of compensation policy, Quinn and Trebilcock note that it is politically rational for politicians to favour explicit forms of compensation where there are high political returns.[113] On the other hand, explicit compensation makes the costs of regulatory change very visible and may be perceived as a sign of government failure. In addition, politicians may therefore prefer policies where losses can be spread widely rather than policies that impose concentrated losses on specific, vocal and politically active groups. In either case, the resulting compensation or transition policies may be designed to maximize political returns, rather than long-term social welfare. Likewise, bureaucracies may favour policies that entrench their authority and status, by favouring programs and regulation that increase departmental budgets and political power, rather than policies of explicit compensation, even if explicit compensation is welfare maximizing. Given the varying circumstances in which regulatory decisions are made, the risk of fiscal illusion does not serve as a compelling rationale to support a policy of compensation for regulatory expropriations.

(c) Efficient Rules for Compensation

Economists have developed a number of models that attempt to balance the trade-off between moral hazard and fiscal illusion. Fischel and Shapiro[114] suggest that a partial compensation rule provides an optimal balance, but they acknowledge that this model produces second-best outcomes. Miceli and Segerson[115] propose a conditional compensation rule. Under the rule, compensation would equal the diminution in value caused by the regulation when the diminution exceeds a certain minimum value. Under an *ex post rule*, the state must pay compensation if the regulation was inefficiently imposed and no compensation is payable if the regulation was efficiently imposed. Under the *ex ante rule*, the state must pay compensation if the landowner made an efficient decision to pursue development and no compensation is payable if the development decision was inefficient. Under the *ex ante rule* a regulation goes too far when it

---

[113]Quinn & Trebilcock, *supra* note 86 at 126-132.
[114]Fischel & Shapiro, *supra* note 95.
[115]Miceli & Segerson, *supra* note 95.

prohibits an efficient land use decision.[116] Miceli and Segerson suggest that if fairness is a concern the *ex ante rule* is preferable because it requires compensation where the landowner makes an efficient decision. If transaction costs are a concern, for example in zoning regulation, the *ex post rule* is preferable because it does not require compensation where the state makes an efficient decision.

While the two rules are theoretically appealing, they assume that an efficient decision can be distinguished from an inefficient decision. The rules do not provide guidance on identifying whether a landowner's or a regulator's decision is efficient. Quinn and Trebilcock argue that unless there is unanimous approval of a decision there is no assurance that it is efficient. Efficiency, in the sense of Pareto optimality, "holds that any social change is desirable which results in everyone being better off, or someone being better off and no one being worse off, than before the change."[117] Kaldor-Hicks optimality modifies Pareto optimality by providing that the winners can, in theory, compensate the losers. Michelman states that "a proposed change is efficient if, after negotiated compensations have been promised by those who stand to gain from the proposal to those who stand to lose by it, the proposal can win unanimous approval."[118] But since individual welfare positions are assumed to be incommensurate, any form of non-negotiated compensation payment as a measure of the loss from a regulatory measure could be quite misleading.[119]

Knetsch argues that efficiency seems to be best served by compensation rules that discriminate between cases of intervention that reflect changing demand and supply conditions (pecuniary externalities) and those involving expropriations of particular properties for public purposes.[120] But this begs the question of what is an expropriation and on what basis it can be assumed that a collectively imposed decision is simply a reflection of pecuniary externalities. The fact that a

---

[116]*Supra* note 96 at 362.
[117]Quinn & Trebilcock, *supra* note 86 at 133.
[118]*Supra* note 23 at 1173-74.
[119]*Supra* note 95 at 134.
[120]*Supra* note 89 at 111.

government measure is taken is no assurance that it is harm-preventing or welfare-maximizing.[121]

Recent economic analyses by Ghosh[122] and Dana[123] question whether non-compensation is always the optimal policy for expropriation. Ghosh argues in "Takings, the Exit Option and Just Compensation" that economists have traditionally agreed that compensation for expropriation leads to inefficiency, assuming that "capital and insurance markets are perfect, governments do not suffer from fiscal illusion, and the takings decision is based on social welfare maximization and not the result of rent seeking."[124] Clearly these conditions will not usually be present. Ghosh argues that traditional economic approaches have assumed demoralization costs are equal to zero because the costs are too difficult to quantify. Since demoralization costs may result from majoritarian excess over minority interests, majority excess can be avoided if the property owner can exit the jurisdiction. Ghosh argues that demoralization costs should be equated with the cost of exercising the option to exit the jurisdiction. Exit strategies are a form of cost avoidance but traditional economic models assume exit costs are low. As Ghosh notes, "when landowners can migrate to a jurisdiction that also finances public projects through eminent domain, the existence of state competition also serves as a way to mitigate an excessive use of the takings power."[125] Since investors can move to other jurisdictions with more favourable regulatory frameworks, Ghosh concludes that the possibility for exit and competition between states alter the traditional conclusion that it is inefficient to provide compensation.

Michelman's utilitarian framework and Ghosh's analysis of the exit option provide sound economic rationales for compensation where the government acts as a participant and enterpriser in acquiring and enhancing public goods. Subject to exceptions such as taxation, there is a legitimate expectation that the government will not act in its enterprise role without paying compensation. Since most governments compensate for acquisitions of property, the value of

---

[121]Quinn & Trebilcock, *supra* note 86 at 143-144.
[122]S. Ghosh, "Takings, the Exit Option and Just Compensation" (1997) Int'l Rev. L. & Econ. 157.
[123]*Supra* note 104 and discussion of moral hazard in Section 1.3.3(a).
[124]*Supra* note 122 at 157.
[125]S*upra* note 124 at 171.

property rights is not typically discounted to reflect the risk of this form of expropriation.[126] Compensation in such cases also disciplines the most egregious forms of fiscal illusion and is consistent with principles of corrective justice. But there are less compelling reasons for compensation where a state changes its social regulation, for example from a regime of lower environmental protection to more stringent protection. In cases of social regulation where property rights are diminished or destroyed and there is no corresponding acquisition of property by the state, determining whether reliance on the regulatory status quo was justified and is normatively compelling requires a detailed ad hoc assessment of the facts. A non-compensation norm for regulatory expropriation maintains optimal incentives because in circumstances of social change it encourages "adaptive behaviour by rewarding individuals who most adroitly adjust in the face of change".[127] Assuming other utilitarian considerations are equal, however, hard reliance cases where there is a complete deprivation of property rights should probably be compensated.[128] This is consistent with Michelman's framework where compensation is due for a nearly total destruction of some previously crystallized value which did not originate under clearly speculative or hazardous conditions.

1.4 Political Institutions and Transitions in Property Rights Regimes

In *Armstrong* v. *United States* Justice Hugo Black stated that "[t]he Fifth Amendment's guarantee ...[is] designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole".[129] The issue of regulatory expropriation essentially involves balancing public and private rights as these rights evolve over time. The role of compensation for expropriation is to balance the transitional compromise. As a result of a regulatory transition, property owners may feel particularly burdened because they are singled out, the property loss is substantial and they have reasonable investment-backed expectations. But these claims must be balanced with the need to protect

[126]See *ibid*. at 153-159 for a discussion of rational expectations and assumption of risk.
[127]Sax (1993), *supra* note 22 at 1449.
[128]Quinn & Trebilcock, *supra* note 86 at 158.
[129]364 U.S. 40 (1960) at 49.

public rights and to allow public and private rights to evolve over time to maximize social welfare.[130]

The decision to compensate may enhance the political feasibility of enacting social regulation and other government measures that involve transitions in property rights regimes. It is likely that property owners will lobby against government measures that negatively interfere with property. As Dana argues, compensation may disarm resistance to regulatory change.[131] Merrill argues that compensation may improve environmental protection by removing or placating opposition to environmental legislation.[132] Compensation may be also be efficient because it ensures that resources are not wasted on lobbying for compensation in the political process. On the other hand, because of political and budgetary constraints, a requirement to pay compensation may deter socially efficient regulation and result in less optimal forms of regulation.[133]

The nature of government institutions is a crucial element in analyzing compensation issues. In *Regulatory Takings*,[134] Fischel argues that the majoritarian model of government applies best to local government, while the pluralistic model applies more generally to national government because higher levels of government are more subject to the log-rolling of pluralistic politics. Majoritarianism at the local level creates a need for compensation because of the increased probability that the majority will impose excessive burdens on a minority. This contrasts with general government regulation at the national level involving a larger number of people and inherently higher settlement costs.[135] Rose makes a similar point by arguing that the courts should not assume that all governments are identical in takings questions. In the case of legislative takings by the US government, citizens are afforded protection by virtue of the fact

---

[130]See C.M. Rose, "A Dozen Propositions on Private Property, Public Rights, and the New Takings Legislation" (1996) 53 Wash. & Lee L. Rev. 265 at 267 where Rose discusses state statutes requiring compensation for state takings. Takings legislation often requires compensation where a state measure diminishes the property values below a certain threshold. See M.W. Cordes, "Leapfrogging the Constitution: The Rise of State Takings Legislation" (1997) 24 Eco. L. Q. 187.

[131]*Supra* note 104.

[132]T.W. Merrill, "Compensation and the Interconnectedness of Property" (1998) 25 Ecol. L. Q. 327 at 342.

[133]See Cohen & Radnoff, *supra* note 95 at 320.

[134]See *supra* note 30.

[135]*Supra* note 30 at 204-207 and at Chapter 9.

that the legislature is large and diverse.[136] Fischel argues that political protections do not work well against government expropriations when economic exit from the jurisdiction is difficult (as is the case with many foreign investment projects) and where political voice is weak. These considerations are particularly applicable to foreign investors and will be discussed in the following chapters.

1.5 Conclusion

In this Chapter I have examined rationales for why governments should and should not compensate property owners when government measures interfere with property rights. The purpose of this chapter was to outline some of the important issues that compensation policy for regulatory expropriation must address: conceptions of property rights, politics and justice; the role of risks, incentives and rational expectations; public rights, regulatory transitions and the role of the political process. The diverse and opposing rationales for compensation for claims of regulatory expropriation illuminate one central point - it is unlikely there is an optimal policy governing whether to compensate claims of regulatory expropriation in all contexts and with respect to all forms of property. A significant difficulty with formulating a general compensation policy for regulatory expropriation is the diverse range of property interests (real property, personal property, intellectual property, contractual interests and state permits, licences, contracts and concessions) that are potentially affected by compensation rules. The optimal compensation policy for regulatory expropriation in the local land use planning context is likely to differ from the optimal policy for intellectual property, large infrastructure projects and natural resource interests. Deciding on compensation policy for regulatory expropriation depends on how a society justifies property rights and, ultimately, on its fundamental conceptions of political theory. Even if an optimal compensation policy could be developed and agreed upon, it would be necessary to develop legal doctrinal rules to implement the policy in highly fact contingent cases. These are a daunting tasks in a relatively homogeneous domestic legal system. In Chapter Three I argue that the scope of expropriation in international law should be limited to cases of appropriation of property and cancellation of investor-state contracts. But before addressing the role that international law should play in protecting property rights, I examine how the current property rights protections under international law.

---

[136] *Supra* note 46 at 598.

2. REGULATORY EXPROPRIATION IN INTERNATIONAL LAW

Introduction

The principle of respect for property rights forms part of generally accepted international law.[1] International decisions make specific reference to respect for private property as a principle of international law.[2] International law supports the principle of respect for private property in a number of areas other than expropriation: state recognition of pre-existing private property claims in territory that no state has previously claimed (*terra nullius*); the principle that acquired rights survive state succession and must be respected by the successor state; and, in cases of military occupation, the principle that immovable private property must be respected.[3] Under international law, a state must pay compensation to foreign nationals for expropriations of property. But there remains significant uncertainty in all three branches of international

[1]F.V. García-Amador, "Fourth Report of the Special Rapporteur - Responsibility of the State for Injuries Caused in its Territory to the Persons or Property of Aliens - Measures Affecting Acquired Rights" (1959) 2 Y.B. Int'l Law Comm. 1 at 4. Also see F.V. García-Amador *et al., Recent Codification of the Law of State Responsibility for Injuries to Aliens* (New York: Oceana Publications, Inc., 1974).

[2]See Section 2.1.2, below.

expropriation law: the range of economic interests protected by international law, what government measures amount to expropriation and what level of compensation is payable upon expropriation.[4] Recent bilateral investment treaties ("BITs") and the investment provisions in plurilateral agreements such as the North American Free Trade Agreement ("NAFTA") and the Energy Charter Treaty[5] clarify the first and third issues by defining "investment" broadly and through detailed provisions on the payment of compensation.[6] This chapter focuses on the crucial and controversial issue of what amounts to an expropriation - crucial because it determines whether a state is responsible under international law for expropriation and controversial because of its implications for national sovereignty and, as will be explored in Chapters Four and Five, its effects on government policy and the choice of regulatory instruments to implement policy.

Throughout this chapter I make the uncontroversial claim, widely supported by international authorities, that international law has failed to develop clear rules to determine what government measures amount to expropriation. Customary international law on this issue is unclear and BITs and other international instruments typically rely on international law to determine what amounts to an expropriation. The chapter begins with a brief overview of the development of the customary international law on expropriation and outlines the applicable general legal principles including public purpose, discrimination and the *lex situs* rule. I then review the sources of international expropriation law and examine the resolutions and declarations of the UN, decisions of the International Court of Justice ("ICJ") and international tribunals, state practice in BITs and other international agreements, foreign investment insurance mechanisms and commentary by international lawyers. I then examine police power (regulatory) justifications for

---

[3]See L.B. Ederington, "Property as a Natural Institution: The Separation of Property from Sovereignty in International Law" (1997) 13 Am U. Int'l L. Rev. 262 for a recent discussion of these three principles.

[4]R. Dolzer, "Indirect Expropriation of Alien Property" (1988) 1 ISCID Rev. 41 at 41.

[5]The treaty covers trade liberalization and investment promotion and protection in the energy sector and is reprinted at (1995) 34 I.L.M. 360.

[6]See Article 1139, NAFTA on the definition of investment and Article 1110 on compensation. For a survey of the provisions in modern BITs see Dolzer and Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995). For specific provisions in individual BITS see the compilation of existing BITS in ICSID, *Investment Protection Treaties*, looseleaf, (Washington: International Centre for Settlement of Investment Disputes 1983).

interference with property rights, including the scope of the police power and the limitations that international law imposes on the exercise of regulatory authority.[7]

2.1 International Expropriation Law

2.1.1 Background

Prior to the development of modern public international law political communities routinely denied legal capacity and rights to aliens. Often the alien's legal status existed at the pleasure of the sovereign. As concepts of natural law became more influential in the 16th and 17th centuries, international law developed more detailed standards for the legal treatment of aliens and acquired rights. The expansion of trade and investment in the 19th century led to increased attention on the status of foreign nationals abroad. From 1840-1940 over sixty arbitral commissions were established by various sets of states to deal with disputes arising from injuries to foreign nationals.[8] Political and economic ties led to commercial treaties which included national treatment provisions for foreign nationals.[9] International law also developed a requirement for states to respect certain fundamental norms, especially with respect to standards of humane treatment, the protection of life and liberty and standards for judicial proceedings. For persons, international minimum standards were embodied in the concept of denial of justice[10] and, in the mid 20th century, were codified in international human rights.

The development of an international minimum standard for the treatment of the property of foreigners has been contentious throughout the twentieth century. In the early 20th century, many European and Latin American jurists argued that foreign nationals are only entitled to equality of treatment under local law (national treatment). The US was an early proponent of an international minimum standard for the treatment of the property of foreigners and opposed the

---

[7]This chapter does not canvass the international law on the taking of enemy property during war or other hostilities or state responsibility for breaches of contract.

[8]I. Brownlie, *Principles of Public International Law*, 5th ed. (Oxford: Clarendon Press, 1998) at 524.

[9]R. Arnold, "Aliens", in R. Bernhardt, ed., *Encyclopedia of Public International Law*, Volume 1 (1992) at 102.

[10]See R.B. Lillich, ed., *International Law of State Responsibility for Injuries to Aliens* (Charlottesville: University Press of Virginia, 1983), C.F. Amerasinghe, *State Responsibility for Injuries to Aliens* (Oxford: Clarendon Press, 1967), A. Freeman, *The International Responsibility of States for Denial of Justice* (New York: Kraus Reprint Co. 1970), G. Fitzmaurice, "The Meaning of the Term "Denial of Justice"" (1932) 13 B.Y.I.L. 93 and S. Verosta, "Denial of Justice", R. Bernhardt ed., *Encyclopedia of Public International Law*, (1992) Volume I at 1007.

Calvo Doctrine supported primarily by Latin American countries.[11] The Calvo Doctrine, named after the Argentinean jurist and diplomat Carlos Calvo, provides that aliens are only entitled to national treatment and, therefore, does not recognize an international minimum standard of treatment for alien property. It also denies the right of foreign nationals to seek diplomatic protection from their national state by requiring that the foreign national submit to the jurisdiction of domestic courts.[12] The US insisted on the Hull Rule, named after US Secretary of State Hull, who, in response to the expropriation of American-held oil interests by Mexico in the 1930's, argued that "prompt, adequate and effective compensation" was required under international law.

In the post-war era, the issue of treatment of foreign investment, control over natural resources and sovereignty was the subject of much controversy at the United Nations and in international law.[13] Developing countries and some Western countries[14] exercised their sovereignty by nationalizing foreign-owned industries, through land reform and by pursuing policies of economic nationalism.[15] In 1962 the United Nations General Assembly passed Resolution 1803 "General Assembly Resolution on Permanent Sovereignty Over Natural Resources"[16] ("Resolution 1803"). The Resolution declares in paragraph 4 that:

> Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall

---

[11]D. Shea, *The Calvo Clause* (1955).

[12]This was often achieved by having the foreign national accept a Calvo Clause in contracts and other documents. See *ibid.*

[13]See N. Schrijver, *Sovereignty Over Natural Resources* (Cambridge: Cambridge University Press, 1997) and I. Brownlie, "Legal Status of Natural Resources In International Law (Some Aspects)" (1979) 162 Rec. des Cours 245.

[14]The UK in the 1970's and Canada in the 1980's enacted legislation to acquire more national control of their respective oil industries. For a discussion of the legislation in the UK see R. Higgins, "The Taking of Property by the State: Recent Developments in International Law" (1982) 176 Rec. Des Cours 259 at 349 - 354. For Canada, see E.P. Mendes, "The Canadian National Energy Program: An Example of Assertion of Economic Sovereignty or Creeping Expropriation in International Law" (1981) 14 Vand. J. Transnat'l L. 475 and C.J. Olmstead, E.J. Krauland & D.F. Orentlicher, "Expropriation in the Energy Industry: Canada's Crown Share Provision as a Violation of International Law" (1984) 29 McGill L.J. 439.

[15]See I. Foighel, *Nationalization: A Study in the Protection of Alien Property in International Law* (London: Stevens & Sons Limited, 1957), G. White, *Nationalisation of Foreign Property* (London: Stevens & Sons Limited, 1961), M. Sornarajah, *The Pursuit of Nationalized Property* (Dordrecht: Martinus Nijhoff Publishers, 1986) and R.B. Lillich, ed., *The Valuation of Nationalized Property in International Law* (Charlottesville: University Press of Virginia, 1972).

[16]GA Res 1803, UN GAOR, 17th Sess., Supp. No. 17, U.N. Doc. A/5344 (1962), (1963) 2 I.L.M. 223.

> be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law.

Significant disagreement on international expropriation law continued in the United Nations in the 1970's at the same time as developing countries advocated a fundamental restructuring of the international economic system. These aspirations are reflected in the "General Assembly Resolution on Permanent Sovereignty over Natural Resources",[17] the "Declaration on the Establishment of a New International Economic Order"[18] and the "Charter of Economic Rights and Duties of States"[19] (the "Charter"). The Charter provides that compensation for expropriation is to be determined based on state law and omits any reference to international law or a minimum international standard in determining compensation. International arbitral decisions and by many authorities on international law suggest that paragraph 4 of Resolution 1803 represents customary international law and argue that later UN instruments do not reflect customary international law.[20] But there continues to be substantial controversy regarding the customary international law standard for calculating compensation and much of the recent literature on international expropriation law focuses on this topic.[21] Nevertheless, it is well-accepted in international law that states must compensate foreign nationals for the most blatant forms of nationalization, expropriation, confiscation, physical takeover or seizure of property. The continued disagreement over the proper standard for measuring compensation serves to

---

[17]GA Res 3171, UN GAOR, 28th Sess., Supp. No. 30, U.N. Doc. A/9559 (1974), (1974) 13 I.L.M. 238.

[18]GA Res 3201, UN GAOR, 29th Sess., Supp. No. 1, U.N. Doc. A/9559 (1974), (1974) 13 I.L.M. 715.

[19]GA Res 3281, UN GAOR, 29th Sess., Supp. No. 1, U.N. Doc. A/9631 (1974), (1975) 14 I.L.M. 251.

[20]*Texaco Overseas Petroleum Company/California Asiatic Oil Company* v. *Libyan Arab Republic* (TOPCO) (1978) 17 I.L.M. 1 (nationalization of an oil concession where Dupuy, sole arbitrator, reviewed the voting patterns of the various resolutions and concluded that the great majority of states representing all geographical areas and economic systems assented to Resolution 1803). See also Burns H. Weston, ""Constructive Takings" under International Law: A Modest Foray into the Problem of "Creeping Expropriation"" (1975)16 Va. J. Int'l L. 103, R. Higgins, "The Taking of Property by the State: Recent Developments in International Law" (1982) 176 Rec. Des Cours 259, R. Dolzer, "Expropriation", in Bernhardt, ed., *Encyclopedia of Public International Law*, Volume 8 (1985), 214, R. Dolzer, "Indirect Expropriation of Alien Property" (1986) 1 ICSID Rev. 41, S. Asante, "International Law and Foreign Investment: A Reappraisal" (1988) 37 I.C.L.Q. 588 and M. Sornarajah, *The International Law of Foreign Investment* (Cambridge: Cambridge University Press, 1994).

[21]O. Schachter, "Compensation for Expropriation" (1984) 78 A.J.I.L. 121, E. Lauterpacht, "Issues of Compensation and Nationality in the Taking of Energy Investments" (1990) J. Energy & Nat. Resources L. 241, P.M. Norton, "A Law of the Future or a Law of the Past: Modern Tribunals and the International Law of Expropriation" (1991) A.J.I.L. 474, C.F. Amerasinghe, "Issues of Compensation for the Taking of Alien Property in the Light of Recent Cases and Practice" (1992) 41 I.C.L.Q. 22, J.A. Westberg, "Applicable Law, Expropriatory Takings and Compensation in Cases of Expropriation: ICSID and Iran-United States Claims Tribunal Case Law Compared" (1993) 8 ICSID Rev. 1 and M. Sornarajah, *supra* note 20.

highlight and affirm the principle that states must pay compensation if they expropriate property and that clearer legal principles are required to determine what government measures amount to expropriation.

Customary international law has traditionally required that states only expropriate for a public purpose. This requirement is reflected in modern BITs and in Article 1110 of NAFTA. There is some disagreement about whether customary international law requires that expropriations be for a public purpose. The public purpose of an expropriation is usually not challenged and there is little authority for questioning a state's determination of public purpose as state acts are generally presumed to be for a public purpose. The public purpose requirement has been raised in cases where it is claimed property has been confiscated for the personal use of government officials. It has also been raised where it is claimed that an expropriation is retaliatory or an unlawful reprisal, as was suggested with respect to the Libyan nationalization of the oil industry. Authorities suggest that a legislature's judgment of the public interest will be respected unless manifestly without reasonable foundation.[22]

Expropriation and nationalization measures taken solely on the basis that the foreign national belongs to a specific racial, religious, cultural, ethnic or national group are unlawful.[23] A state may not expropriate in a discriminatory manner. Discrimination implies unreasonable distinction, for example an expropriation that invidiously singles out the property of a single nationality or ethnic group. Where one national or ethnic group owns all of a particular industry, bona fide nationalization of that industry for a public purposes is not discriminatory.[24] In addition to discriminatory expropriations, there are other forms of expropriation that are prohibited by international law: seizures that are part of crimes against humanity; expropriations contrary to specific treaty obligations or that are unlawful reprisals; and expropriations of diplomatic missions.[25]

---

[22]See §712, American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (Washington, American Law Institute Publishers: 1987) [hereinafter the Third Restatement] at 210 for a discussion of public purpose and cases.

[23]Weston, *supra* note 20 at 447.

[24]See sources in *supra* note 15.

[25]Brownlie, *supra* note 8 at 541. Also see Sornarajah, *supra* note 20 at 315-321.

Under private international law the existence of property rights, their nature and scope, and who is entitled to exercise them is determined by the *lex situs.*[26] Public international law looks to the *lex situs* and the rules of private international law to determine whether property rights have been acquired. Once the *lex situs* recognizes property as a bundle of intangible rights, an expropriation can occur through interference with the whole bundle of rights or any part.[27] International law recognizes that property comprises tangible property such as land and goods and intangible property such as contract rights and patents.[28]

There is no authoritative codification of international expropriation law. The American Law Institute has codified the international law governing expropriation in §712 of the Third Restatement[29] and this paragraph is often referred to as an authoritative statement of international law. The Third Restatement refers to state responsibility arising for a "taking" of property. Much of the discussion that follows in this chapter focuses on whether the Third Restatement, by focusing on a taking of property (a deprivation of property rights), rather than an appropriation of property by the state, is an accurate statement of customary international law. Since state regulatory action often only prohibits certain uses of property or the exercise of certain rights, it is crucial to determine if state responsibility arises for negative regulatory prohibitions that deprive an owner of property rights. The Third Restatement provides, in part, that:

> 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;
> ....
> (3) other arbitrary or discriminatory acts or omissions by the state that impair property or other economic interests of a national of another state.

---

[26]*Dicey and Morris The Conflict of Laws*, 11th ed. (London: Stevens & Sons, 1987).

[27]See B.A. Wortley, *Expropriation in Public International Law* (Cambridge: Cambridge University Press, 1959) at 4 - 8, Sornarajah, *supra* note 20 at 294 and T. Honore, "Ownership" in A.G. Guest (ed.) *Oxford Essays in Jurisprudence* (London: Oxford University Press, 1961).

[28]Norway v. US, *Norwegian Shipowners' Claims* (1922), 1 U.N.R.I.A.A. 307 at 324-325, 328-334 as discussed in Section 2.1.2. Also see US v. Guatemala, *Schufeldt Claim* (1930) 2 U.N.R.I.A.A. 1101 and J.H. Herz, "Expropriation of Foreign Property" (1941) 35 A.J.I.L 243 at 244 - 246.

[29]See *supra* note 22.

"Taking" is defined in the *Restatement of the Law (Second) The Foreign Relations Law of the United States*[30] ("Second Restatement") as:

> Conduct attributable to a state that is intended to, and does, effectively deprive an alien of substantially all benefit of his interest in property, constitutes a taking of the property...even though the state does not deprive him of his entire legal interest in the property. [31]

But, according to the Third Restatement, a state is not responsible for loss of property or other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture from crime, or other action of the kind that is commonly considered as within the police powers of states.[32] These exceptions are considered below in Section 2.2.

2.1.2 International Expropriation Law: A Review of International Decisions

Article 38 of the *Statute of the International Court of Justice* sets out what are commonly referred to as the sources of international law. Article 38(1)(d) states that decisions of international tribunals are defined as subsidiary means for the determination of rules of law. Tribunal decisions, especially international arbitral decisions, therefore cannot be treated as definitive authority on international law even though they are frequently cited as compelling authority on the existence of customary international law.[33] Article 38 provides:

> 38(1) The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:
> (a) international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
> (b) international custom, as evidence of a general practice accepted as law;
> (c) the general principles of law recognized by civilized nations;
> (d) subject to the provisions of Article 59,[34] judicial decisions and teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

There are very few international decisions dealing with regulatory expropriation. Like many domestic legal systems, international law has not established clear criteria for determining what

---

[30]American Law Institute, *Restatement (Second) of the Foreign Relations Law of the United States* (Washington: American Law Institute Publishers, 1965).

[31]This definition does not appear in the Third Restatement although it is reflected in the Reporters' Notes. The Third Restatement states that the same substantive position on the scope of takings is taken as is the Second Restatement.

[32]Third Restatement §712(g).

[33]See V.D. Degan, *Sources of International Law* (The Hague: Kluwer Law International, 1997) for a discussion of the sources of international law.

constitutes an expropriation of property, short of a transfer of title to the state. While there are categories of cases in which government measures have been found to be expropriatory, there is little direction in the cases or arbitral decisions on the distinction between expropriatory, compensable takings and regulatory, non-compensable takings.[35] The question is complicated by the range of government measures that can potentially affect property rights, such as legislative, executive or judicial actions; inducing others to physically take-over property; forced sales of property at low prices; deprivation of management, control or profits; the cancellation or non-issuance of licenses and permits necessary for business; or exorbitant taxation.[36] As recent claims[37] under Chapter Eleven of NAFTA demonstrate, the issue is not as clear as Friedman suggested in his 1953 treatise, *Expropriation in International Law*:

> Indirect expropriation resulting from the normal functioning of public services would not appear to give rise to any great difficulty from the point of view of international law.[38]

The growth of the welfare state and new forms of social regulation have increased the number of government measures that affect property rights. As a result, claims of regulatory expropriation may arise in many areas not envisioned by Friedman and where older arbitral authorities involving seizures and confiscation do not address whether state responsibiltiy arises. The exisiting international law principles delimiting the scope of expropriatory measures are only slightly clearer than in 1963 when Christie wrote in his seminal article "What Constitutes a Taking of Property under International Law" that:

> Such cases as there are recognize the principle laid down by the commentators, that interference with an alien's property may amount to expropriation even when no explicit attempt is made to affect the legal title to the property, and even though the respondent State may specifically disclaim any such intention.[39]

---

[34]Article 59 provides that decisions of the ICJ have no binding force except between the parties.

[35]Sornarajah, *supra* note 20 at 301 and other authorities cited in note 20.

[36]See Sornarajah, *supra* note 20 at 284 and G.C. Christie, "What Constitutes a Taking Under International Law, (1962) 33 B.Y.I.L 307. A discussion of the potential expropriatory effect of exchange controls is outside the scope of this paper. Exchange controls are a complex area of domestic and international economic law governed by the International Monetary Fund's Articles of Agreement and a special body of international law.

[37]See Chapter Four as to whether the expropriation provisions in NAFTA incorporate a higher standard than that in customary international law..

[38]S. Friedman, *Expropriation in International Law* (London: Stevens & Sons Limited, 1953) at 1.

[39]Christie, *supra* note 36 at 309.

The principle that an expropriation can involve ancillary rights even if there is no intention to expropriate those rights was recognized in *Norwegian Shipowners' Claims*.[40] As a result of World War I, the US, through the United States Shipping Board Emergency Fleet Corporation, requisitioned privately held ships in the US including ships under construction for a number of Norwegian shipowners. The shipowners contended that the US requisition included not only the partly-completed ships but also the contract rights for the ships. These rights were very valuable given the high demand for ships as a result of the war. The US took the position that it had only requisitioned the partly-completed ships. The international tribunal established by the US and Norway to hear the matter held that the contract rights for the ships had been taken and that the shipowners were entitled to the market value of the contracts. The tribunal analyzed the question of expropriation primarily in terms of US constitutional principles and held that the loss of use of the contracts was equivalent to a taking of property under the US Constitution's Fifth Amendment. The Tribunal held that compensation was due to the shipowners under US law and under international law based on the respect for private property. The US agreed to pay the award but stated, at the time, that it did not accept the decision as a precedent. The decision has subsequently been cited by numerous international tribunals to confirm the principle that an intention to expropriate is not necessary for a finding of expropriation and that states are responsible for expropriations that occur indirectly.

The intention and indirect expropriation principles arose four years later before the Permanent Court of International Justice ("PCIJ") in *Case Concerning Certain German Interests in Polish Upper Silesia*[41] involving the seizure of a factory by Poland. Poland had agreed in treaties with Germany not to expropriate certain property of German nationals. The German Government had contracted with a Germany company ("Bayerische") to operate a factory owned by Germany. The factory was later transferred to a German company ("Oberschlesische"). Bayerische had a management agreement with Oberschlesische under which it managed the factory and used its own (Bayerische's) patents and contracts in the operation of the factory. Poland later seized the factory. The case is important because it affirmed that, under international law, property rights must be respected. Second, the PCIJ affirmed that expropriation for reasons of public utility,

[40]Norway v. US (1922), 1 U.N.R.I.A.A. 307.

judicial liquidation and similar measures is lawful. Third, by seizing the factory and machinery, the PCIJ held that Poland also expropriated Bayerische's contractual rights, patents and licenses even though Poland did not purport to expropriate Bayerische's intangible property. The PCIJ held that by expropriating the property of Oberschlesische, Poland had also expropriated the property of Bayerische and that compensation was payable.

The third of the triumvirate of early cases, *The Oscar Chinn Case*[42], was decided by the PCIJ in 1934. In 1929 Oscar Chinn, a British subject, started a river transport, ship-building and repairing business in the Belgian Congo. At the time, Unatra, a Belgian company, whose shares were more than half owned by the Belgian government, provided most of the river transport in the Belgian Congo. Unatra operated under an agreement with Belgium under which Unatra was bound to provide fixed services based on transport rates set by Belgium. Under the agreement, if Unatra ran a deficit, Belgium compensated the company for any losses. In 1930 - 1931 the global recession seriously affected trade in the Congo. In response, Belgium substantially lowered transport rates to reduce the price of colonial produce and agreed to refund the company any losses suffered as a result. The rate reduction was for an initial period of three months, but was prolonged for successive periods because of the acuteness of the depression.

Britain claimed that the effect of the reduction in transport rates forced Chinn to abandon his business and was the establishment of a de facto monopoly. The primary issue before the PCIJ was the interpretation of the Convention of Saint Germain-en-Laye and whether the actions of Belgium violated treaty obligations to maintain commercial and navigational freedom and equality. In the alternative, Britain argued that Belgium violated the vested rights of Chinn by making it commercially impossible for him to carry on business. The majority of the Court, by six votes to five, denied the British claims and, with respect to the vested rights argument, held that Chinn's original position was characterized by the possession of customers and the possibility of making a profit and that he did not have a vested right that was expropriated. The Court reasoned that Belgium did not interfere with the ability of Chinn or any producer to contract for transport services. In his dissenting opinion on other grounds, Sir Cecil Hurst held

---

[41]Germany v. Poland (1926), P.C.I.J. Series A/B, No. 7.

Belgium's support of Unatra made it more profitable for producers to contract elsewhere but did not interfere with any acquired rights or with Chinn's liberty to carry on business.[43] Commentators such as Dolzer and Christie have noted that it is difficult to generalize any principles from the case given its unique facts. Belgium did not intend to drive out Chinn from business, was responding to a serious economic situation for a limited time and the trade occurred on a public waterway. [44] And as the PCIJ made clear, Chinn did not have a vested right to engage in trade without competition, for example, an exclusive concession. A broad reading of the case would suggest state subsidization that makes it unprofitable to engage in business does not amount to an expropriation.

There are a number of international tribunal decisions in which claimants have been successful in obtaining compensation for "involuntary sales". In *Gowan and Copland*[45] two American citizens had discovered a sizable guano deposit on an island near Venezuela. The men began operations to remove the guano but were forced by Venezuelan authorities to leave the island under threat of imprisonment. They later agreed to enter a contract under which they were permitted to work on the deposit for 15 months after which their operations were to be turned over to the government. The United States-Venezuelan Claims Commission awarded the men $20,000 because the transaction was in the nature of a forced sale. In several other cases involving sales of properties during the Nazi regime, tribunals have held that sales below market value brought about by pressure short of actual force cause such transfers to be the functional equivalents of deprivations for which compensation is due.[46] Sales below market value brought about by coercion and intimidation have therefore been found to be expropriatory.

Other notable cases include decisions by the United States Foreign Claims Settlement Commission in the post-war era. In *Jeno Hartman*[47] the Commission found that the Hungarian government had expropriated the claimant's bakery by taking control of the property. The

---

[42]Britain v. Belgium (1934), P.C.I.J. Series A/B, No. 63.
[43]*Ibid.* at 122 and 125.
[44]Dolzer, *supra* note 1 at 46 and Christie, *supra* note 36 at 322.
[45]US v. Venezuela, 4 Moore, Int'l Arb. 3354 (United States-Venezuelan Claims Commission).
[46]See Christie, *supra* note 36 at 324 - 329.

owner did not receive any compensation for the use of the property and could not use, enjoy or sell the property even though the title to the property remained with him. In *Albert Bela Root*[48] the Commission found that the Hungarian Government had expropriated the claimant's property where the government had prohibited the sale or occupancy of a house. But a number of other cases were decided in which substantial interference with property rights was not held to be expropriatory. These include placing of property under temporary national administration, the refusal to grant an export licence for jewelry or to permit the transfer of funds abroad.[49] In 1962, Christie concluded that the cases to date establish that:

> even though a State may not purport to interfere with rights to property, it may, by its actions, render those rights so useless that it will be deemed to have expropriated them.[50]

A number of cases[51] involving claims of expropriation have been argued before the ICJ but have been decided on grounds that do not provide any particular guidance on what types of regulatory measures amount to expropriation. In *Barcelona Traction*, Belgium alleged that the acts and omissions of the Spanish courts in placing Barcelona Traction into bankruptcy constituted a denial of justice and an expropriation of Barcelona Traction shares held by Belgian nationals. While the case is best known for the principle that only the state in which a company is incorporated may make an international claim on behalf of the company, in the course of their reasons, Judges Tanaka and Gros indicated that the acts complained of appeared to be a form of disguised expropriation.

In *Interhandel*, Switzerland made a claim against the US for the seizure of a Swiss company's assets during World War II. The Swiss company, Interhandel, began court proceedings in the US in 1948 for the restitution of its property but later Switzerland brought the case before the ICJ. In *Interhandel*, the ICJ affirmed that the rule that local remedies must be exhausted before international proceedings may be instituted is a well-established rule of customary international

---

[47]Decision No. Hung.-717 (1958), *Tenth Semiannual Report to the Congress for the Period Ending June 30, 1959* at 45. See discussion by Christie, *supra* note 36 at 313 - 316.

[48]Decision No. Hung.-1625 (1958), *ibid* at 61.

[49]As described by Christie, *supra* note 36 at 318.

[50]Christie, *supra* note 36 at 311.

[51]*Interhandel Case* (Switzerland v. US), [1959] I.C.J. Rep. 6, *Barcelona Traction, Light and Power Company, Limited* (Belgium v. Spain), [1970] I.C.J. Rep. 4 and *Case concerning Elettronica Sicula S.p.A.* (US v. Italy), [1989] I.C.J. Rep. 15.

law. Before resorting to an international court, the state where the violation occurred should have an opportunity to redress the violation by its own means. The ICJ therefore refused to review the claim on its merits.

Most recently in *Case concerning Elettronica Sicula S.p.A.*, the ICJ considered whether certain actions by Italy prevented ELSI from liquidating its assets and resulted in a taking of property. Elettronica Sicula S.p.A. ("ELSI") produced electronic components in Italy and was a subsidiary of two American corporations. As a result of continuing financial problems, ELSI's board of directors decided to shut-down operations and liquidate ELSI to minimize ongoing losses. In order to protect local employment, the local mayor issued a requisition order under which the town took temporary control of ELSI's factory. ELSI appealed this order and later made a bankruptcy petition. The requisition order was later annulled and the trustee in bankruptcy brought a suit for damages resulting from the requisition order arguing that the requisition order had caused the bankruptcy. Among other things, the US claimed that the requisition and the delay in overturning the requisition interfered with the American corporations' management and control of ELSI and their interests in ELSI. The ICJ found that ELSI's bankruptcy was not caused by the requisition order, but rather by ELSI's precarious financial situation. The ICJ denied the US's claim that Italy's actions were a taking under the Treaty of Friendship, Commerce and Navigation between the two countries as the mayor's order did not cause or trigger the bankruptcy. It also denied the US's claim that ELSI was deprived of its rights to dispose of property, holding again that the mayor's action was not the cause of the property loss.[52] The ICJ made two points of particular relevance to the discussion in this thesis. First, in submissions on the treaty there was argument over the Italian and English versions of the treaty on the scope of expropriation. The Court held that the word "taking" is wider and looser than "espropriazione".[53] Second, the Court held that the requisition could not amount to a taking under the treaty unless it constituted a significant deprivation of the American corporations' interest in ELSI's plant.[54]

---

[52]See K.J. Hamrock, "The *ELSI* Case: Toward an International Definition of "Arbitrary Conduct" (1992) 27 Texas Int'l L.J. 837 for discussion of the case.

[53]*Supra ELSI* , note 51 at §113.

[54]*Supra ELSI* , note 51 at §119.

2.1.3 Iran-United States Claims Tribunal Cases

The jurisprudence of the Iran-United States Claims Tribunal (the "Tribunal"), set up to assess claims of nationalization and expropriation of American and Iranian investments after the 1979 Iranian revolution, has produced a substantial amount of jurisprudence on expropriation.[55] The Tribunal consists of nine members: three chosen by Iran, three by the US and the remaining three chosen by the Iranian and American arbitrators. The Tribunal hears claims in chambers of three members. The Tribunal is the first international arbitral tribunal since World War II to consider a significant number of expropriation claims. Tribunal decisions are based on Article V of the US and Iranian Claims Settlement Declaration[56] that states in part:

> The Tribunal shall decide all cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law as the Tribunal determines to be applicable...

While the cases illustrate many different types of expropriation it is unclear to what extent the jurisprudence can be used to generalize about customary international law and state practice, as the Tribunal's jurisdiction covers "expropriations or other measures affecting property rights"[57] and the Tribunal applied the terms of the 1955 Treaty of Amity between Iran and the United States. The Treaty of Amity provides that:

> property shall not be taken except for a public purpose, nor shall it be taken without the prompt payment of just compensation.

The Tribunal's decisions deserve close attention. First, the sheer body of jurisprudence currently filling 28 volumes of Iran - U.S. Claims Tribunal Reports cannot lightly be ignored. Second, a wide variety of expropriation cases arose in which the Tribunal applied international expropriation law. Third, leading international law practitioners and arbitrators participated as counsel and members of the Tribunal, thorough submissions of fact and law were presented to the Tribunal and the resulting decisions provide a review of international expropriation law. Nevertheless, there are a number of caveats to the precedential value of the cases. First, as with

---

[55]See generally G.H. Aldrich, *The Jurisprudence of the Iran-United States Claims Tribunal* (Oxford: Clarendon Press, 1996), C.N. Brower & J.D. Brueschke, *The Iran-United States Claims Tribunal* (The Hague: Martinus Nijhoff Publishers Publishers, 1998), W. Mapp, *The Iran United States Claims Tribunal: The first ten years 1981 - 1991* (Manchester: Manchester University Press, 1993) and S.R. Swanson, "Iran-U.S. Claims Tribunal: A Policy Analysis of the Expropriation Cases" (1986) 18 Case W. Res. J. Int'l L. 307.

[56]Claims Settlement Declaration, January 19, 1981 in (1981) 1 Iran-U.S. C.T.R. 9.

[57]Article II, Claims Settlement Declaration, January 19, 1981, *ibid.* at 11.

all arbitral decisions, they are only subsidiary sources of international law. Second, the unique circumstances of revolutionary Iran means that the types of regulatory expropriations the Tribunal was adjudicating are substantially different from the types of regulatory expropriations that this thesis analyzes, which are typically the result of the normal functioning of public services in a stable political environment. And third, as noted above, the jurisdiction of the Tribunal covered expropriation as well as other measures affecting property rights and the decisions do not always clearly distinguish whether state responsibility arose because the government measure amounted to an expropriation or whether it was a measure affecting property rights.

The Tribunal found several categories of Iranian government measures to be expropriatory, including the nationalization of banks and the insurance industry, the *de facto* nationalization of the oil and gas industry, the appointment of managers and supervisors for businesses, physical seizures and retention of goods, the failure of the government to assist in the exportation of goods left in Iran and various actions taken by workers councils.[58] Many cases focussed on the loss of the management and control of businesses resulting from the government appointment of managers and supervisors and squarely address when an interference with property rights becomes expropriatory. It is important to note that by the time of the first Tribunal decision in 1983, the government measures in question had been in place for over three years and, therefore, whether the measures were temporary or had ripened into expropriations was rarely an issue.[59]

Starrett Housing Corporation v. *Islamic Republic of Iran*[60] is one of the leading cases on the loss of management control. Starrett and a number of subsidiaries, including an Iranian subsidiary, Shah Goli, had entered into agreements with an Iranian bank for the financing and development of a large apartment project. The project was financed through advanced sales to purchasers and bank loans secured against the project and guaranteed by Starrett. As a result of the revolution, the American managers and construction team left Iran and Iran later appointed a manager to direct all project activities. Under Iranian law, the government-appointed manager of Shah Goli

[58]See Aldrich, *supra* note 55 at 171-276.
[59]Aldrich, *supra* note 55 at 172.
[60](1983) 4 Iran-U.S. C.T.R. 122.

was the legal substitute for the original manager. Iran had also passed a law requiring purchase monies to be deposited to special accounts in government controlled banks and had frozen Shah Goli's bank account. The Chairman of the Tribunal, Lagergren, found that the appointment deprived Starrett and its subsidiaries of the use and management of its property. He held that Iran had expropriated the physical property as well as the right to manage and complete the project, to deliver the apartments and to collect the proceeds of sale. He held (consistently with other post-war arbitral decisions) that a government's assumption of control over property does not automatically justify a conclusion that a project has been expropriated and that, for a finding of expropriation, the owner must be deprived of fundamental rights of ownership and the deprivation cannot be temporary. In his reasons Lagergren states:

> [it] is recognized in international law that measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the state does not purport to have expropriated them and the legal title to the property formally remains with the original owner.[61]

In *Starrett* and other similar cases the Iranian government argued that it had to enact measures to deal with the management of the companies because the American management had abandoned the projects. This claim was rejected in *Starrett*. International expropriation law recognizes that property owners have a fundamental right to control and manage their property but also recognizes that some interference with management does not automatically amount to a taking. For example, the requirement for a national on a subsidiary's board of directors would not be an interference with management creating a duty to compensate. In addition, certain emergency situations may require interference with management rights.[62] In *Starrett*, the second Tribunal member, Holtzmann, concurred with Lagergren but argued that Starrett's property was expropriated by a number of government measures prior to the formal process of appointing the temporary manager. These measures included the acts of revolutionaries, the blocking of bank accounts, a coerced agreement to reduce the contract price for apartments and the forced departure of Starrett personnel. Holtzmann reiterated the principle that these measures deprived Starrett of its fundamental rights to manage and control its property and argued that the date of effective expropriation should have been earlier.

---

[61] *Ibid.* at 154.

[62] Christie, *supra* note 36 at 333-334 and 337.

In *Tippetts, Abbett, McCarthy, Stratton and TAMS-AFFA Consulting Engineers of Iran*[63] the majority of the Tribunal found that the claimants were entitled to compensation for their 50% interest in a joint venture, as the Iranian government had appointed a manager for the business and the claimant was deprived of the control and benefit of its property. Whether the Tribunal decided that property had been expropriated is slightly unclear because the Tribunal held that the claimant was subjected to measures affecting property rights and then states:

> ... The Tribunal prefers the term "deprivation" to the term "taking", although they are largely synonymous, because the latter may be understood to imply that the Government had acquired something of value, which is not required.
>
> A deprivation or taking of property may occur under international law through interference by a state in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected.
>
> While assumption of control over property by a government does not automatically and immediately justify a conclusion that property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral. The intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.[64]

Not all forms of government interference will amount to an indirect expropriation. The Tribunal did not find expropriations in cases of interference with bank accounts, where shares of shareholders other than the claimant were taken and where the claimant retained some control over the property.[65] The only case where the Tribunal did not find an expropriation as the result of the police power was with respect to the seizure of a liquor license by the US Internal Revenue Service. This case is described in more detail in Section 2.2 below.

2.1.4 Arbitrations under ICSID

The International Centre for Settlement of Investment Disputes ("ICSID") was created by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.[66] ICSID was established to provide a neutral forum for the resolution of investment

---

[63](1984) 6 Iran-U.S. C.T.R. 219.
[64]*Ibid.* at 225.
[65]See Aldrich, *supra* note 55 at 171-276.
[66]*Reprinted in* (1965) 4 ILM 524.

disputes and in an attempt to "depoliticize" the settlement of investment disputes.[67] As of December, 1998, 37 cases had been concluded under ICSID and 26 were pending.[68] These include disputes relating to the exploitation of natural resources, concessions agreements and various construction, management and licensing contracts.[69] Since many cases involve the interpretation of specific investor-state contracts or concessions, the cases provide little guidance on regulatory expropriation. To the early 1990's, only four ICSID awards have dealt with typical expropriation claims and three of these involved situations in which a joint venture foreign investment project was taken over by military action.[70] The fourth involved the revocation of a long-term timber concession. In all of these cases, there was little dispute that these actions created state responsibility and the decisions do not address situations involving indirect expropriations. Since NAFTA, the Energy Charter Treaty and many BITs provide for ICSID arbitration it is likely ICSID panels will address more expropriations claims in the future. Indeed, as of early 1999, five NAFTA Chapter Eleven claims had been registered at ICSID.[71]

2.1.5 Bilateral and Other International Investment Instruments

The desire to have clearer rules governing foreign investment and the recognition of the importance of foreign investment for economic growth has led many countries to conclude bilateral treaties on foreign investment and, more recently, to negotiations under the auspices of the Organisation for Economic Co-operation and Development ("OECD") on a *Multilateral Agreement on Investment* ("MAI"). In this section I review the early attempts at codifying international law on expropriation, provisions in BITs and other international instruments on expropriation and the draft provisions on expropriation in the MAI.

There were three early attempts in the post-war era to develop a multilateral treaty establishing clear rules for state responsibility for expropriation. These attempts ultimately failed because of

---

[67]I.F.I. Shihata, *Towards a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA* (Washington: International Centre for Settlement of Investment Disputes, 1993).

[68]"List of Concluded Cases" and "List of Pending Cases"online: ICSID Homepage <http://www.worldbank.org/icsid/cases> (last accessed: 18 June 1999).

[69]*Ibid.* at 7-8.

[70]J.A. Westberg, "Applicable Law, Expropriatory Takings and Compensation in Cases of Expropriation; ICSID and Iran-United States Claims Tribunal Case Law Compared" (1993) 8 ICSID Rev. 1 at 10.

[71]See discussion of NAFTA investment claims in Chapter Four.

the lack of state support for the proposals. The 1959 draft of the *Convention on Investments Abroad* (the "Abs-Shawcross Draft Convention") was drafted by a committee under the direction of Dr. Abs, Director-General of the Deutsche Bank, and Lord Shawcross and was the first post-war attempt to develop an international investment code.[72] Article III of the Abs-Shawcross Draft Convention provides, in part, that:

> No Party shall take any measures against nationals of another Party to deprive them directly or indirectly of their property except under due process of law and provided that such measures are not discriminatory or contrary to undertakings given by that Party and are accompanied by the payment of just and effective compensation...[73]

Two years later, the 1961 *Convention on the International Responsibility of States for Injuries to Aliens*[74] ("Harvard Draft") was prepared by *rapporteurs* L.B. Sohn and R.R. Baxter at Harvard Law School in an attempt to codify the international law on state responsibility. The Harvard Draft provides in Article 10 that all takings are to be compensated and defines a taking in Article 10(3)(a) as:

> A "taking of property" includes not only an outright taking of property but also any such unreasonable interference with the use, enjoyment, or disposal of property as to justify an inference that the owner thereof will not be able to use, enjoy, or dispose of the property within a reasonable period of time after the inception of such interference.

According to the commentary accompanying the Harvard Draft, a state can employ a wide variety of measures for the purpose of making it impossible for an investor to use or enjoy its property. For example, a state may make it impossible for an investor to operate a factory by blocking the factory gates on the grounds of maintaining public order; through labour legislation it may set wages at a prohibitively high level; or it may deny visas for required technical staff.[75] Article 10(5) of the Harvard Draft provides that uncompensated takings under the police power are not wrongful:

> An uncompensated taking of property of an alien or a deprivation of the use or enjoyment of property of an alien which results from the execution of the tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health, or morality; or from the valid exercise of

---

[72]See Chapter 8 of G. Schwarzenberger, *Foreign Investments and International Law* (New York: Frederick A. Praeger, 1969).

[73]*Ibid.* At 117.

[74](1961) 55 A.J.I.L. 545. This cite includes the history and text of the Harvard Draft and is accompanied by extensive commentary.

[75]*Ibid.* at 559.

> belligerent rights; or is otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful, provided:
>
> (a) it is not a clear and discriminatory violation of the law of the State concerned;
> (b) it is not the result of a violation of any provisions of Articles 6 to 8 of this Convention[76]
> (c) it is not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world; and
> (d) it is not an abuse of the powers specified in this paragraph for the purpose of depriving an alien of his property.

In the early 1960's, a number of Organisation for Economic Co-operation and Development (the "OECD") countries prepared a draft *Convention on the Protection of Foreign Investment*[77] which was revised and approved by the OECD in 1967 (the "OECD Draft"). Article 3 of the OECD Draft provides in part:

> No Party shall take any measures depriving, directly or indirectly, of his property a national of another Party unless the following conditions are complied with:
>
> (i) The measures are taken in the public interest and under due process of law;
> (ii) The measures are not discriminatory or contrary to any undertaking which the former Party may have given; and
> (iii) The measures are accompanied by provisions for the payment of just compensation....

The commentary to the OECD Draft remarks that measures that are otherwise lawful can be applied in such as a way as to deprive the investor of its property. It suggests that excessive or arbitrary taxation, prohibition of dividend redistribution coupled with compulsory loans, or the denial of essential export or import licences may amount to a taking.[78] The OECD Draft failed to gain sufficient support among OECD countries for adoption but it served as an important model for later BITS.[79]

The uncertainty in international law and the desire by investment-exporting countries for more complete codes of protection for foreign investment led many developed countries to pursue bilateral investment treaties ("BITs") with developing countries. [80] Germany and Pakistan signed the first BIT in 1959 and Germany continued to sign investment treaties with many

---

[76]These Articles provide procedural protection.
[77](1968) 7 ILM 117.
[78]*Ibid.* at 126.
[79]R. Dolzer & M. Stevens, *supra* note 6 at 2.
[80]See Dolzer & Stevens, *ibid.*at 257 for a comprehensive bibliography of sources dealing with BITs.

developing countries throughout the 1960's.[81] There has been an exponential growth of BITs in the 1990's. By the end of 1997 over 140 countries had concluded more than 1513 BITs. In 1997 alone, 153 BITs were concluded.[82] The importance of foreign direct investment for developing countries is highlighted by the increasing number of BITs between developing countries and other developing countries. At a UN Conference on Trade and Development ("UNCTAD") meeting in January 1999, eight new BITS were negotiated between the G-15 countries bringing the number of BITs between G-15 countries to 38 and the number of BITs between G-15 countries and non-G-15 countries to 394.[83] Canada refers to its BITs as Foreign Investment Protection and Promotion Agreements ("FIPAs") and currently has signed FIPAs with 22 countries. Of Canada's FIPAs, 17 are based on Chapter Eleven of NAFTA.[84]

State practice in BITs has converged on a number of common provisions. BITs typically provide that a State may expropriate property provided that the expropriation is non-discriminatory, is for a public purpose, is performed in accordance with due process of law and compensation is paid. BITs have extensive provisions on the definition of investment and the standard of compensation for expropriated property.[85] In addition, BITs typically have

---

[81] *Ibid.* at 267.

[82] UN Conference on Trade and Development, Press Releases TAD/INF/2786 (7 January, 1999) and TAD/INF/2787 (14 January, 1999) at http://wwww.unctad.org/en/press/.

[83] 3 Bridges Weekly Trade News Digest (1999) No. 1 & 2. (online: International Centre for Trade and Sustainable Development Homepage <http://www.ictsd.org>. The G-15 comprises Algeria, Argentina, Brazil, Chile, Egypt, India, Indonesia, Jamaica, Kenya, Malaysia, Mexico, Nigeria, Peru, Senegal, Sri Lanka, Venezuela and Zimbabwe.

[84] "Listing of Canada's Foreign Investment Protection and Promotion Agreements (FIPAs)" online: Department of Foreign Affairs and International Trade Homepage <http://www.dfait-maeci.gc.ca/tna-nac/fipa-e.asp> (last modified May 1999).

[85] There is disagreement whether BITs create and solidify customary international law on the standard of compensation for expropriated property through evidence of state practice and the acknowledgment by states that they are obligated to act in accordance with an international minimum standard (*opinio juris*) or whether they reflect a lacuna in the current law and create a *lex specialis* that does not create or solidify international law. According to Guzman, states pursue BITs out of economic self-interest and not a sense of legal obligation and therefore the prevalence of BITs cannot be used to support a rule of customary international law that incorporates the Hull Rule. Rather less-developed countries ("LDCs) face a prisoner's dilemma in which it is optimal for them collectively to reject the Hull Rule, but in which each individual LDC is better off by signing BIT's that give them an advantage over other LDCs in the competition to attract foreign investors. See A.T. Guzman, "Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties" (1998) Va. J. Int'l L. 639. Also see K.L. Vandevelde, "The Political Economy of a Bilateral Investment Treaty" (1998) 92 A.J.I.L. 621, K.L. Vandevelde, "Sustainable Liberalism and the International Inevstment Regime" (1998) 19 Mich. J. Int'l L. 373 and sources in *supra* note 21. The 1998 *World Investment Report* at 117-118 suggests that BITs are relatively insignificant in determining the level of foreign direct investment and that BITs are increasingly regarded by foreign investors as a standard institutional structure.

provisions on fair and equitable treatment, national treatment, most-favoured nation status and the prohibition of performance requirements.[86] However, BITs offer little guidance on what government measures amount to expropriation and typically state that the matter is to be determined in accordance with international law. Recent BITs typically do not define expropriation and often simply refer to "measures tantamount to expropriation" or "measures having the effect of expropriation". Current American treaties have given up defining "taking" so as not to restrict the potential scope of investment protection.[87] Thus, while the expropriation provisions have the virtue of simplicity and open-endedness, they are circular and rely on the rules of international law to determine when an expropriation has occurred. Table 1 below reproduces a representative sample of expropriation provisions in recent BITs.[88]

Table 1: Expropriation Provisions in Recent Bilateral Investments Treaties

Country	**Expropriation Provisions**
Austrian Model BIT	expropriation comprises "nationalization or any other measure having equivalent effect"[89]
Canada - BITs with Egypt and Venezuela	"Investments ... shall not be nationalized, expropriated or subjected to measures having an effect equivalent to nationalization or expropriation..."[90]
China and Indonesia	"Investment ... shall not be nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation..."[91]
Cuba and Barbados	"Investments ... shall not be nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation..."[92]

[86]Dolzer and Stevens, *supra* note 6.

[87]Sornarajah, *supra* note 20 at 297.

[88]See Dolzer and Stevens, *supra* note 6 at Chapter 4 and United Nations Centre on Transnational Corporation, *Bilateral Investment Treaties* (New York, United Nations, 1988). The text of all BITs are available in ICSID, *Investment Protection Treaties*, looseleaf, (Washington: International Centre for Settlement of Investment Disputes 1983).

[89]Article 1, Austria - Model Agreement in Dolzer and Stevens, *supra* note 6 at 168.

[90]Article VIII, *Agreement between the Government of Canada and the Government of the Arab Republic of Egypt for the Promotion and Protection of Investments* (November 13, 1996), Article VII, *Agreement between the Government of Canada and the Government of the Republic of Venezuela for the Promotion and Protection of Investments* (July 1, 1996) in *Investment Promotion and Protection Treaties*, looseleaf (New York: Oceana Publications, Inc., 1998). Both of these treaties provide for binding investor-state arbitration.

[91]Article IV, *Agreement between the Government of the Republic of Indonesia and the Government of the People's Republic of China on the Promotion and Protection of Investments* (November 18, 1994) in *Investment Promotion and Protection Treaties*, *supra* note 90.

[92]Article 5, *Agreement between the Government of Barbados and the Republic of Cuba for the Promotion and Protection of Investments* (February 19, 1996) in *Investment Promotion and Protection Treaties*, *supra* note 90.

Country	Expropriation Provisions
India and the Netherlands	"measures having effect equivalent to nationalisation or expropriation"[93]
France's - BITs with Hungary, Korea and Malaysia	"toutes autres measures dont l'effet est de déposséder, directement ou indirectement, les investisseurs" or "toute autres formes[measure] de dépossession, directe ou indirecte"[94]
Sweden and Argentina	"any direct or indirect measure" [of expropriation] or "any other measures having the same nature or the same effect".[95]
United Kingdom Model BIT	measures "having effect equivalent to nationalisation or expropriation"[96]
United States Model BIT	"Investments shall not be expropriated or nationalized either directly through measures tantamount to expropriation or nationalization"[97]

Dolzer notes that while most BITs refer to expropriation and nationalization, some BITs refer to dispossession, taking, deprivation or privation of property. He argues that the latter terms are considered quite wide in scope.[98] These terms are generally not used in BITs even though they were in the draft codifications such as the Harvard Draft and the OECD Draft. The Harvard Draft refers to a "taking of property" and the OECD Draft refers to "any measures depriving, directly or indirectly, ... property". While in *ELSI*, the ICJ held that the scope of word "taking" is wider and looser than "espropriazione",[99] it remains unclear whether the scope of a taking of property is wider than a measure tantamount (or having the effect) of expropriation. The meaning of a measure tantamount to expropriation suggests a measure that has the same effect as expropriation on the property owners, i.e. one that deprives a property owner of property rights. On the other hand, if a wider meaning was intended, it is unclear why drafters of BITs did not choose the wording in the Harvard Draft or OECD Draft.

[93]Article 5, *Agreement between the Kingdom of the Netherlands and the Republic of India for the promotion and protection of investments* (November 6, 1995) in *Investment Promotion and Protection Treaties*, *supra* note 90.

[94]Dolzer and Stevens, *supra* note 6 at 101.

[95]Dolzer and Stevens, *supra* note 6 at 101 - 102.

[96]Dolzer and Stevens, *supra* note 6 at 232.

[97]Dolzer and Stevens, *supra* note 6 at 245.

[98]Dolzer and Stevens, *supra* note 6 at 98.

[99]*Supra ELSI* , note 51 at §113.

In addition to BITs, there are a growing number of regional and sector specific investment protection and promotion frameworks and other investment related initiatives. Other instruments include the Energy Charter Treaty, the Asean Plan of Action on Cooperation and Promotion of Foreign Investment and Intra-Asean Investment, the Colonia and Buenos Aires Investment Protocols of Mercosur and the Statement on Investment Protection Principles adopted by the Council of the European Communities to elaborate the Lomé IV Convention.[100] Article 13 of the Energy Charter Treaty provides that investments "shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation." These international agreements generally do not clarify the distinction between regulation and expropriation.[101]

In order to create a comprehensive set of rules for foreign investment and to liberalize investment measures, in the 1995 Ministerial meeting the OECD ministers established a negotiating group to begin negotiating a *Multilateral Agreement on Investment* ("MAI").[102] In response to opposition from citizens groups and concerns by negotiating countries,[103] the negotiations were suspended in April 1998. On December 3, 1998 the OECD announced that negotiations on the MAI were no longer taking place.[104] The MAI would have contained provisions similar to those in BITs and, in certain areas, furthered investment liberalization.

---

[100]See World Investment Report 1998: Trends and Determinants - Overview (New York and Geneva: United Nations, 1998) at 59-74 and A.R. Parra, "The Scope of New Investment Laws and International Instruments" in R. Pritchard, ed., Economic Investment, Foreign Investment and the Law (London: Kluwer Law International, 1996) at 27 for a description of these instruments and initiatives.

[101]Also see the survey of multilateral and bilateral instruments in World Bank, *Legal Framework for the Treatment of Foreign Investment* (Washington D.C.: The World Bank, 1992). The surveys reviews 25 multi-lateral documents on investment.

[102]For a description of the background of the MAI see E.M. Burt, "Developing Countries and the Framework for Negotiations on Foreign Direct Investment in the World Trade Organization" (1997) 12 Am. U. J. Int'l L. & Pol'y.

[103]Opposition to the MAI in Canada was spearheaded by the Council of Canadians. For commentary criticizing the MAI see Jackson & M. Sanger, eds., *Dismantling Democracy* (Toronto: Lorimer, 1998), Legislative Assembly, Province of British Columbia, Special Committee on The Multilateral Agreement on Investment, *First Report*, (29 December 1999), T. Clarke & M. Barlow, *MAI: The Multilateral Agreement on Investment and the Threat to Canadian Sovereignty* (Toronto: Stoddart, 1997) and T. Clarke & M. Barlow, *MAI Round 2: New Global and Internal Threats to Canadian Sovereignty* (Toronto: Stoddart, 1998). For academic commentary on the MAI see Symposium: International Regulation of Foreign Direct Investment: Obstacles & Evolution, (1998) 31 Cornell Int'l L.J. and S. Picciotto, "Linkages in International Investment Regulation: The Antinomies of the Draft Multilateral Agreement on Investment" (1998) U. Pa. J. Int'l Econ. L 731.

[104]Press Release (3 December, 1998), online: OECD homepage <http://www.oecd.org/daf/cmis/mai/maindex.htm> (date accessed: 25 February 25, 1999).

The expropriation and compensation provisions of Article IV.2.1 of the MAI Negotiating Text and Commentary as of April 24, 1998 (the "MAI")[105] provide:

> 2.1. A Contracting Party shall not expropriate or nationalise [directly or indirectly][106] an investment in its territory of an investor of another Contracting Party or take any measure or measures having equivalent effect (hereinafter referred to as "expropriation") except:
>
> a) for a purpose which is in the public interest,
> b) on a non-discriminatory basis,
> c) in accordance with due process of law, and
> d) accompanied by payment of prompt, adequate and effective compensation in accordance with Articles 2.2 to 2.5 below.

In response to criticisms of the MAI, a number of interpretive notes were added to the text. This included a clarification of the expropriation provision:

> Articles -- on General Treatment, and -- on Expropriation and Compensation, are intended to incorporate into the MAI existing international legal norms. The reference in Article IV.2.1 to expropriation or nationalisation and "measures tantamount to expropriation or nationalisation" reflects the fact that international law requires compensation for an expropriatory taking without regard to the label applied to it, even if title to the property is not taken. It does not establish a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue raising and other normal activity in the public interest undertaken by governments. Nor would such normal and non-discriminatory government activity contravene the standards in Article --.1 (General Treatment).

In addition to Article IV.2.1, an interpretive note on the taxation measures states that the imposition of taxes does not generally constitute expropriation but accepts that taxation measures may constitute expropriation, but not if the measure is "within the bounds of internationally recognised tax policies and practices."[107]

For the purposes of determining what government measures amount to expropriation, recent BITs and other international investment agreements and initiatives provide little guidance. Dolzer clearly states the problem that "current versions of investment treaties do not in any way

---

[105]The MAI Negotiating Text and Commentary (as of April 24, 1998), online: OECD homepage <http://www.oecd.org/daf/cmis/mai/negtext.htm>.

[106]The chair's package of proposals for text on environment and labour would have eliminated "directly or indirectly" from the provision and included the interpretive note reproduced below.

[107]MAI at 87.

illuminate the issue of indirect expropriation; they rather state the problem, and presumably the rules of general international law are meant to provide the solutions."[108]

2.1.6 Foreign Investment Insurance Mechanisms

Since there are significant risks when investing in foreign countries, most capital exporting nations have established mechanisms to provide foreign investment insurance to their nationals investing abroad.[109] Various types of insurance are offered - export insurance, political risk insurance and insurance against expropriation. Under most systems the investor pays a premium for insurance against certain specified risks, including expropriation. If the investor's property is expropriated it claims under the insurance contract and the insurer (typically a state corporation or enterprise) is subrogated to the claim of the claimant against the foreign state. This arrangement reflects a solution to the practical problem for foreign investors that under traditional international law principles only states have standing to bring international claims against other states. NAFTA, the Energy Charter and BITs now address this problem through investor-state arbitration provisions.

The Multilateral Investment Guarantee Agency ("MIGA") was established in 1985 under the auspices of the World Bank to encourage investment flows, particularly to less-developed countries.[110] The MIGA provides protection for private foreign investment and technical assistance and policy advice on investment issues. Under Article 2 of the *Convention Establishing the Multilateral Investment Guarantee Agency*[111] (the "Convention"), the MIGA may issue guarantees against non-commercial risks in respect of an investment in a member country made by the national of another member country. The MIGA may guarantee eligible

---

[108]Dolzer, *supra* note 4 at 56.

[109]See P.E. Comeaux & N.S. Kinsella, *Protecting Foreign Investment Under International Law* (New York: Oceana Publications, 1997) and R.K. Paterson *et al.*, *International Trade and Investment Law in Canada,* 2d ed. (Toronto: Carswell, 1994).

[110]See S.K. Chatterjee, "The Convention Establishing the Multilateral Investment Guarantee Agency" (1987) 56 I.C.L.Q. 76. for a summary of the provisions of the Convention. As of March 31, 1999, there were 154 member states to the Convention Establishing the Multilateral Investment Guarantee Agency and 16 other states were in the process of fulfilling membership requirements (online: MIGA homepage <http://www.miga.org/welcome.htm> (date accessed: 9 June 1999).

[111](1985) 24 I.L.M. 1605.

investments from a number of risks including expropriation. Expropriation is defined in Article 11(a)(ii) of the Convention as:

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

Article 8 of the General Conditions of Guarantee for Equity Investments for MIGA Contracts of Guarantee[112] has a broad definition of expropriation that including government measures that (i) deprive the project of assets; (ii) deprive the investor of the right to receive dividends; (iii) prevent the exercise of voting rights with respect to shares; (iv) prevent the exercise of material rights; and (v) impose financial obligations that make it impossible for an otherwise viable project to continue operating without losses. In order to make a claim any deprivation must continue in effect for one year. Article 8.4 specifies that:

> No measure shall be deemed to be expropriatory if it constitutes a bona fide non-discriminatory measure of general application of a kind that governments normally take in the public interest for such purposes as ensuring public safety, raising revenue, protecting the environment, or regulating economic activities, unless the measure is designed by the Host Government to have a confiscatory effect such as causing the Guarantee Holder to abandon the Guaranteed Investment or sell it at a distressed price.

Claims on US foreign investment insurance contracts have been the subject of a number of arbitrations.[113] The *Revere Copper Arbitral Award*[114] involved a claim by Revere Copper and Brass Incorporated on an investment insurance contract with the US Agency for International Development ("AID"). AID's obligations were later taken over by the Overseas Private Investment Corporation ("OPIC"). Revere Copper had developed a bauxite mining and processing operation in Jamaica through a wholly owned subsidiary, Revere Jamaica Alumina, Limited ("RJA") under a 25-year agreement made in 1967 with the Government of Jamaica (the "Agreement"). The Agreement governed the payments of taxes and royalties to Jamaica for 25 years. In 1972, the newly elected government of Michael Manley initiated a review of the

---

[112](1989) 28 I.L.M. 1233.

[113]See V.R. Koven, "Expropriation and the "Jurisprudence" of OPIC" (1981) 22 Harv. Int'l L.J. 269. The Export Development Corporation (the "EDC") provides export and political risk insurance to Canadian exporters and investors. There are no reported cases of claims against EDC insurance contracts.

[114]*In the Matter of Revere Copper and Brass, Inc. and Overseas Private Investment Corporation*, (1980) 56 I.L.R. 258.

bauxite industry. As a result of this review, in 1974 the Jamaican government imposed new requirements on RJA including increases in royalties and levies, extraction quotas, exchange controls and export controls.

The Contract of Guarantee between Revere and OPIC (the "Contract") insured Revere against losses resulting from "Expropriatory Action" as defined in the Contract. Section 1.15 of the Contract provided, in part, as follows:

> 1.15 Expropriatory Action. The term 'Expropriatory Action' means any action which is taken, authorized, ratified or condoned by the Government of the Project Country, commencing during the Guaranty Period, with or without compensation therefor, and which for a period of one year directly results in preventing:
> ...
> (d) the Foreign Enterprise from exercising effective control over the use or disposition of a substantial portion of its property or from constructing the Project or operating the same;

The Contract excludes any action resulting from:

> (1) any law, decree, regulation, or administrative action of the Government of the Project Country which is not by its express terms for the purpose of nationalization, confiscation, or expropriation (including but not limited to intervention, condemnation, or other taking), is reasonably related to constitutionally sanctioned governmental objectives, is not arbitrary, is based upon a reasonable classification of entities to which it applies and does not violate generally accepted international law principles;

The majority of the three member arbitration tribunal found that that the Government of Jamaica repudiated the Agreement in contravention of international law and that by repudiating its long-term commitments to RJA it directly prevented RJA from exercising effective control over the use and disposition of its property. OPIC argued that RJA still had the rights and property it had before 1974 - the facility, the mining lease and an ability to operate. The majority regarded RJA's control of the facility as no longer effective in view of the destruction of RJA's contract rights. It reasoned that the control of a large industrial enterprise is exercised by a continuous stream of decisions and without the stability of the Agreement such decisions simply became gambles. The freedom to make rational management decisions is at the heart of effective control. The majority therefore concluded OPIC was liable under the Contract.

The minority opinion held that Jamaica's actions did not amount to 'Expropriatory Action' within the meaning of the Contract as RJA remained in control of its business and the plant and it was

not prevented from managing its plant, operating its business or exporting alumina. The new taxes breached the terms of the Agreement but did not cause a loss of effective control. The minority found that the bauxite levy amounted to approximately 20% of RJA's gross receipts for alumina and that this was not a confiscatory measure.

Revere Copper reinforces the principle expressed in the Iran - US Claims Tribunal cases and other international arbitral decisions that government measures substantially interfering with the management or control of a business enterprise may be expropriatory. However, the applicability of the decision is limited because the case focused on the interpretation of the insurance contract and a clear breach of a long-term concession agreement with a stabilization clause (a contractual provision intended to freeze the state of domestic laws with respect to the project). In addition, the definitions of expropriation in insurance mechanisms may be broader than the definition under customary international law.[115] Whether or not they are higher, Dolzer argues it is reasonable "to assume that the major capital-exporting countries do not assume that the standard of protection granted by international law is higher than the one expressed in these insurance contracts.[116] Insurance mechanism exclude certain state regulatory measures from the definition of expropriation. For example, in *International Bank of Washington* v. *OPIC,*[117] an arbitral tribunal found that regulations aimed at forestry conservation were not an expropriation as they had only caused delay with respect to the investor's logging operations and operations could be continued by obtaining regulatory exemptions.[118]

2.2 Regulatory Expropriation and the Police Power

All states regulate property rights and, by entering into a state, a foreign national accepts the benefits and burdens of domestic regulation. When a foreign national acquires or creates property, the state's regulatory framework will limit property rights. Under international law, a substantial inference with property rights is required to justify a claim of expropriation. Typical regulatory measures, such as zoning regulation requiring building setbacks and setting height restrictions, restrict property rights but are within the sovereign power of the state to regulate the

[115]Koven, *supra* note 113 at 280.
[116]Dolzer, *supra* note 4 at 58.
[117](1972) 11 I.L.M. 1216.

use of property. The sources of international law considered in this chapter suggest that measures such as fiscal legislation (unless confiscatory), land use planning, currency restrictions and measures for the protection of the environment, public health, safety and morality will normally justify severe interference and even destruction of an alien's property rights.[119] In addition, confiscation as a penalty for crimes is recognized as a valid use of the police power.[120] However, a state's justification that a measure is based on its police powers does not preclude an international tribunal from making an independent determination of the issue. In this section I examine the scope of the police power, review how international law disciplines the exercise of the police power and then examine another possible framework for state responsibility for expropriation.

2.2.1 The Scope of Police Power Regulation

There are very few international cases on the scope of the police power. In the *Parsons* case the destruction of liquor was held to be within the police power of the government.[121] In *Kügele* v. *Polish State*,[122] the Upper Silesian Arbitral Tribunal dismissed a claim that a series of licence fees imposed by Poland had forced the claimant to close his brewery and that Poland had therefore taken the property. The Tribunal held that the increase in a licence fee did not take away or impair the right to engage in a trade.

The Iran - US Claims Tribunal decided very few cases where it analyzed the police power. In *Sea-Land Service Inc.* v. *The Islamic Republic of Iran*[123] the Tribunal held that restrictions on the type of cargo that Sea-Land could unload was a reasonable and legitimate measure during a time of civil unrest. In *Too* v. *Greater Modesto*,[124] an Iranian national brought several claims including a claim against the US for the seizure by the Internal Revenue Service ("IRS") of a restaurant liquor licence held by an Iranian national. The IRS had seized and sold the liquor

---

[118]See Koven, *supra* note 113 for a discussion of OPIC cases.
[119]Christie, *supra* note 36 at 331- 332.
[120]Brownlie, *supra* note 8 at 538.
[121]VI RIAA at 25.
[122]6 Ann. Dig. 69 (1931-32).
[123](1984) 6 Iran-U.S. C.T.R. 149.
[124](1989) 23 Iran-U.S. C.T.R. 378.

licence to cover overdue withholding taxes. The Tribunal confirmed the general principle in §712 of the Third Restatement that a state is not responsible for loss of property or any other economic disadvantage resulting from bona fide, non-discriminatory general taxation, regulation, forfeiture from crime, or other action of the kind that is commonly considered as within the police powers of states.[125]

In order to maintain a conceptual distinction between expropriations and police power regulation, reference cannot be made solely to public utility or benefit to justify non-compensation. Since all lawful expropriations must be for a public purpose, the general public utility of a measure does not justify taking property from a property owner without compensation. In US takings jurisprudence, police power regulation of the use of property is justified by the prevention of harm or protection of the public. The US takings case, *Mugler* v. *Kansas*,[126] discussed in Chapter One, succinctly summarizes the rationale:

> A prohibition simply upon the use of property for purposes that are declared by valid legislation to be injurious to the health, morals, or safety of the community, cannot, in any just sense be deemed a taking or an appropriation of property for the public benefit. Such legislation does not disturb the owner in the control or use of his property for lawful purposes, nor restrict his right to dispose of it, but is only a declaration by the State that its use by any one, for certain forbidden purposes, is prejudicial to the public interests.[127]

In "The Taking of Property by the State", R. Higgins, in the context of reviewing US takings jurisprudence, questions the distinction between a taking for public use that requires compensation and an indirect taking for regulatory purposes that does not. She writes:

> Is this distinction intellectually viable? Is not the State in both cases (that is, either by a taking for a public purpose, or by regulation) purporting to act in the common good? And in each case has the owner of the property not suffered loss? Under international law standards, a regulation that amounted (by virtue of its scope and effect) to a taking, would need to be "for a public purpose" (in the sense of in the general, rather than for a private interest). And just compensation would be due.[128]

Higgins argues that no compensation is payable for general regulatory measures that substantially decrease the value of property provided the right to use, enjoy, manage and control

---

[125]Third Restatement §712(g).

[126]123 U.S. 623 (1887) [hereinafter *Mugler*].

[127]*Supra* note 8 at 668-69.

[128]Higgins, *supra* note 20 at 331.

property are left substantially intact.[129] But her framework suggests that there is no police power exception to a substantial deprivation of property rights. This formulation begs the question of what amounts to an expropriation. Higgins' argues compensation is required for regulatory expropriations because of the burden they place on property owners in the name of the public purpose. But she does not clarify what types of harmful uses of property, if any, would be exempt from a compensation requirement. Higgin's analysis is similar to that of recent US takings jurisprudence. As discussed in Chapter 1, in *Lucas* v. *South Carolina Coastal Council,*[130] Justice Scalia held that:

> Where the State seeks to sustain regulation that deprives land of all economically beneficial use, we think it may resist compensation only if the logically antecedent inquiry into the nature of the owner's estate shows that the proscribed use interests were not part of his title to begin with...
>
> .. that title is somehow held subject to the "implied limitation" that the State may subsequently eliminate all economically valuable use is inconsistent with the historical compact recorded in the Takings Clause that has become part of our constitutional culture.[131]

In *Lucas* the Court held that is was unlikely that a complete land development prohibition could be justified under nuisance law and remanded the case for retrial.

When a foreign national buys property, the foreign national will only acquire the property rights that are inherent in the title and subject to the existing regulatory framework. International law looks to the *lex situs* to determine the scope of the acquired rights. Under the categorical rule in *Lucas*, a taking occurs where a government measures results in a land becoming economically valueless. The coherence of this position is appealing. If there is a taking, there must be compensation. But as the dissenting judges in *Lucas* noted, reference to nuisance law or some other inherent limitation of property rights does not provide an objective value-free basis for upholding regulation anymore than a legislative determination of harm. The harm-preventing determination by the state is similar to the nuisance determination by a court as both depend on a determination of whether the use is harmful.

---

[129]Higgins, *supra* note 20 at 271.
[130]112 S. Ct. 2886 (1992).
[131]*Ibid.* at 2899-2900.

Defining a certain core of police power regulation based on the "normal operation of the law" or "measures that government commonly take"[132] does not eliminate uncertainty because they depend on conceptions of the proper scope of government regulation that are not shared universally. It would be preferable to specify core areas of police power regulation which could be used to justify interference with property rights. These areas would include measures for public order, safety, health and the protection of the environment. A common element of these categories of measures is that property rights are restricted based on a determination of the harm caused by the uses of property. In addition, an express exemption is required for fiscal legislation. In order to maintain the integrity of the police power, general economic measures or regulation could not be used to justify an expropriation of property rights. While a state may legitimately take the view that foreign domination of a specific industry is harmful to national interests, expropriations motivated by economic nationalism require compensation. For example, the creation of a state monopoly for life insurance would not seem to be a justifiable exercise of state police powers by which obligation to pay compensation may be avoided.[133]

Finally, the scope of the police power in areas of public morality is particularly difficult to define. Gambling and alcohol are often prohibited under the police power on the basis of public morality. But in a world of divergent moral philosophies how are judgments to be made about the scope of the police power? It is unlikely that it can extend to the suppression of rich foreign property owners on the basis that the idle rich are detrimental to public morality.[134] Under customary international law the scope of the police power is broad. For example, the Second Restatement suggests that a government decree outlawing a profitable gambling casino would not constitute a taking of property. But where a government has authorized gambling through a licence or concession and the authorization is revoked in breach of the conditions in the licence or concession, state responsibility may still arise. The next section examines discipline that international law places on the exercise of police powers.

2.2.2 Disciplining the Exercise of the Police Power: Abuse of Rights and Arbitrariness

[132]These formulations are used in the Harvard Draft and insurance mechanisms.

[133]Christie, *supra* note 36 at 335.

[134]J.F. Williams, "International Law and the Property of Aliens" (1928) 9 B.Y.I.L. 1 at 23-28.

Within the scope of the core police power regulatory functions, states exercise a broad discretion to regulate provided that the regulation is not an abuse of rights, arbitrary or discriminatory. Abuse of rights and arbitrariness and abuse of rights are often used interchangeably, but as described below, arbitrariness falls within the concept of abuse of rights. Abuse of rights is a general principle of public international law that disciplines state action. An abuse of rights may occur where a state exercises its rights in a manner that prevents other states from exercising their rights; exercises rights for a purpose other than that for which the right exists; or arbitrarily exercises rights and causes injury to another state but does not clearly violate its rights.[135] The concept of abuse of rights is an expression of the principle of good faith, codified in Article 26 of the Vienna Convention on the Law of Treaties, that provides that every treaty must be performed in good faith by the parties. The doctrine of abuse of rights focuses on the manner in which rights are exercised rather than the existence of a right. In the *Trail Smelter Arbitration*, the arbitrator held that the abuse must be of "serious consequence" and the injury must be "established by clear and convincing evidence".[136] In *Case concerning Rights of National of the United States of America in Morocco,*[137] a case dealing with the Nazi practice of imposing flight taxes, the ICJ found an abuse of rights where the state did not exercise its power to value property for the purposes of taxation "reasonably and in good faith".

Arbitral cases in the 19th and early 20th centuries affirm that a state is responsible for arbitrary conduct that damages property, such as wonton destruction or confiscation.[138] Under international human rights law, a person may not be arbitrarily deprived of property. The Universal Declaration on Human Rights of 1948 provides in Article 17:

> (1) Everyone has the right to own property alone as well as in association with others.
> (2) No one shall be *arbitrarily* deprived of his property. [emphasis added]

In *Case concerning Electtronica Sicula SpA (ELSI)* the ICJ stated:

> To identify arbitrariness with mere unlawfulness would be to deprive it of any useful meaning in its own right. Nor does it follow from a finding by a municipal court that an act was unjustified, or unreasonable, or arbitrary, that that act is necessarily classed as

---

[135]A. Kiss, Abuse of Rights in R. Bernhardt (ed.), *Encyclopedia of Public International Law,* Volume 1 (1992) at 4 - 5.

[136]3 R.I.A.A. 1907 at 1965 as quoted by Kiss, *ibid.* at 8.

[137]I.C.J. Rep. (1952) 176 at 212.

[138]See authorities cited in F.V. García-Amador, *The Changing Law of International Claims* (New York: Oceana Publications, Inc., 1984) at 187-191.

> arbitrary in international law, though the qualification given to the impugned act by a municipal authority may be a valuable indication.[139]

and

> Arbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law. This idea was expressed by the Court in the Asylum case, when it spoke of "arbitrary action" being "substituted for the rule of law" (Asylum Judgment, I.C.J. Reports 1950, p. 284). It is a wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety.[140]

This a nebulous standard for defining arbitrariness.[141] It also establishes a very high standard of review. In ESLI, the Italian Courts had found that the requisition of the ELSI plant was unlawful and beyond the administrative powers of the mayor. The ICJ held that illegality was not sufficient to make the mayor's conduct arbitrary. In dissent, Judge Schewebel held that a number facts made the requisition arbitrary - the requisition was an illegal act and was issued to assuage public opinion. He also criticized the majority for finding that the review of the mayor's order by the Italian courts corrected the arbitrariness of the mayor's act. The *ELSI* decision suggests a high and vague standard for a finding of arbitrariness. Hamrock argues that the ICJ's test of arbitrariness is subjective and unpredictable and he suggests a four part test for the determination of arbitrariness. A governmental action would be deemed arbitrary if (1) the action taken was not authorized by law; (2) the action was taken for an improper purpose; (3) the action was taken because of irrelevant circumstances; or (4) the action was patently unreasonable.

Various authors and authorities have proposed tests for the legitimate exercise of the police power. In his treatise, *Expropriation in International Law*, Wortley argues that regulation under the police power may justify the uncompensated deprivation of property, but that the state must not act carelessly or abusively.[142] Christie suggests that if a prohibition is "reasonably necessary to the performance by a State of its recognized obligations to protect the public health, safety, morals or welfare, then it would normally seem that there has been no 'taking' of property."[143] The Second Restatement provides that conduct causing damage to an alien does not depart from

---

[139]See *ELSI*, *supra* note 51 at 75

[140]See *ELSI*, *supra* note 51 at 76.

[141] K.J. Hamrock, "The *ELSI* Case: Toward an International Definition of "Arbitrary Conduct" (1992) Texas J. Int'l L 837 at 846.

[142]Wortley, *supra* note 27 at 110.

[143]Christie, *supra* note 36 at 338.

the international standard of justice if it is reasonably necessary for the maintenance of public order, safety or health.[144]

International law provides a broad margin of discretion in the exercise of police powers. Unlike international trade regulation where there are explicit disciplines on regulatory measures that may be trade-restrictive,[145] customary international law does not impose a least-investment restrictive standard for the treatment of property rights or require justification where the state deviates from internationally accepted standards or practices.[146] The increasing discipline on standards in international trade agreements may affect the determination of whether a government measure is arbitrary, can be based on a recognized police power justification and therefore whether state responsibility for expropriation arises. Standardization potentially limits government discretion by establishing regulatory standards against which government measures are assessed. For example, if there are Codex Alimentarius standards for a product, a ban on the product by the state may raise a rebuttable presumption that the state is acting arbitrarily. The interaction between international investment law and international trade law and the appropriate test for legitimate police power regulation is discussed in more detail in the following chapters.

2.2.3 Alternate Frameworks for State Responsibility for Regulatory Expropriation

Traditional international law analysis of state responsibility for expropriation focuses on whether there has been a deprivation of property, but then provides a defence or exception based on the police power. This is the framework set out in the proposed multilateral frameworks for investment reviewed in Section 2.1.5, in foreign investment insurance mechanisms and that supported by most international legal authorities. This framework of analysis has a clear parallel with US takings jurisprudence. Indeed, Reporters' Note 6 in the Third Restatement suggests that the line international law draws between regulation and expropriation is similar to that drawn in US takings jurisprudence. However, caution must be exercised in transferring US takings

---

[144]§197, *supra* note 30.

[145]See M.J. Trebilcock & R. Howse, *The Regulation of International Trade* 2nd ed. (New York: Routledge, 1999) and J. Johnson, *International Trade Law* (Irwin Law: Concord, 1998).

[146]See *ibid.* for a discussion of international standards and the Uruguay Round *Technical Barriers to Trade Agreement* ("TBT Agreement") and *Agreement on the Application of Sanitary and Phytosanitary Measures* ("SPS Agreement").

jurisprudence to international law because it represents only one state's view of the appropriate balance between private property and public rights.

A review of the sources of international law, including general principles of law, may suggest a different framework of responsibility for expropriation. Aréchaga argues that the legal foundation for the duty to compensate for expropriation is found in the doctrine of unjust enrichment. [147] While Aréchaga focuses on unjust enrichment as the guiding principle for determining the quantum of compensation, it could also serve as a general theory for determining when state responsibility arises for expropriation. State responsibility for unjust enrichment would require that the state pay compensation only where it acquires the use or benefit of property. Aréchaga argues that the total suppression of a detrimental or inconvenient industrial or commercial activity for reasons of general policy is not subject to compensation.[148] A review of national frameworks for compensation for expropriation gives some credence to unjust enrichment as a general principle of law. In some Commonwealth countries, including Canada, compensation is only required for expropriation when there is a deprivation of property rights and a corresponding appropriation of economic value.[149] This requirement is similar to the Sax's framework for takings that only requires compensation where the state acts as participant and enterpriser in acquiring and enhancing public goods.

The requirement that the government acquire something of value in order for there to be an expropriation was expressly rejected in the Iran-US Claims Tribunal jurisprudence.[150] But the appropriation framework cannot be so lightly dismissed. In all of the case reviewed in this Chapter, the state has arguably acquired, directly or indirectly, the use, benefit or management of the investor's property. In all of the early decisions there was a clear appropriation of property rights. In the Iran-US Claims Tribunal jurisprudence, while the Tribunal finds that a "state can interfere with property rights to such an extent that these rights are rendered so useless that they

---

[147]E. J. de Aréchaga, "State Responsibility for the Nationalization of Foreign Owned Property" (1978) 11 N.Y.U. J. Int'l L. & Pol. 179.

[148]*Ibid.* at 182.

[149]T. Allen, "Commonwealth Constitutions and the Right Not to Be Deprived of Property" (1993) 42 I.C.L.Q. 523. See Chapter Five for a review of Canadian expropriation law.

[150]Section 2.1.3, above.

must be deemed to have been expropriated",[151] in all of the cases in which a taking of property was found, Iran exercised such extensive control over the property that it could be deemed to have acquired its use. This is true with respect to the appointment of supervisors and managers and, arguably, also true with respect to the denial to permit the exportation of oil refinery equipment that is owned by the foreign national. The failure to allow exportation is a de facto appropriation of the property by the state. Finally, in the ICSID cases, there were physical takeovers of property or the abrogation of contracts. A cancellation of a contract, while a distinct species of wrong in international law, is conceptually similar to the state reacquiring rights that it has transferred by contract.

As I discuss in Chapter Five, Canadian expropriation cases suggest that appropriation is a flexible concept that can be used to ensure that government regulation of property does not go "too far" while avoiding the definitional uncertainties of the police power. Canadian courts have not applied the requirement for an appropriation of property formalistically. The courts have found negative prohibitions to amount to appropriations of property. It is striking that a Canadian court, using an appropriation analysis, found that the government had expropriated property in a case with facts very similar to *Lucas*.[152] In *Mariner Real Estate Ltd.* v. *Attorney General of Nova Scotia*[153] the a Canadian court found that public lands were benefited by the denial of permission to build single family residences in an ecologically sensitive beach area and that compensation was therefore due for an expropriation.

Based on the principle of respect for acquired rights, the majority of international authorities on expropriation focus on the deprivation of property rights as the basis for state responsibility. The international minimum standard is a standard designed to protect foreign nationals and focuses on the effect of state action. The significant weakness of the appropriation framework is its failure to consider the effect of government measures on the property owner. Government measures that are not an appropriation of property (even under a broad and flexible conception of appropriation) may deprive an investor of the effective control of an investment or from being

---

[151]*Supra* note 61.

[152]Section 1.1, above.

[153](1998), 165 D.L.R. (4th) 727, 171 N.S.R. (2d) 1 (N.S.T.D.).

physically able to operate its business. For example, a state may make it impossible for an investor to operate a factory by blocking the gates on the grounds of maintaining public order; through labour legislation it may set wages at a prohibitively high level; it may deny visas for required technical staff; or it may not allow the import of materials or equipment. Where one or a series of these measures continue for period of time, the interference may be so great that a deprivation could be deemed to have occurred even though there was no appropriation. In the next chapter, I examine what policy should underlie foreign investment protection and develop a framework for state responsibility for expropriation.

2.3 Conclusion

After decades of adjudication in domestic legal systems no precise theory or rule has developed to determine the line between expropriation and regulation.[154] A clear line does not exist in international law. Commentators have identified categories of expropriations that have been regarded as compensable takings but there is a lack of clear criteria for identifying regulatory expropriations.[155] The existing authorities on international law only provide some general principles for determining when interference with property rights should be compensated. In this chapter I reviewed the various sources of international law on the treatment of foreign-held property to discern some of the broad principles of state responsibility for expropriation, and, in particular, examined state responsibility for claims of regulatory expropriation. The principles are summarized below.[156]

1. A state must pay compensation to a foreign national whose property has been expropriated. Compensation must be made notwithstanding that the expropriation was for a public purpose, in the public interest or for legitimate social or economic reasons.

2. A state can be held responsible for expropriation even if it does not intend to expropriate property.

---

[154]Dolzer, *supra* note 20 at 44.

[155]Sornarajah, *supra* note 20 at 283.

[156]This list draws substantially on similar summaries by Christie, *supra* note 36 at 337-338 and Aldrich, *supra* note 55 at 217-218.

3. A formal act of expropriation, such as a transfer of title or confiscation, is not required in order for state responsibility to arise. The form of the government measure is unimportant. Rather, the focus is on the effect of the government measure on the property owner.

4. The majority of international legal authorities suggest that a state is responsible for expropriation if a government measures substantially deprives the foreign national of the use, enjoyment, management and control of property, whether or not the state has obtained anything of value. The incidental effects of regulatory action can be expropriatory.

5. A state is liable for outright seizures or appropriations of property.

6. State responsibility will arise where the conduct of the state is designed to cause the foreign national to abandon property or to sell it at a distress price.

7. If a foreign national retains substantial use of other property rights, a restraint on disposition or export of property from a state is unlikely to entitle the property owner to compensation for expropriation.

8. State responsibility does not arise for bona fide, non-discriminatory measures that are commonly accepted within the taxation and police powers of the state. An uncompensated deprivation of property rights can be justified under the state's police power to maintain the environment, public health, safety and morality and to enforce penal law.

9. If a state relies on the police power defence as the basis for non-compensation, the intention, motives and purposes of the state are relevant. The police power justification cannot be used if the state's actions are discriminatory or arbitrary.

10. There are no precedents in international law where a state has been held responsible for a regulatory expropriation because of the effect of measures taken to protect the environment, public health, safety or morality. The state may exercise broad discretion in regulating uses of property that the state deems harmful or injurious.

11. A property owner cannot be indefinitely deprived of property rights. Temporary deprivations are justifiable under the police power for compelling reasons of state.

12. A state is liable for acts that damage foreign property that are an abuse of rights under international law.

3. FRAMEWORK FOR STATE RESPONSIBILITY FOR REGULATORY EXPROPRIATION

Introduction

Foreign direct investment ("FDI") plays a significant role in the global economy. The private sector increasingly participates in basic infrastructure development in developing and developed countries. Basic infrastructure - ports, railways, roads, water and telephone services and electrical generation and transmission facilities - is often financed through FDI.[1] FDI has now surpassed official development assistance as the engine of sustainable development.[2] Global foreign direct investment ("FDI") flows are rapidly increasing. FDI inflows increased 19% in 1997 from $338 billion to a new record of $400 billion, while outflows reached $424 billion up from $333 billion in 1997. While developed countries receive two-thirds of inward FDI stock and are the source of 90% of outward FDI stock, in the 1990's developing countries increased their share of FDI inflows from $34 billion in 1990 (17% of global inflows) to $149 billion in

[1]See World Bank, *The Private Sector in Infrastructure: Strategy, Regulation and Risk* (Washington D.C.: The World Bank, 1997).

1997 (37% of global inflows).[3] The significant increases in FDI and the importance of FDI to the global economy have resulted in concerted efforts to develop more comprehensive international rules for the legal treatment of foreign investment.[4] Investment policy is on the agenda of many states and international organizations. In addition to the OECD's work on the proposed MAI,[5] the World Trade Organization ("WTO") and the United Nations Conference on Trade and Development ("UNCTAD") are analyzing investment issues.[6]

The controversy over the proposed MAI[7] and claims of expropriation under the NAFTA[8] reinforce the need for analysis of international investment protection rules. BITs typically require that a state pay compensation where the state directly or indirectly expropriates property or takes measures tantamount to expropriation, but they fail to define when a regulatory measure is expropriatory. This lack of clarity is a serious flaw in international investment agreements. A broad interpretation of expropriation potentially conflicts with a state's ability to regulate the economy and to adopt social regulations for the protection of the public and the environment, while a narrow interpretation may expose investors to abusive and opportunistic state conduct. In addition, since many investment agreements provide for binding investor-state arbitration, there is significant uncertainty about how the vague expropriation standard will be interpreted by

---

[2]D.C. Estey & B.S. Gentry, "Foreign Investment, Globalisation, and Environment" in *Globalisation and Environment: Preliminary Perspectives* (Paris: OECD, 1997) at 143.

[3]See *World Investment Report 1998: Trends and Determinants - Overview* (New York and Geneva: United Nations, 1998) at 1 - 12.

[4]See discussion in Section 2.1.5 on BITs and multilateral frameworks. More generally, see *World Investment Report 1998: Trends and Determinants* (New York and Geneva: United Nations, 1998) [hereinafter *World Investment Report*] at Chapters III and IV for a summary of international developments on investment protection, the Organisation for Economic Co-operation and Development's ("OECD") preparatory work on the draft Multilateral Agreement on Investment ("MAI") at http://www.oecd.org/daf/cmis/mai and World Bank, *Legal Framework for the Treatment of Foreign Investment* (Washington D.C.: The World Bank, 1992) [hereinafter *Legal Framework*].

[5]*Ibid.* For a collection of the OECD's declarations and decisions on international investment see Organisation for Economic Co-operation and Development, *OECD Working Papers Vol. V: The OECD Declaration and Decisions on International Investment and Multinational Enterprises Basic Texts* (Paris: OECD, 1997).

[6]UNCTAD's Commission on Investment, Technology, and Related Finance Issues studies the impact of international investment regulation on developing countries. The WTO has established a Working Group on the Relationship between Trade and Investment. See *World Investment Report*, *supra* note 4 at 71-73.

[7]For a summary of some of these concerns in Canada, see Canada, Third Report of the Standing Committee on Foreign Affairs and International Trade and First Report of the Sub-Committee on International Trade, Trade Disputes and Investment, "Canada and the Multilateral Agreement on Investment" (December 1997) and British Columbia, Special Committee on the Multilateral Agreement on Investment, First Report of the Special Committee on the Multilateral Agreement on Investment (29 December 1998).

[8]See Chapter Four.

arbitrators and the appropriateness of allowing foreign investors to use such a process to challenge social regulation.

In order to address the uncertainty over the scope of expropriation in international law, in this chapter I develop a framework for how international law should treat claims of regulatory expropriation. I argue that the level of investment protection in international law for foreign investment should be based on a policy of promoting investment flows that are welfare maximizing for both host states and foreign investors. Investment protection is primarily an instrument of economic policy[9] and reference solely to the principle of respect for acquired rights does not serve as a compelling basis for the development of international law on investment protection. In the first section, I argue that states should have significant autonomy in the regulation of foreign investment, even if regulation significantly interferes with property rights or the value of the investment. Allowing states to determine compensation policy for government measures that interfere with property rights is optimal because: (i) an international standard requiring compensation in all cases of regulatory expropriation is unlikely to be economically efficient; (ii) flexibility is maintained for host country welfare-maximizing regulation; and (iii) more effective and efficient risk allocation mechanisms are available to foreign investors. Compensation policy for regulatory expropriations should generally be a matter of domestic policy. Under a national treatment principle, foreign investors would receive effective equality of treatment. Investors should treat each state's compensation policy for regulatory and property rights transitions as another factor in assessing the suitability of the host state for investment. In the second section, I set out the basic criteria for an international minimum standard for investment protection. The international minimum standard acts as a mandatory default rule for the treatment of foreign investment and protects foreign investors from exploitative conduct that is discriminatory, arbitrary or opportunistic[10] by requiring compensation where the state acquires property for public uses, by ensuring that foreign investors receive effective equality of treatment with respect to measures affecting investment

[9]See J. Voss, "The Protection and Promotion of Foreign Direct Investment in Developing Countries: Interests, Interdependencies, Intricacies" (1982) 31 I.C.L.Q. 686.

[10]The concept of opportunistic behaviour by governments is considered by E. Atwood & M.J. Trebilcock in "Public Accountability in an Age of Contracting Out" (1996) 27 C.B.L.J 1 in the context of government contracting.

and by requiring states to accord investors a minimum standard of treatment. In the third section I address the relationship between investment protection and international trade law. Since border measures and other government measures that restrict trade may also have significant investment effects, overlaps between the disciplines in international trade law and international investment law may result in two parallel international disciplines for a government measure, each with different tests, processes and consequences. Under the framework proposed in this chapter, since compensation for regulatory expropriation would only arise for appropriations of property, it is unlikely that a border measure, such as an import restriction, would fall within the scope of appropriation. In order to avoid inconsistent results, reduce "system frictions"[11] and to provide equality of treatment between traders and investors, it is necessary to distinguish between those measures most appropriately subject to international trade law disciplines and those investment measures most appropriately subject to international investment law disciplines. As will be discussed, it is a conceptually and practically complex issue to establish rules to determine the circumstances in which international trade law and international investment law should apply to government measures that affect foreign investment.

This chapter does not address the investor-state arbitration process. As a result of investment claims under NAFTA, many critics have questioned whether investor-state arbitration is an appropriate dispute resolution mechanism for investment disputes. A related issue is the extent to which an essentially private international commercial arbitration process needs to be modified to provide greater transparency and representation of civil society interests.[12] For the purpose of this chapter, I assume that effective investment protection requires a binding dispute resolution process that provides effective remedies for violations of the international minimum standard of treatment. Whatever process is used, the substantive rules governing the scope of expropriation must be defined with greater clarity than hitherto in BITs and NAFTA. Chapter Five addresses the investor-state arbitration process.

---

[11]This term if used by Sylvia Ostry in the context of non-tariff barriers to trade. See Trebilcock & Howse, *infra* note 65 at 6.

[12]For a discussion of these issues see J. Soloway, "NAFTA's Chapter Eleven: The Challenge of Private Party Participation" (1999) 16 J. Int'l Arb. 1 for a discussion of the process under NAFTA. For dispute resolution under BITS, see R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995).

3.1 Policy Framework for Regulatory Expropriation

3.1.1 A Review of Proposed Policy Frameworks

There is very little analysis in international judicial and arbitral decisions on the policy rationale for imposing state responsibility for the state's treatment of foreign-held property. As described in Chapter Two, the primary rationale cited in international decisions for protecting property rights is the principle of respect for acquired rights. In addition, since many of the older expropriation cases involved discriminatory or arbitrary conduct by states, state responsibility arose independently under those principles.

The major studies by international law publicists that consider the scope of expropriation in international law acknowledge that international law fails to provide a detailed framework for determining when government regulation amounts to expropriation.[13] A number of these studies have reinforced the need for a policy basis for analyzing state responsibility for regulatory expropriation. In "The Taking of Property by the State",[14] Higgins argues that questions of property takings should be thought less as a conflict between the developed and developing world and more as a search about decision making for burden sharing in an interdependent world.[15] But Higgins does not develop a framework for how burdens are to be shared. Dolzer's approach is more methodological. He argues that in the absence of primary sources of international law, general principles of law provide a foundation for existing international law. He suggests that a study is required of all major legal systems and cultures to determine the operating principles in national legal orders. With respect to the distinction between prohibitions on optimal use, the prohibition of economically reasonable use and the prohibition of existing use, he writes that:

> [T]he various domestic orders uniformly indicate, in principle, that no compensation is due when the measure is necessary in order to protect the public from a danger arising

---

[13]See Chapter Two and, in particular, G.C. Christie, "What Constitutes a Taking of Property under International Law" (1962) 33 B.Y.I.L. 307, F.V. García-Amador *et al.*, *Recent Codification of the Law of State Responsibility for Injuries to Alien* (New York: Oceana Publications, Inc., 1974), D.F. Vagts, "Coercion and Foreign Investment Rearrangements" (1978) 72 A.J.I.L. 17, R. Higgins, "The Taking of Property by the State: Recent Developments in International Law" (1982) 176 Rec. des Cours 259, R. Dolzer, "Indirect Expropriation of Alien Property" (1988) 1 ISCID Rev. 41 and Weston, *infra* note 18.

[14]*Ibid.*

[15]*Ibid.* at 278.

> from the property; the police power in its various forms generally overrides property rights, even though certain definitional issues have plagued courts and commentators in this area. When the measure is not based on the police power and infringes upon existing use, the state normally will enter into conflict with legitimate expectations, i.e., the very foundations of the concept of property, and the destruction of investment-backed expectations based on property rights will typically violate the guarantee of private property in the absence of compensation.[16]

He notes that the application of the principles to specific cases may require judgments of a delicate economic and political nature.

Weston, in his work on the appropriate measure of compensation for nationalization and expropriation, has developed the most overtly policy oriented approach to expropriation. In his work on the international minimum standard for compensation he adopts a "preferred community policy".[17] He uses this analysis to analyze the "takings-regulation" problem and argues that:

> [t]he only true test of the international "taking-regulation" (compensation) problem would seem to be, in short, the test of a policy which favors a peaceful, productive, and equitable global economy perceived in terms of the common *inclusive* interests of the world community, perceived in terms of aggregate well-being. [18]

and

> it is no longer sufficient, if ever it was, to premise international responsibility on "acquired rights" or "sacrosanctity of private property" doctrine. In a world of competing economic ideologies, the principle of compensation, if it is to have any meaning at all, must be geared to policies which have as their central (and unifying) theme the promotion of a peaceful, productive, and equitable flow of wealth across national boundaries.[19]

Weston argues that the "takings-regulation" question is a compensation problem and is not capable of rational solution without reference to the overriding social policies that compensatory decisions are meant to serve.[20] Weston identifies three policies important to a peaceful, productive and equitable global economy.[21] First, the use of force through coercive practices

---

[16]Dolzer, *supra* note 13 at 62.

[17]B.H. Weston, "Community Regulation of Foreign-Wealth Deprivations: A Tentative Framework for Inquiry" in R. Miller & R. Stanger, eds., *Essays on Expropriation* (Ohio: Ohio State University Press, 1967) and B.H. Weston, "International Law and the Deprivation of Foreign Wealth: A Framework for Further Inquiry" in R. Falk & C. Black, eds., vol. 2, *The Future of the International Legal Order* (Princeton: Princeton University Press, 1970).

[18]B.H. Weston, ""Constructive Takings" under International Law: A Modest Foray into the Problem of Creeping Expropriation", (1975) 16 Va. J. Int'l L. 103 at 124.

[19]*Ibid.* at 147.

[20]*Ibid.* at 122.

[21]*Ibid.* at 124-130.

should be reduced as coercion is unlikely to produce a mutuality of interests promoting universal security and abundance. He argues that the more intrinsically coercive a government measure is, the more justified the demand for compensation. Second, Weston argues that the promotion of worldwide economic development requires foreign trade and investment and that "host country deprivative "regulations" that appear actually to retard global well-being by hindering economic development, as measured by, *inter alia*, all the foreign-wealth deterrence-withdrawal barometers explicitly and implicitly assembled in the traditional "taking"-"regulation" tests, should be deemed "constructive takings"".[22] According to Weston, the taking-regulation distinction should not depend on whether the foreign investment contributes to the state because such a distinction confuses liability with remedies. He argues that the distinction between beneficial and harmful foreign investment is central to the question of quantum and not the principle of compensation. It is unclear whether Weston's reference to harmfulness means the type of harms that police power regulation traditionally addresses or a wider and more overtly political conception of harm, such as foreign control of natural resources. It is reasonable to assume he means the latter because he accepts the traditional takings tests which acknowledge a police power defence. The third factor is the preservation of minimum human rights and the degree to which government measures are abusive of human right norms. In cases of direct takings there is a presumption of compensation so that no single person must bear a disproportionate burden of public projects.

More recently, Swanson, in referring to Weston's formulation of the "preferred community policy", has argued that international law should use a substantial diminution of value test under which a taking will be found when the state affects a foreign investment in such a way as to deprive the investor of substantially all value in an investment.[23] According to Swanson, in order to encourage international development, it is necessary to protect established economic values that are deprived of substantially all value.[24] He argues that the substantial diminution in value test is analogous to that used by Lagergren in *Starrett Housing Corporation* v. *Islamic Republic of Iran*. To recall the discussion in Chapter Two, in *Starrett*, Lagergren states that "[it]

---

[22]*Ibid.* at 128.

[23]S.R. Swanson, "Iran-U.S. Claims Tribunal: A Policy Analysis of the Expropriation Cases" (1986) 18 Case W. Res. J. Int'l L. 307 at 318.

is recognized in international law that measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the state does not purport to have expropriated them and the legal title to the property formally remains with the original owner."[25]

3.1.2 A Policy Framework for Regulatory Expropriation

The level of investment protection in international law for foreign investment should be based on a policy of promoting investment flows that are welfare maximizing for both host states and foreign investors. This requires a balance between stability and change. Investors generally desire economic, political and regulatory stability.[26] While some investors may make investments with the expectation or desire that significant changes in the domestic environment will create opportunities that they will be in the best position to capture, investors making large capital-intensive or infrastructure investments involving large sunk costs typically desire stability, security, transparency and predictability. Stability for investors means that the state into which the investor invests will not unduly frustrate the legitimate reliance of the investor.[27] Legitimate reliance is a necessary element in maintaining "a continuous and increased international flow of capital, which...is crucial for the development and stabilization of the international economy in general, and the economy of developing countries in particular."[28] But overly broad investment protection may have a number of negative effects that are inconsistent with optimal investment protection. A system of too stringent property rights limits regulatory flexibility and may hinder regulation that is welfare maximizing for the host state. States regulate property to protect the public interest by ensuring that property uses do not cause harm to public interests and that resources are used in a manner that maximizes social welfare. The regulatory regime affecting investment must adapt to changes in society. Investment protection policy must strike a balance between stability, security, predictability and fairness for the foreign investor and the legitimate state regulation of the economy and property uses. Stability does not

---

[24]*Ibid* at 320.

[25](1983) 4 Iran-U.S. C.T.R. 122 at 154.

[26]G. Verhoosel, "Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies: Striking a "Reasonable" Balance between Stability and Change" (1998) 29 Law & Pol'y Int'l Bus. 451 at 453.

[27]R. Dolzer, "New Foundations of the Law of Expropriation of Alien Property" (1981) 75 A.J.I.L. 553. at 579.

[28]*Ibid.* at 580.

mean regulatory standstill; it is not reasonable to expect laws never to change - expectations and reliance are a matter of degree.[29] As Weston notes, the essence of the law of state responsibility is to find an accommodation between the interest of states in achieving economic freedom and well-being and the interest of the foreign investor in being assured a minimum level of security and cooperation.[30] Important considerations in analyzing the appropriate international minimum standard of investment protection include: maintaining incentives for welfare maximizing compensation policy; the vulnerability of the foreign investor to unfair state conduct; maintaining flexibility for regulatory transitions and the availability of other investment protection mechanisms.

(a) Maintaining Incentives for Welfare Maximizing Compensation Policy

Since investment protection policy is an instrument of economic policy, economic analysis of law can provide insight into appropriate compensation policy for claims of regulatory expropriation and whether international law should require compensations for claims of regulatory expropriation.[31] In Chapter One, I concluded that claims for compensation of regulatory expropriation resulting from social regulation are not compelling. Economic analyses have concluded that compensation for expropriation leads to inefficiency assuming that "capital and insurance markets are perfect, governments do not suffer from fiscal illusion, and the takings decision is based on social welfare maximization and not the result of rent seeking."[32] Non-compensation maintains appropriate investment incentives by not encouraging over-investment or inducing moral hazard. Requiring compensation for claims of "environmental expropriation", for example, where a coal-fired electrical generation facility becomes no longer economically viable because of stricter environmental, may lead to over-investment in environmentally damaging investment. Whether compensation is economically efficient will also depend on the nature of the regulation and property interest affected. A general policy requiring states to

---

[29]See discussion of Kaplow's arguments Section 1.3.2, above.

[30]B.H. Weston, "The Charter of Economic Rights and Duties of States and the Deprivation of Foreign-Owned Wealth" (1981) 75 A.J.I.L. 437.at 475.

[31]See discussion in Section 1.3 on utilitarian and economic analyses of compensation and J.L. Dunoff & J. P. Trachtman, "Economic Analysis of International Law" (1999) 24 Yale J. Int'l L. 1 for a discussion of economic analysis of international law and a bibliography of law and economic analysis of international law. Also see J.P. Trachtman, "International Regulatory Competition, Externalization, and Jurisdiction" (1993) 34 Harv. Int'l L. J. 47.

[32]S. Ghosh, "Takings, the Exit Option and Just Compensation" (1997) Int'l Rev. L. & Econ. 157 at 157.

compensate for deprivations of diverse forms of property rights - real property, personal property, intellectual property, and a range of contractual and state granted authorizations - is unlikely to be efficient.

Michelman's utilitarian framework and Ghosh's analysis of the exit option provide sound rationales for compensation where the government acts as a participant and enterpriser in acquiring and enhancing public goods. Subject to an exception for taxation, in countries where there is a legal tradition of property rights protection there is a legitimate expectation that the government will not act in its enterprise role without paying compensation for the goods and services it acquires. Property values are not typically discounted to reflect the risk of this form of expropriation as the result of these settled expectations.[33] Compensation in cases of appropriation also disciplines the most egregious forms of fiscal illusion, opportunistic and discriminatory conduct and is consistent with principles of corrective justice. But where government prohibits the use of property as a result of social regulation, for example, from a regime of lower environmental protection to more stringent protection, there are less compelling reasons for compensation. In cases of social regulation where property rights are diminished or destroyed and there is no corresponding enhancement of a public enterprise, whether reliance on the regulatory status quo was justified and is normatively compelling requires a detailed assessment of the facts. While a non-compensation norm maintains optimal incentives because in circumstances of social change it "reflects a decision to encourage adaptive behaviour by rewarding individuals who most adroitly adjust in the face of change",[34] assuming other utilitarian considerations are equal, hard reliance cases where there is a complete deprivation of property rights should probably be compensated.[35] This is consistent with Michelman's framework where compensation is due for a nearly total destruction of some previously crystallized value which did not originate under clearly speculative or hazardous conditions.

---

[33]See *ibid*. at 153-159 for a discussion of rational expectations and assumption of risk.

[34]J.L. Sax, "Property Rights and the Economy of Nature: Understanding *Lucas v. South Carolina Coastal Council*" (1993) 45 Stan. L. Rev.1433 at 1449.

[35]J. Quinn & M.J. Trebilcock in "Compensation, Transition Costs, and Regulatory Changes" (1982) 32 U.T.L.J. 117 at 158 for analysis of the role compensation plays in regulatory transitions.

The international minimum standard of investment protection should serve as a supervisory mechanism over state conduct to ensure that states are not acting in a manner that is clearly abusive. States compete for foreign direct investment through investment protection and promotion policies and the comparative advantages the host state offers to investors. Subject to the disciplines of the international minimum standard proposed below, states should determine compensation policies for regulatory expropriations. In addition, at least in the present international environment, competition between states for foreign investment creates significant incentives for states to provide stable and predictable investment climates where the investment-backed expectations of foreign investors are respected. Investment promotion and protection policies adopted by developing countries demonstrate that states compete for FDI.[36] In an environment where states compete for FDI, states are sensitive to their reputations as destinations for investment because of investor perceptions of whether state commitments are credible.

While state competition is likely to have a positive effect on the treatment of foreign investment it is not sufficient as a discipline on potentially abusive and opportunistic state conduct. Vandevalde cautions that BITs are driven by economic nationalism and only offer a facade of liberalization since many do not discipline interventionist policies or performance requirements. He views the current trend to a more liberalized investment regime as fragile.[37] And Chua argues that privatization and influxes of foreign investment are not irreversible processes. With few exceptions, developing countries in Latin America and Southeast Asia "have been cycling back and forth between privatization and nationalization for as long as they have been independent."[38] As the result of shifting political and economic values, states may adopt more nationalist policies that take advantage of the particular vulnerability of foreign investors. It is at these times that an effective international minimum standard of treatment is most needed to protect foreigner investors from exploitative state conduct.

---

[36]See *World Investment Report*, *supra* note 4 and United Nations Conference on Trade and Development, *Survey of Best Practices in Investment Promotion* (New York and Geneva: United Nations, 1997).

[37]K.L. Vandevelde, "The Political Economy of a Bilateral Investment Treaty" (1998) 92 A.J.I.L. 621 and K.L. Vandevelde, "Sustainable Liberalism and the International Investment Regime" (1998) 19 Mich. J. Int'l L. 373.

(b) The Vulnerability of the Foreign Investor to Unfair Conduct

The international minimum standard of treatment for foreign-held property evolved in the 19th century to protect foreign nationals from exploitative conduct while travelling, living or doing business abroad. Foreign investors are particularly vulnerable to abusive state conduct because they lack political representation ('voice") and because they often cannot leave the jurisdiction without losing the benefit of their investment ("exit").[39] The lack of voice and exit options deprive the foreign investor of two important disciplines on unfair conduct. In a domestic political system, politics is an ongoing process of political accommodation. If this process works in everyone's interests equally, the benefits and burdens of government action, while potentially having a disproportionate effect in the short term, should balance out over the long-term. This is often referred to as the "log-rolling" phenomena. [40] While log-rolling may result in a balance of gains and losses over the long-term, whether this occurs is empirically difficult to ascertain. In the case of deprivations of property rights affecting foreign investors, it is unlikely log-rolling will protect the investor. First, the investor typically lacks representation in the political process and may not have any input into decisions that significantly affect its investment. The lack of representation in the political process can be seen as a special type of demoralization cost because the losers in the political compromise lack the political influence or standing to ensure that they receive either some type of in-kind compensation or receive concessions in the future. Second, receiving reciprocal advantages in the long-run will not mitigate the burdens of regulation where the investor hopes to recoup its investment in the short-term and to leave the jurisdiction. Third, where government measures result in very severe losses, it is unlikely that adequate subsequent benefits will be obtained to off-set losses. For example, nationalization policies are often predicated on the assumption that the foreign investor will be excluded from future economic participation in the economy. Fourth, economic nationalism is often a popular domestic policy. The nationality of the foreign investor makes the foreign investment a target for government measures. Finally, payments of compensation to a foreign investor may be

---

[38]A.Chua, "The Privatization-Nationalization Cycle: The Link Between Markets and Ethnicity in Developing Countries" (1995) 95 Colum. L. Rev. 223.

[39]See A. Hirschman, *Exit, Voice, and Loyalty - Responses to Decline in Firm, Organizations, and States* (Cambridge University Press, 1970) on the concept of voice and exit as disciplines on market actors.

[40]This discussion draws on the analysis of log-rolling in Quinn & Trebilcock, *supra* note 35.

viewed as a political failure, and are unlikely to be widely supported by the domestic political constituency.

In addition to a lack of voice, investors may not be able to "exit" as a risk mitigation strategy, especially where investment is immobile or costs are sunk. A foreign national with a sunk investment, for example, an infrastructure development such as a water or electricity concession, is extremely vulnerable to indirect or creeping forms of property deprivation through a series of regulatory measures. Cases such as *Revere Copper*[41] demonstrate how a series of regulatory measures can make an investment financially unviable. In addition, by taking advantage of a foreign investor's lack of voice and the inability of investors to exit the jurisdiction, the state can choose policies that, while not overtly discriminatory, externalize the cost of social regulation to foreign investors. It is important to note that a foreign investor's vulnerability is context dependent. In cases where an economically powerful transnational corporation invests in a country, it may have significant influence on host country policy. In addition, transnational corporations are able to diversify and self-insure more efficiently. Small and medium-sized enterprises are the most vulnerable to host state measures. Insufficient legal protection is a significant disincentive to investment by small and medium-sized enterprises.[42]

Foreign investors are vulnerable to administrative arbitrariness by the host state. According to Levy and Spiller, the ability of a state to make credible commitments to foreign investors depends on the extent to which structures exist in a state to constrain arbitrary administrative action.[43] A necessary condition for sustained and large-scale private investment is that administrative arbitrariness be restrainable. In the context of utility regulation, Levy and Spiller argue that utilities are particularly vulnerable to "administrative expropriation" because regulators may set prices below long-run replacement costs. In order to promote investment, states require institutions that reduce the potential for opportunistic state behaviour while not imposing undue constraints on appropriate regulation. Since states differ in their institutional

[41] *Supra*, section 2.1.6.

[42] Voss, *supra* note 9 at 691.

[43] B. Levy & P.T. Spiller, "Regulation, Institutions, and Commitment in Telecommunications: A Comparative Analysis of Five Country Studies" in *Proceedings of the World Bank Annual Conference on Development Economics 1993* (Washington: The World Bank, 1994).

endowments, they use different mechanisms to resolve the tension between stable rules and maintaining flexible regulatory regimes to respond to changes. Levy and Spiller's study indicates that countries that lack investor confidence may have to sacrifice regulatory flexibility in order to provide credible commitments. For example, explicit commitments can be legislated and incorporated into a licence or project agreement that is binding on the state rather than allowing regulators to have extensive administrative discretion. While legislated commitments may be subject to legislative over-ride, once a state is contractually bound to an investor, subsequent attempts to cancel, void or unilaterally amend such contract rights may rise to a claim of expropriation or a claim to breach of contract under international law.[44]

In order to protect investors, the international minimum standard should discipline the most abusive and opportunistic forms of arbitrary administrative action and require respect for contractual commitments. Where a country is unable to provide credible commitments because of a lack of national institutions, voluntary substitutes, such as contractual commitments and investment guarantees issue by the Multilateral Investment Guarantee Agency, or other foreign investment insurance mechanisms, are available.[45]

(c) Maintaining Flexibility for Regulatory Transitions

Objections to the expropriation provisions in NAFTA and the draft MAI focus on their potential scope and the concern that governments will have to pay compensation when they pursue social regulation that interferes with property rights or reduces the value of an investment. Many commentators argue that NAFTA, the Energy Charter Treaty[46] and the draft MAI cover "environmental expropriations". It is claimed environmental expropriations could include: remediation orders to prevent toxic seepage; changes to existing concession licences to protect fisheries, flora or fauna; changes to land use regulation; and requirements to use only environmentally acceptable resource extraction techniques that increase the costs of resource

[44]See *infra* note 53 regarding the enforceability of state contracts.
[45]See Section 2.1.6, above.
[46]G. Verhoosel, *supra* note 26 at 466.

extraction.[47] While governments would not be prohibited from pursuing such policies, the requirement to pay compensation would require that states "rent-back" jurisdiction by paying compensation for measures depriving investors of property rights.[48] As a result of political and budgetary constraints, a requirement for states, particularly developing states, to pay compensation for deprivations of property rights may deter socially efficient regulation and result in less optimal forms of regulation.[49]

Social regulation under a state's police powers will typically involve the regulation of activities that the state, through its political processes, determines are harmful. Police power regulation such as the protection of health, the environment, and public order, often depends on the level of risk a society is willing to bear and fundamental choices of political philosophy. Where the actions of a member of society are deemed harmful to the interests of society, the state regulates the harm-causing action. Social regulation internalizes or prohibits externalities, in order that the exercise of one person's liberties does not infringe those of another. While there is no guarantee that the political process will result in welfare maximizing regulation, regulatory transitions are the political expression of what a state determines to be welfare-maximizing. In a well-functioning political process, the legal framework for transitions is mediated through the political process and the particular transition policy chosen will be the result of political compromise.[50] Regulatory transitions are the playing out of political compromises and allow public and private rights to evolve over time. As a general rule these choices should be respected.

The concern for the foreign investor is that unanticipated regulatory measures may threaten the viability of an investment project. Failure to obtain environmental approvals, closure of energy and mining facilities for environmental reasons and discriminatory application of laws may

---

[47]Legislative Assembly, Province of British Columbia, Special Committee on The Multilateral Agreement on Investment, *First Report*, (29 December 1999) at 107.

[48]Testimony of I. Robinson, University of Michigan, (9 October 1998) before The Special Committee on The Multilateral Agreement on Investment, Legislative Assembly, Province of British Columbia.

[49]D. Cohen & B. Radnoff, "Regulation, Takings, Compensation, and the Environment: An Economic Perspective" in C. Tollefson, ed., *The Wealth of Forests: Markets, Regulation, and Sustainable Forestry* (Vancouver: UBC Press, 1998) at 320.

deprive a foreign investor of the ability to operate a facility. According to Verhoosel, environmental regulation in developing and transition economies is one of the most unpredictable factors facing potential investors and has a detrimental impact on foreign investment and the transfer of environmentally sound technology.[51] Foreign investment may be discouraged if investors lack the ability to manage these risks.

Allowing states to pursue legitimate social regulation without compensation is a fundamental recognition that each state is in the best position to decide what type of regulatory transitions and compensation policy is welfare maximizing for the host state. Regulatory transitions that foster sustainable development through changes to economic, environmental, health and safety regulation should be promoted. While security and stability is significant to investors, it should not be the role of international law to require states, particularly developing states, to pay compensation for regulatory transitions that foster sustainable development or protect citizens from harmful uses of property. Dolzer argues that "[r]eliance upon structures that reinforce underdevelopment does not deserve protection under modern international law; for arrangements falling into this category, the risks involved should probably be allocated to the investor".[52] In the event of regulatory transitions from a low health, environmental or safety regime to a higher standard regime, states should be able to establish and modify their proper levels of health, environmental, and safety regulation and determine transition policy. A presumption of non-compensation policy for regulatory expropriation maintains optimal incentives because it encourages adaptive behaviour in investors and allows flexibility for regulatory transitions.

(d) The Availability of Other Investment Protection Mechanisms

The international minimum standard for the treatment of foreign investment is only one of a number of mechanisms that are available to protect foreign investors from property deprivations. Investors have access to other risk management mechanisms. These include contractual

---

[50]See generally L. Kaplow, "An Economic Analysis of Legal Transitions" (1986) 99 Harv. L. Rev. 511 and Quinn & Trebilcock, *supra* note *supra* note 35.

[51]Verhoosel, *supra* note 26 at 453-454.

[52]Dolzer, *supra* note 27 at 587 (footnotes omitted).

provisions in project and investment agreements,[53] national investment codes and other domestic legal protections,[54] foreign investment insurance[55] and diversification of investments. In addition to investment protections, to the extent that government measures affect trade in goods or services that have an incidental affect on an investment, the General Agreement on Tariffs and Trade and the WTO agreements resulting from the Uruguay Round provide explicit disciplines on government measures and a binding state-to-state dispute resolution mechanism.

Foreign investors, particularly those involved in infrastructure or natural resource extraction projects with significant sunk costs, often negotiate stabilization or freezing clauses in their project agreements with states to ensure that project operations are not adversely affected by changes in fiscal, environmental and other regulation. In recent years, re-negotiation clauses and risk allocation provisions have been included in investor-state contracts.[56] Under international law, state responsibility may arise for the cancellation of contracts or the voiding of state-granted property interests. Cancellation or a measure tantamount to cancellation that is confiscatory is a form of expropriation of property for which state responsibility may arise, unless there is some commercial or police power justification for the cancellation.[57]

Investment specific agreements on regulatory frameworks and compensation are more likely to produce welfare-maximizing results than the requirement that all property deprivations be compensated. Through a project specific agreement, the investor can obtain contractual protection for key operational and regulatory requirements, for example, specific provisions on rates of return for a electricity generation project, increases in tolls for a road concession or environmental standards.

---

[53]This paper does not address the international law on the enforcement of investor-state contracts and, in particular, the validity of stabilization clauses. See generally *Legal Framework*, *supra* note 4 and Verhoosel, *supra* note 26 at 456 who writes that "arbitral practice has explicitly and repeatedly confirmed the validity of stabilization clauses".

[54]See "Principles Governing Foreign Investment as Reflected in National Investment Codes" in *Legal Framework*, *supra* note 4 at 107 and the bibliography on national investment codes at 199.

[55]See Section 2.1.6, above, for a discussion of insurance mechanisms.

[56]Verhoosel, *supra* note 26 at 455.

[57]See discussion in I. Brownlie, *Principles of Public International Law*, 5th ed. (Oxford: Clarendon Press, 1998) at 549 – 555.

Many countries have adopted investment codes to promote and protect foreign and to immunize investors against the negative impact of possible changes in domestic policy. Although the codes are not immune from legislative override and there is uncertainty with respect to the legal effect of stability provisions in investment codes and the extent to which they provide the same protection as contractual stabilization clauses,[58] the codes reflect a commitment to provide ground rules for foreign investment. Investment codes regularly contain stability provisions providing that the contractual rights and fiscal regime applicable at the time of making the investment will not be altered.[59] Some of these investment codes are sector specific. For example, the *Russian Production-Sharing Agreement*[60] (the "PSA") provides a legislative code for investments in the oil sector. It contains a stability provision providing that if regulation is passed that adversely impacts the investor's "commercial results under the Agreement, the Agreement shall be subject to amendment in order to ensure that the Investor obtains the commercial results he could have obtained if the legislation ... effective as of the date of the Agreement conclusion, had applied."[61] The PSA has an explicit exemption for bringing health, safety, environmental regulation into conformity with accepted and generally recognized international practice and standards.[62] In addition, regulatory regimes for industries where the risk of administrative arbitrariness is high can provide for explicit legislated commitments that provide for binding agreements between foreign investors or the state.[63]

Foreign investment insurance and contractual mechanisms allow foreign investors to allocate risk more effectively and efficiently than through a international minimum standard requiring compensation for all deprivations of property rights. The international minimum standard sets the mandatory default rules for treatment and is unsuited to implement compensation policy for the effect of regulatory changes on disparate types of investment and property rights. Investors are likely to be in the best position to assess the risks of regulatory change on their investment

---

[58] See Verhoosel, *supra* note 26 at 460-461.

[59] Verhoosel, *supra* note 26 at 461

[60] (1996) 35 I.L.M. 1251.

[61] *Ibid.* Article 17 from Verhoosel, *supra* note 26 at 461.

[62] The PSA does not define international practice and standards and Verhoosel argues that the vagueness of the general exception may potentially deter foreign investors and could be the source of considerable litigation. See Verhoosel, *supra* note 26 at 462.

[63] Levy & Spiller, *supra* note 43 at 233.

and to adopt appropriate risk management strategies. The use of different risk allocation mechanisms (insurance, contractual provisions and diversification strategies) allows investors to tailor a investment-specific investment protection strategy. If specific regulatory transitions are highly risk sensitive for a specific investment project, appropriate risk management strategies can be adopted.

3.2 Legal Framework for State Responsibility for Regulatory Expropriation

In this section I propose a legal framework for investment protection for property rights. The international minimum standard for regulatory expropriation must balance the need for stability and fairness with state regulatory autonomy, sustainable development and respect for domestic policy choices. In the previous section, I argued that states should have a significant degree of discretion in regulating property rights because it is more likely to be economically efficient, it allows states to pursue welfare-maximizing policies and that contractual provisions and insurance allow foreign investors to identify and allocate risks. This section focuses on the minimum protections that are required to protect foreign investors from opportunistic conduct.[64]

In the context of trade regulation, Trebilcock and Howse have recently argued that states should have substantial political autonomy in formulating domestic regulatory and related policies, provided they respect a fully elaborated principle of non-discrimination.[65] Non-discrimination requires that states accord national treatment, guarantee effective equality of competitive opportunities and that the state does not engage in disguised or unjustifiable forms of discrimination. Non-discrimination is fully consistent with the policy framework in the previous section. It allows states to pursue domestic policies but requires that the state justify any treatment that does not provide effective equality of opportunity. Foreign investors should only be entitled to supernational treatment (the international minimum standard) where the effect of

[64]See E. Atwood & M.J. Trebilcock, "Public Accountability in an Age of Contracting Out", *supra* note 10 on opportunism in government contracting.

[65]M. Trebilcock & R. Howse, "Trade Liberalization and Regulatory Diversity: Reconciling Competitive Markets with Competitive Politics", (1998) 6 Eur. J. L. & Eco. 5

domestic regulation falls below well-accepted standards of justice.[66] In the context of investment protection, the international minimum standard should require that states compensate foreign investors when property is acquired. The burden of enhancement to public enterprises should not be borne by one property owner, and, in particular by a foreign investor who is vulnerable to opportunistic state conduct. The other elements of the international minimum standard of treatment include respect for investor-state contracts, national treatment and a minimum standard of fair and equitable treatment.[67] Each element is considered below.

3.2.1 Expropriations of Property

The most discriminatory form of state conduct is where a states acquires property for a public purpose without compensating the property owner. International law has recognized that a state can acquire the use and benefit of property in myriad ways. The international authorities reviewed in Chapter Two indicate that the form of the measure and the intention of the state are irrelevant. International law imposes state responsibility for a variety of forms of property deprivation. The most common categories of appropriation are nationalizations, physical occupations, transfers of property, forced sales and the creation of state monopolies. The requirement for compensation for appropriations essentially captures what Sax refers to as the state acting as participant and enterpriser in acquiring and enhancing public property.[68]

Another significant form of indirect appropriation is government acquisition of an investor's fundamental rights to manage and control its investment. This situation is considered in Section

---

[66]See E.M. Graham, "Regulatory Takings, Supernational Treatment, and the Multilateral Agreement on Investment: Issues Raised by Nongovernmental Organizations" (1998) 31 Cornell Int'l L. J. 599 who argues that foreign investors should not receive supernational treatment.

[67]In a recent article on the MAI, Graham outlines a similar approach. He argues that traditionally the major purpose of investment protection has been to protect foreign investors from discrimination by the host state actions. Graham reviews economic analyses of compensation for expropriation concludes that as a result of moral hazard and transactions costs, compensation for regulatory takings does not result in efficient outcomes. Graham argues that the expropriation provisions of the MAI should only apply to physical takings. Otherwise, foreign investors would receive supranational treatment and be privileged as compared to domestic investors. But he argues that if a state applies its regulations in a highly discriminatory manner so as to create a *de facto* expropriation or a significant diminution of value, the investor should be protected. He suggests a requirement that if a regulation is significantly prejudicial, for example if national treatment is denied, or due process of law has been denied, then state responsibility should arise. See E.M. Graham, *ibid.*

[68]See Sax, Section 1.1, above.

2.1.3 in the review of Iran-US Claims Tribunal decisions, such *Tippetts* and *Starrett*.[69] Where a state exerts managerial control over an investment, for example, through the appointment of managers, supervisors or administrators and the appointment is not a temporary, the state effectively acquires the investor's fundamental management rights.

The requirement for states to pay compensation for appropriations of property should not be formalistic; all forms of direct and indirect appropriation would fall within the scope of appropriation. For example, Canadian jurisprudence on the meaning of appropriation has held that an appropriation can occur through a negative prohibition.[70] In *British Columbia* v. *Tener*,[71] Tener held Crown granted mineral claims in a provincial park. The Court found an appropriation where the government denied Tener access to the park to mine the claims. The Court determined that denial of access to the lands amounted to the recovery by the Crown of a part of the mineral rights that it had previously granted. Where government regulation such as in *Lucas* or *Mariner Real Estate Ltd.*[72] results in land losing all economic value through stringent prohibitions on uses, such that the land obtains park-like status, a tribunal may find that the measure is appropriation of property because the government has effectively acquired a property interest in the regulated property. An "appropriation" would clearly require that the state has acquired a property interest, as defined in that state's domestic law.

What amounts to an appropriation of property is not without doubt, and the use of an appropriation framework for state responsibility will not resolve all uncertainties. Nevertheless, this approach offers several advantages. The requirement for the state to have acquired a property interest as defined by domestic law has a defined scope. Requiring compensation in cases of appropriation is unlikely to interfere with domestic regulatory authority. But since cases of regulatory expropriation, like cases of nuisance, are highly fact contingent, there is some

[69]In *Starrett*, the Iranian government appointed a manager who took over the management of a large apartment project. In *Tippetts*, the Iranian government appointed a manager for a joint venture project. See Section 2.1.3, above.

[70]See Section 5.1, below, for a discussion of Canadian expropriation law.

[71]*British Columbia* v. *Tener*, [1985] 1 S.C.R. 533.

[72]See discussion in Section 1.1, above, on *Lucas* and in Section 2.2.3, above, on *Mariner Real Estate Ltd.*

inherent uncertainty as to what an investment tribunal characterizes as an appropriation of property.

The most controversial area of state responsibility is the question of compensation for where a state measure deprives the investor of property rights or the benefit of its property, but where there is no appropriation of property. This is typically the case with many forms of social regulation, such as environmental regulation of property. From the perspective of the foreign investor whether there is an appropriation of property is irrelevant. Through skillful design of regulation, it is possible that a state could impose regulatory measures that functionally have as severe an effect on the investor as an outright appropriation. By adopting appropriation as the guiding principle for state responsibility for expropriation, I have chosen not to follow the approach favoured by many international legal authorities. That approach, exemplified by the Third Restatement, focuses on whether there is a substantial deprivation of property but allows states to justify such deprivations under the police power. Conceptually it is very difficult to delineate between takings and police power regulation and to define with any certainty when the police power should justify a taking while respecting domestic political autonomy. Bona fide and reasonable social regulation can have severe effects on property rights, the cases are very fact specific, involve competing legitimate interests and occur on a spectrum ranging from slight regulatory burden to regulation that completely destroys investment-backed expectations. Tests of deprivation that focus on significant reductions in value or the deprivation of the benefit of an investment suggest that the role of the international minimum standard is to protect economic value. However, welfare maximizing regulatory transitions may incidentally result in losses of economic value. Investment protection should be designed to protect investors from unfair treatment and not to provide insurance for the effects of all forms of state interference. Under the framework proposed in this section, in addition to the protection from all forms of appropriation, all government measures would be subject to a national treatment requirement and review under the minimum standard of treatment as defined below. Cases of administrative arbitrariness will likely violate one of these two principles. In particular, any measure designed or intended to cause economic injury to a foreign investor would be a violation of the minimum standard of treatment. For additional protection, a foreign investor can avail itself of the risk management mechanisms described in the previous section.

Under this framework, as a general rule, most forms of regulatory prohibition would not amount to an appropriation of property. For example, no claim of expropriation would arise if a government banned the production and sale of a product that it deemed to be dangerous to public health, even if this resulted in the complete loss of the value of the investor's investment. In contrast, an appropriation may occur if the government prohibited production and sale of the product by the investor and then took over the production through a government corporation. Under the proposed framework the government's decision to prohibit production and sale could not be clearly unreasonable or be motivated by the desire to harms the foreign investor. As is considered below, such action would violate the minimum standard of treatment.

An appropriation framework does not entail a rejection of international case and arbitral authority. The review of international authorities in Chapter Two suggests that decided cases are generally consistent with imposing state responsibility for appropriations of property. Requiring compensation for appropriations of property avoids definitional uncertainties over the broadness of the deprivation framework and concerns that it requires compensation for social regulation that interferes with the economic viability of an investment. And, in conjunction with the other elements of the proposed international minimum standard, it provides a high degree protection against opportunistic and exploitative state conduct. In addition, on a purely pragmatic and political level, since the appropriation framework conceptually limits expropriation to where government acquires some defined property right, it may prove to be a much more internationally acceptable standard of investment protection and allay concerns that investment protection will prevent states from enacting social regulation.

3.2.2 National Treatment

Foreign investors are particularly vulnerable to discriminatory measures taken by the host state. The customary international law minimum standard provides that the state may not expropriate in a discriminatory manner. This standard is vague and requires elaboration. In order to provide protection against exploitative and discriminatory treatment that causes economic injury, states should accord national treatment to foreign investors. This requirement is in accordance with

state practice in BITs and plurilateral agreements such as NAFTA. A national treatment provision would require that a state accord the investor and the investment no less favourable treatment than the state accords to its own investors and their investments in like circumstances with respect to the management, operation, maintenance, use, enjoyment or disposal of investments.[73]

According to Trebilcock and Howse, effective equality of opportunity lies at the heart of the national treatment principle. [74] In the context of international trade regulation they argue that measures that have a substantial disparate impact on foreign trade should require a demonstration that they (i) serve a non-trade related domestic policy and are not a disguised form of discrimination (the sham principle); and (ii) are not an unjustified means of obtaining those objectives (the least restrictive means or proportionality test). They further argue that the burden of proof for complainants should be relatively high in order to respect domestic political sovereignty and to ensure supra-national panels do not simply second-guess domestic policy decisions. They suggest that a clearly unreasonable standard may be an appropriate middle ground between complete deference to domestic regulation and a "correctness standard". Trebilcock and Howse's proposal is an appropriate standard for the national treatment of foreign investors. Particularly because foreign investors are physically located in a host country and subject to all national laws, fair treatment of foreign investors requires an effective national treatment principle. Otherwise, government measures can be designed to have disproportionate impacts on foreign investors. This may allow the costs of social regulation to be externalized onto foreign investors. Requiring states to justify measures that have a disparate impact on foreign investors provides effective constraints on discriminatory policies. National treatment ensures that investors can compete on a equal footing with nationals and discipline other forms of exploitative state conduct.[75]

---

[73]National treatment with respect to the right to establishment raises issues other than investment protection. National treatment in the context of investment protection is limited to protection once the investment is made.

[74]Trebilcock & Howse, *supra* note 65 at 31-32.

[75]The test for what constitutes "in like circumstances" must have sufficient flexibility to allow investment specific regualtion. For example, environmental permitting and regulation is becoming increasingly site specific because of the unique ecological characteristic of sites. See International Institute for Sustainable Development, *NAFTA's Chapter Eleven and the Environment: Addressing the Impacts of the Investor-State Process on the Environment* (Winnipeg: International Institute for Sustainable Development, 1999) online: IISC homepage

3.2.3 Respect for State Contracts

Where an investment is particularly prone to "administrative expropriation" it will generally be optimal for investors and states to allocate the risk of regulatory expropriation contractually, rather than requiring states to pay compensation under the international minimum standard. The effectiveness of contractual risk allocation requires that states respect contractual obligations.[76] In most large scale investment projects there are significant sunk costs and certain conditions must exist in order for the project to be economical. Project agreements with the host state can allocate risks of regulatory change. Projects with significant sunk costs are potentially immune to exploitative government regulation because the economic viability of the project depends, as in *Revere Copper*, on investment-backed expectations and a continuous stream of management decisions. Government regulation can affect all aspects of a project from hours of operation, environmental regulation to taxation. Since the risk of regulatory changes is significant, foreign investment in large scale projects is more likely to be welfare-maximizing when the risks of regulatory transitions are allocated contractually. Where risks are not expressly allocated, the international minimum standard would apply as the default rule.

3.2.4 Minimum Standard of Treatment

Even if an investor is accorded national treatment, a state may act opportunistically or treat a foreign investor abusively. The international minimum standard of treatment in customary international law is designed to ensure that states are responsible for injuries and damages caused by arbitrary acts. The customary international standard of treatment requires that states not act arbitrarily or commit an abuse of rights. In addition, under customary international law, states may not deny judicial protection to a foreign investor in a way that constitutes a denial of justice.[77]

<http:iisd1.iisd.ca/trade/chapter11.htm> (last accessed: 22 July, 1999) [hereinafter IISD Chapter Eleven Report] at 30-31.

[76]The framework proposed here does not address the enforceability of investor-state contracts. The framework assumes that a state's contractual commitments are binding. See generally, *Legal Framework for the Treatment of Foreign Investment*, *supra* note 4 at 137 for a discussion state contracts and the principle of *pacta sunt servanda*.

[77]See R.B. Lillich, ed., *International Law of State Responsibility for Injuries to Aliens* (Charlottesville: University Press of Virginia, 1983), C.F. Amerasinghe, *State Responsibility for Injuries to Aliens* (Oxford: Clarendon Press, 1967), A. Freeman, *The International Responsibility of States for Denial of Justice* (New York:

Almost all recent BITs provide that states must accord investors "fair and equitable" treatment. There is no general agreement on the meaning of this provision and, specifically, whether it represents an independent, self-contained standard, or whether it is simply a reference to the minimum standard of treatment required by international law (i.e. non-discrimination, no abuse of rights and no denial of justice).[78] The NAFTA and many BITs also provide that the state will accord full protection and security to an investor. This obligation refers to state protection of investments from destruction or damage by third parties. Full protection and security does not make a state strictly liable for injuries resulting from civil unrest or other injuries to investment caused by third parties. It imposes an obligation on the state to exercise due diligence to protect the investment.[79]

Customary international law prohibits arbitrary conduct by the state but does not provide a workable test for determining when state conduct is arbitrary or for constraining conduct that is opportunistic. The use of the "fair and equitable treatment" standard is an appropriate standard with respect to procedural fairness, but it is inappropriate for all government measures to be subject to detailed review of whether the policy choices made by the government are fair and equitable based on some conception of distributive justice. This is objectionable for the same reasons that Trebilcock and Howse acknowledge in the context of trade regulation. It would invite "supra-national panels to second-guess the domestic policy choices of democratically elected, accountable, and competitive governments by applying a strict *de novo* cost-benefit analysis of their own."[80] The term "fair and equitable treatment" lacks precision because it is not clear to what extent it is a requirement for fair and equitable administrative and judicial processes as compared to fair and equitable measures; "treatment" has a wide meaning and likely disciplines both procedural and substantive acts and omissions.

Kraus Reprint Co. 1970), G. Fitzmaurice, "The Meaning of the Term "Denial of Justice"" (1932) 13 B.Y.I.L. 93 and S. Verosta, "Denial of Justice", R. Bernhardt ed., *Encyclopedia of Public International Law*, (1992) Volume I at 1007 and Section 2.2.2, above.

[78]R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995) at 58-59.

[79]*Ibid.* at 61 and *Asian Agricultural Products Ltd.* v. *Republic of Sri Lanka* (ICSID Case No. ARB/87/3), Award of the Tribunal dated 21 June 1990, *reprinted in* (1991) 6 ICSID Rev. - FIJL 526 at 543-548.

[80]Trebilcock & Howse, *supra* note 65 at 32.

The MAI Negotiating Text (as of 24 April 1998)[81] has the following provisions on investment protection:

> 1.1 Each Contracting Party shall accord to investments in its territory of another Contracting Party fair and equitable treatment and full and constant protection and security. In no case shall a Contracting Party accord treatment less favourable than that required by international law.
>
> 1.2 A Contracting Party shall not impair by [unreasonable or discriminatory] [unreasonable and discriminatory][82] measures the operation, management, maintenance, use, enjoyment or disposal of investments in its territory of investors of another Contracting Party.

The concept of fair and equitable treatment is an appealing standard. Investment protection policy should surely ensure that foreign investors are treated fairly and equitably. But as a substantive standard, what is fair and equitable is impermissibly vague and subject to wide variations of interpretation. The requirement for fair and equitable treatment should be limited to fair and equitable procedural treatment. In order to discipline arbitrary state measures but limit the potential for undue interference in domestic policy decisions, the minimum standard of treatment could include a provision such as proposed above in Article 1.2. But an unreasonableness standard is too strict a standard of review because it potentially allows a panel reviewing domestic measures to substitute its own opinion of the reasonableness of a measure. The "clearly unreasonable" standard suggested above with respect to national treatment would be an appropriate deferential standard. This minimum standard of treatment would protect investors from conduct that is abusive or arbitrary. The word "impair" should also not be used. Many regulatory measures may "impair" the use and enjoyment of property in the sense that they constrain certain activities. The focus should be on whether the state measure damages or injures the investment. With these considerations in mind, a possible formulation for an international minimum standard treatment could be as follows:

> 1.1 Each Contracting Party shall accord to investments in its territory of another Contracting Party fair and equitable procedural treatment and full and constant protection and security. In no case shall a Contracting Party accord treatment less favourable than that required by international law.

---

[81] *Supra* note 4.

[82] The terms in square brackets in Article 1.2 indicate alternate potential wording.

> 1.2 A Contracting Party shall not injure or damage by measures that are clearly unreasonable the operation, management, maintenance, use, enjoyment or disposal of investments in its territory of investors of another Contracting Party.

An interpretative note could accompany the above articles to provide guidance on what constitutes a clearly unreasonable measure and what type of measures would violate the minimum standard of treatment. This would include the following elements:

1. Measures must be enacted in good faith. All state acts and omissions that are intended or designed to cause economic injury to an investment would violate the minimum standard of treatment. Government measures that coerce, harass or are designed to intimidate the foreign investor may amount to a violation of the minimum standard of treatment.

2. There must be a lawful basis for the government measure, that is, the objective of the measure must be constitutionally sanctioned under domestic law and international law. For example, a government measure imposed by a government official for revenge or to extort would not constitute legitimate regulation. Measures that violate peremptory norms of international law, such as gross human rights violations, would violate the minimum standard of treatment.

3. Measures must be non-discriminatory. Non-discrimination requires national treatment as discussed above.

4. State measures should not be judged on whether they interfere with foreign investment in the least-restrictive way or whether a reasonable choice was made among competing regulatory options. This would allow an international tribunal to weigh the reasonableness of state policy choices. The state is in the best position to make this determination.

5. In assessing whether treatment is clearly unreasonable a number of factors would be relevant including: the nature and purpose of the government measure; whether there is a rational connection between the purpose of the measure and the treatment of the foreign investor; the level of protection and risk that a state deems is appropriate; whether the measure is specifically directed at the investor; the impact of the measure on the reasonable investment-backed expectations of the investor; and whether the state is attempting to avoid investment-backed expectations that the state created or reinforced through legislated commitments or other official acts.

6. Treatment would be deemed not to be clearly unreasonable if it is in accordance with internationally recognized standards and practices, or in conformity with generally accepted codes of conduct, such as the Draft Code of Conduct on Transnational

Corporations, unless there was a specific contractual commitment otherwise.[83]

7. Some discipline on taxation and fiscal measures is required where the foreign investor claims a tax is confiscatory. This could be in the form of a self-judging mechanisms under which taxation authorities from a number of states would have to decide whether the taxation measure amounts to a confiscation of property.[84] Or a reference could be made to internationally recognized tax policies and practices.[85]

8. The state must allow transfers of assets relating to an investment to be made freely and without delay. BITs commonly have specific provisions on transfers specifying the conditions under which transfers may be prevented. It would be preferable to have a separate and specific provision for transfers.

3.3 The Relationship Between Investment Protection and International Trade Law

Investment liberalization in the 1980's and 1990's has occurred in tandem with increased trade liberalization. Unlike the institutional structure for trade (the General Agreement on Tariffs and Trade (the "GATT") and now the World Trade Organization (the "WTO")), there is no multilateral institutional structure for international investment and little co-ordination between the WTO system and the growing patchwork of BITs and other international investment agreements. Yet in a global economy with liberal investment and trade regimes, businesses can increasingly treat investment and trade as alternatives in sourcing goods and services and in their market access strategies.[86] In such an economy, the decision to establish local production facilities through foreign direct investment or to export to a market is primarily dictated by the comparative advantages each strategy offers rather than restrictions imposed by investment and trade regimes. Even though firms may treat trade and investment as substitutes or complements, there is very little integration between the investment and trade regimes. The treatment of foreign investment in the GATT has traditionally focused on investment measures that have a direct effect on trade in goods, for example local content requirements.[87] The Uruguay Round Agreement on Trade-Related Investment Measures reaffirms that states may not apply

---

[83]*Reprinted in* (1984) 24 I.L.M. 626.

[84]This mechanism is used in NAFTA. See Chapter Four, below.

[85]See commentary to Article VIII, Taxation, MAI Negotiating Text (as of 24 April 1998) at 87.

[86]See M.J. Trebilcock & R. Howse, Chapter 13, Investment and Trade in *The Regulation of International Trade* 2nd ed., (New York: Routledge, 1999) and S. Picciotto, "Linkages in International Investment Regulation: The Antinomies of the Draft Multilateral Agreement on Investment" (1998) U. Pa. J. Int'l Econ. L 731 at 744.

investment measures that are inconsistent with the provisions of Article III and Article XI of the GATT and includes an illustrative list of the most blatant forms of trade-restrictive investment measures.

The international trading system has an institutional architecture, an interconnected series of substantive obligations and a developing jurisprudence on trade-restrictive measures. As a result of the Uruguay Round, international trade law has detailed agreements to discipline barriers to trade including rules on standards-related measures in the *Technical Barriers to Trade Agreement* ("TBT Agreement") and *Agreement on the Application of Sanitary and Phytosanitary Measures* ("SPS Agreement"). Under the NAFTA and WTO trade regimes, there is no private right of action to challenge trade-restrictive measures or to claim compensation. Under investment rules, states are required to pay investors compensation for injuries and damages caused by breaches of investment obligations. If investors could challenge trade-restrictive measures that have investment effects, a unique remedy would be available to investors but not traders. In commenting on the proposed expropriation provisions in the MAI, Graham notes that under the MAI foreign investors would be in a uniquely privileged category, since unlike other property owners who suffer loses from trade regulation (or deregulation), international investors would be entitled to claim compensation.[88] Other asset holders (including displaced workers) cannot make a claim for economic losses resulting from trade liberalization. Since a private remedy is not available for breaches of trade obligations, allowing foreign investors a privileged right to challenge trade-restrictive measures that have incidental investment effects cannot be supported as a matter of principle. In addition, subjecting trade-restrictive measures to an investment process may result in inconsistent results, especially if investor-state arbitration is used. For example, a WTO Panel may find a trade-restrictive measure is consistent with national treatment under GATT, the TBT Agreement or the SPS Agreement, while an arbitration panel under a BIT may find that the same government measure violates national treatment under investment rules.

---

[87]M.J. Trebilcock & R. Howse, *ibid.*
[88]Graham, *supra* note 66 at 611.

The overlap between trade and investment disciplines is clearly evident in investment claims under Chapter Eleven of the NAFTA. In one claim discussed in more detail in the next chapter, Ethyl Corporation claimed that Canada had breached its investment obligations under Chapter Eleven by banning the importation of MMT, a fuel additive used by Ethyl's subsidiary in Canada. An investment in a host country may rely on imported inputs and equipment for its operations or on the ability to export goods and services produced by the investment. As a result, import and export restrictions, standard-related measures and other regulatory measures taken by the host country can have adverse effects on investments. Any form of government regulation may potentially adversely impact trade or investment. For example, a ban on the importation or sale of hormone-fed beef where there is no local production has a disparate impact on trade. However, where the same regulation is enacted (potentially at the behest of local farmers) in a market where hormone-fed beef is not imported but is raised in operations owned by a foreign investor, the measure could have a disparate impact on the foreign investor. In other cases both traders and foreign investors may be equally impacted by the measure.

As a matter of general principle investors should not be in a privileged status to challenge and obtain compensation for trade-restrictive measures. Therefore, international investment rules should apply only to government measures that are primarily aimed at investment regulation. However, at a conceptual level it is very difficult to distinguish between measures that impact trade and investment by reference to nature of the measure. The impact of a government measure may often depend more on market structure than the nature of the measure. For instance, if a government imposes an import restriction on a specialized piece of equipment that is required for the operations of a high technology facility operated by a foreign investor, the measure takes the form of a barrier to trade. This barrier could be potentially challenged by another state on behalf of the importer or exporter under international trade law or by a foreign investor under a BIT. The same reasoning applies to an environmental or health measure such as a prohibition on the importation and sale of hormone-fed beef.

Under the framework proposed in this chapter, since compensation for expropriation would only arise for appropriations of property, a measure that restricts trade would not amount to an appropriation of property. But a trade-restrictive measure that has investment effects could

violate the state's obligation to accord national treatment or the minimum standard of treatment. This could result in a trade-restrictive measure being subject to a review under both international trade and investment rules. Where trade-restrictive measures have investment effects, the measure should be subject to discipline under international trade law and not subject to review under investment rules. This approach avoids inconsistent results, reduces "system frictions"[89] and provides equality of treatment between traders and investors. However, defining the precise rules to implement this principle in practice requires that a framework be developed to govern the interrelationship between international trade law and international investment law. This is a complex interrelationship that deserves further study.

3.4 Conclusion

In this chapter I have argued that states should have significant autonomy to determine regulatory policy even where regulation affects the value of a foreign investment. The international minimum standard should discipline appropriations of property, provide national treatment, require respect for state contracts and ensure investors are accorded a minimum standard of treatment. In proposing the above framework, the focus is to delineate a principled approach to investment protection that balances protection for investment with regulatory flexibility. Whether an appropriation occurs or there is a breach of another element of the proposed international minimum standard in any particular circumstance is typically highly fact contingent and requires a detailed assessment of the facts. Weston makes this point by arguing that "[t]he "taking"-"regulation" problem, being Hydra-headed and therefore given to many different issues of fact and policy, simply cannot be defined, let alone resolved, by "rules of decision" which only look to one or two of its diverse aspects".[90] While cases of regulatory expropriation demand ad hoc judgement, a framework is required to identify and assess the competing interests of states and investors. It is not suggested that the framework proposed here is a complete code for investment protection. The primary focus has been on the treatment of claims of regulatory expropriation and how claims for deprivations of property rights should be addressed. A complete code of investment protection would have to address these issues in more

[89]The term if used by Sylvia Ostry in the context of non-tariff barriers to trade. See Trebilcock & Howse, *infra* note 65 at 6.

detail and address other issues such as transfers of assets, movement of key personnel and dispute resolution. In addition, while the broad elements of investment protection have been outlined, refinements to the principles are required. For example, certain exceptions to the national treatment principle for subsidies to domestic firms or national security may be warranted.

As statistics on FDI suggest, FDI has continued to increase notwithstanding uncertainty in the meaning of expropriation under customary international law or investment agreements. Given the determinants of foreign investment, it is unlikely that clearer global rules on investment protection will have a significant effect on levels of FDI. Clearer rules on investment protection allow foreign investor to allocate the risks of foreign investment more effectively, to discipline exploitative conduct by states and to allow states the flexibility to adopt welfare-maximizing regulation. In addition, clarifying the limits of state responsibility for treatment of foreign investment allows for a principled debate on the appropriate level of investment protection in a global economy.

---

[90]Weston, *supra* note 18 at 120.

4. CLAIMS OF EXPROPRIATION UNDER CHAPTER ELEVEN OF THE NAFTA

Introduction

Claims of expropriation under Chapter Eleven (Investment) of the North American Free Trade Agreement[1] ("NAFTA") have been extremely controversial.[2] A significant cause of the controversy is that at least six of the claims involve environmental regulation. The claims, and the investment protection provided in Chapter Eleven, are viewed by many environmental organizations and opponents of investment liberalization as an assault on the ability of governments to regulate investment, a vindication of the rights of investors over the public

[1] *Reprinted in* December 17, 1992, (1992) 32 I.L.M. 605.

[2] For commentary on claims under Chapter Eleven see D. Schneiderman, "NAFTA's Takings Rule: American Constitutionalism Comes to Canada" (1996) 46 U.T.L.J. 499 [discussed in Chapter 5], J. Soloway, "Environmental Trade Barriers Under Nafta: The MMT Fuel Additives Controversy" (1999) 8 Minnesota J. of Global Trade 55, [hereinafter Soloway (MMT Controversy)] and J. Soloway, "NAFTA's Chapter Eleven: The Challenge of Private Party Participation" (1999) 16 J. Int'l Arb. 1 [hereinafter Soloway (Chapter Eleven)]. See Section 4.3, below, for media coverage of specific claims. For a comprehensive non-governmental organization report on Chapter Eleven and the environment, see International Institute for Sustainable Development, *NAFTA's Chapter Eleven and the Environment: Addressing the Impacts of the Investor-State Process on the Environment* (Winnipeg: International

interest and proof that trade and investment liberalization results in less effective social regulation. The claims initiated under Chapter Eleven have been used by North American opponents of the Multilateral Agreement on Investment ("MAI") to demonstrate the alleged dangers of replicating the investment protection provisions of the NAFTA in a multilateral treaty and of pursuing further trade and investment liberalization.[3] In this Chapter I analyze the scope of the expropriation provisions in Chapter Eleven. The first section provides an overview of the key investment protection provisions of Chapter Eleven. In the second section I examine how tribunals under Chapter Eleven may interpret Chapter Eleven. The third section reviews the Chapter Eleven claims that have been made to date. I focus primarily on the claim by Ethyl Corporation because of the controversy that surrounded the initiation and the settlement of the claim. It also exemplifies the type of claim of regulatory expropriation that, according to the framework set out in Chapter Three, would not involve state responsibility and which is more appropriately reviewed under trade obligations. The final section concludes with a review of proposals for clarifying Chapter Eleven. This chapter does not address the use of investor-state arbitration in Chapter Eleven and concerns about the appropriateness of allowing private parties to sue governments in a private arbitration process when the private investor is challenging state regulatory measures. This issue is addressed in Chapter Five.

4.1 Overview of Chapter Eleven

Chapter Eleven of the NAFTA essentially incorporates the provisions of the US model bilateral investment treaty ("BIT").[4] Given the troubled history between the US and Mexico on the treatment of US investment in Mexico, one of the primary reasons for Chapter Eleven, in particular the expropriation and investor-state arbitration provisions, was to provide greater protection for US investment in Mexico.[5] For Canada, the investment chapter was compatible with Prime Minister Brian Mulroney's Conservative government's policy of liberalizing foreign

---

Institute for Sustainable Development, 1999) online: IISC homepage <http:iisd1.iisd.ca/trade/chapter11.htm> (last accessed: 22 July, 1999) [hereinafter IISD Chapter Eleven Report].

[3]The MAI and prospects for a multilateral framework for investment are discussed in Chapter Five.

[4]J. Johnson, *The North American Free Trade Agreement: A Comprehensive Guide* (Aurora: Canada Law Book Inc., 1994) at 278. See Section 2.1.6, above, for a discussion of BITs.

[5]T. Levy, "NAFTA's Provision for Compensation in the Event of Expropriation: A Reassessment of the 'Prompt, Adequate and Effective' Standard" (1995) 31 Stan. J. Int'l L. 423 on US-Mexican foreign investment disputes.

investment in Canada. It was also consistent with the general form of foreign investment protection agreements Canada was entering with other countries.[6] The acceptance of the NAFTA investment chapter was a significant change of policy for the Mexican government. Like most Latin American countries, Mexico has traditionally adopted the Calvo Doctrine which provides that aliens are only entitled to national treatment and, therefore, does not recognize an international minimum standard of treatment for alien property. It also denies the right of foreign nationals to seek diplomatic protection from their national state by requiring that the foreign national submit to the jurisdiction of domestic courts.[7] By agreeing to Chapter Eleven, the government of President Carlos Salinas de Gotari reversed Mexico's historical commitment to the Calvo Doctrine and committed Mexico to significant liberalization of its investment regime, an acceptance of a minimum international standard for measuring compensation and binding international arbitration.[8]

Chapter Eleven comprises three sections. Section A (Investment) of Chapter Eleven establishes a framework of investment obligations that broadens the coverage of the investment protection provided in the Canada-United States Free Trade Agreement[9] ("FTA"). Unlike the FTA, provincial and state measures are covered by Chapter Eleven of the NAFTA.[10] Section A sets out the investment obligations and includes provisions on national treatment, most-favored-

---

[6]See R.K. Paterson *et al.*, *International Trade and Investment Law in Canada*, 2nd ed. (Toronto: Carswell, 1994) for an overview of Canadian investment law and policy.

[7]B.S. Amor, "International Law and National Sovereignty: The NAFTA and the Claims of the Mexican Jurisdiction" (1997) 19 Houston J. Int'l L. 565 at 582 notes that Article 27 of the Mexican Constitution incorporates the Calvo Doctrine. Article 27 provides: "Only Mexicans by birth or naturalization and Mexican companies have the right to acquire ownership of lands, waters, and their appurtenances. The State may grant the same right to foreigners, provided they agree before the Ministry of Foreign Relations to consider themselves as nationals in respect to such property, and bind themselves not to invoke the protection of their governments in matters relating thereto; under penalty, in case of noncompliance with this agreement, of forfeiture of property acquired to the Nation."

[8]Daly writes that the Mexican Chamber of Deputies stated that submission of a dispute to international dispute resolution is not an invocation of diplomatic protection and is thus not inconsistent with the Calvo Doctrine. See J. Daly, "Has Mexico Crossed the Border on State Responsibility for Economic Injury to Aliens? Foreign Investment and the Calvo Clause in Mexico After the NAFTA" (1994) 25 St. Mary's L.J. 1147 at 1181-3. *Contra* see Amor, *ibid.*, who argues there is a conflict between Chapter Eleven of the NAFTA and Article 27 of the Mexican Constitution.

[9]*Reprinted in* (1989) 27 I.L.M. 281.

[10]Articles 105 and 201(2). This is subject to the reservations and exceptions in Article 1108. Article 1108(1) provides that Articles 1102 (National Treatment), 1103 (Most-Favored-Nation Treatment), 1106 (Performance Requirements) and 1107 (Senior Management and Boards of Directors) do not apply to a local government. See *infra* note 19 for the exceptions set out in the three annexes.

nation treatment, minimum standard of treatment, performance requirements, senior management and boards of directors, transfers of assets and expropriation and compensation. Section B (Settlement of Disputes Between a Party and an Investor of Another Party) establishes a binding arbitration process which can be invoked by private party investors. Section C sets out the definitions.[11]

An analysis of the scope of Chapter Eleven begins with Article 1101 which provides that the chapter applies to measures adopted or maintained by a Party relating to: (a) investors of another Party;[12] (b) investments of investors of another Party in the territory of the Party; and (c) with respect to performance requirements and environmental measures, all investments in the territory of the Party. The application of Chapter Eleven to measures that are covered by other chapters is unclear. This issue is considered in more detail in the discussion of the claim by Ethyl Corporation discussed below at Section 4.3.1.

Investment is broadly defined in Section C of Chapter Eleven and includes: an enterprise;[13] an equity security in an enterprise; certain debt securities of an enterprise; certain loans to an enterprise; an interest in an enterprise entitling the owner to share in the enterprise's assets upon dissolution or in the enterprise's income or profits; real estate and other tangible and intangible property acquired in the expectation or used for the purpose of economic benefit or other

[11]This chapter only reviews the provisions relating to expropriation. On Chapter Eleven generally, see B. Appleton, *Navigating NAFTA* (Toronto: Carswell, 1994), Johnson, *The North American Free Trade Agreement: A Comprehensive Guide*, *supra* note 4, J.G. Castel *et al.*, *The Canadian Law and Practice of International Trade*, 2nd ed. (Toronto: Edmond Montgomery Publications Limited, 1997) and M.J. Trebilcock & R. Howse, *The Regulation of International Trade* 2nd ed. (New York: Routledge, 1999). For a discussion of arbitration under Section B of NAFTA, see C.D. Eklund, "A Primer on the Arbitration of NAFTA Chapter Eleven Investor- States Disputes" (1994) 11 J. Int'l Arb. 135, R.C. Levin & S.E. Marin, "NAFTA Chapter Eleven: Investment and Investment Disputes", (1996) II:3 NAFTA: L. & Bus. R. Amer. 83 and Soloway (Chapter Eleven), *supra* note 2. For a critical theory perspective on Chapter Eleven see J.E. Alvarez, "Critical Theory and the North American Free Trade Agreement's Chapter Eleven" (1996-97) Inter-American L.R. 303.

[12]"Party" means a party to NAFTA.

[13]Enterprise is further defined in Article 201 and means "any entity constituted or organized under applicable law, whether or not for profit, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, sole proprietorship, joint venture or other association." Since the definition of "investor of a Party" includes "an enterprise of such Party", it may be possible for a Canadian national to incorporate an enterprise in the US or Mexico and become an "investor of a Party" in order to obtain investment protection under Chapter Eleven in Canada.

business purposes; and certain contractual interests. The definition of investment excludes debt securities of state enterprises, loans to state enterprises and accounts receivable.

The definition of expropriation in Article 1110 is almost identical to Article 1605 of the FTA.[14] Article 1110(1) states:

> No party may 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 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); and
> (d) on payment of compensation in accordance with paragraphs 2 through 6.

Paragraphs 2 through 6 provide for compensation equivalent to fair market value to be paid without delay, to be fully realizable and for interest to accrue from the date of expropriation. This essentially codifies the Hull Rule of prompt, adequate and effective compensation.[15] Article 1105(1) on minimum standard of treatment provides:

> Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.

Unlike some BITs where "fair and equitable treatment" is a self-contained standard, Article 1105(1) of NAFTA, by using the word "including", appears to subsume "fair and equitable treatment" under the minimum standard of treatment of customary international law.[16]

There are a number of exceptions and reservations to Chapter Eleven. Chapter 21 provides a number of general exceptions to the terms of the NAFTA. Article 2102 provides that for the purposes of Part Two (Trade in Goods), except to the extent that a provision of that Part applies to services or investment,[17] and Part Three (Technical Barriers to Trade), except to the extent that a provision of that Part applies to services, GATT Article XX and its interpretive notes are

---

[14]Article 1605 of the FTA provides, in part, that "[n]either Party shall directly or indirectly nationalize or expropriate an investment in its territory by an investor of the other Party or take any measure or series of measures tantamount to an expropriation of such an investment...".

[15]See Section 2.1.1, above, on the Hull Rule.

[16]R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995) at 60.

incorporated into the NAFTA. The general exception clause in GATT does not apply to Chapter Eleven. Applying the GATT Article XX exception to Article 1110 would clearly defeat the requirement to pay compensation for expropriation. Even if creating an ecological reserve is necessary to protect the environment, it does not justify expropriating one investor's property to establish the reserve. Article 2102 provides a general exemption for actions taken to protect essential security interests. Article 2103(6) on taxation provides that Article 1110 applies to taxation measures but that the investor must refer the matter to the taxation authorities listed by the Parties. If these authorities do not agree to consider the measure or fail to agree that a taxation measure is not an expropriation within six months, then the investor may proceed with its claim.[18] Therefore, subject to a consensus determination by the Parties, the Parties have effectively retained the right to collectively determine whether a taxation measure is an expropriation. Within Chapter Eleven there are many article specific exceptions. In addition, Article 1108 provides that Parties may make reservations from the obligations relating to national treatment, most-favored-nation status, performance requirement and senior management and boards of directors.[19]

4.2 Interpretation of Article 1110

The NAFTA is an international treaty and must be interpreted according to customary international law rules of treaty interpretation. It is generally accepted that the *Vienna Convention on the Law of Treaties*[20] ("Vienna Convention") codifies customary international law on the interpretation of treaties.[21] Article 31(1) of the Vienna Convention provides that a

---

[17]The reference is to investment provisions in Part Two, such as *Annex 300-A: Trade and Investment in the Automotive Sector*.

[18]Article 2103(6) appears to require that the taxation authorities of all three Parties must agree that the taxation measure in question is not an expropriation. The matter is not without doubt because Article 2103(6) requires a reference to the "appropriate competent authorities". This could be interpreted to mean the competent authorities of only the state that enacted the measure and the investor's state.

[19]Article 1108. In Annex I, the Parties list reservations for non-conforming existing measures. Under Article 1108(1)(a)(ii), the Parties had until January 1, 1996 to list non-conforming sub-national measures. Annex II lists sectors, subsectors and activities for which each Party has made to reservations for existing and future non-conforming measures. Finally, Annex III list certain activities reserved to the state. Only Mexico has made reservations under Annex III.

[20]*Reprinted in* (1969) 8 I.L.M. 679.

[21]The Vienna Convention has been applied in the interpretation of NAFTA. See *In the Matter of Tariffs Applied by Canada to Certain U.S-Origin Agricultural Products*, 2 December 1996, CDA-95-200801 (Ch. 20 Panel) as noted by J. Johnson, *International Trade Law* (Irwin Law: Concord, 1998) at 41.

"treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context in light of its object and purpose." Article 31 also provides that the context of the treaty includes the text and any agreement relating to the treaty made by the parties and that any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions will be taken into account. In Ethyl Corporation's claim against Canada under Chapter Eleven, the tribunal established under Chapter Eleven to hear the Ethyl's claim (the "Tribunal") held a hearing and made an Award on Jurisdiction.[22] In considering Canada's argument that Section B (Settlement of Disputes Between a Party and an Investor of Another Party) is to be construed strictly, the Tribunal noted in its Award on Jurisdiction that under the Vienna Convention there is no presumption that limitations of sovereignty must be strictly construed. In interpreting a treaty there is no presumption of strict, or for that matter, broad interpretation.[23]

Article 32 of the Vienna Convention provides that recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty, to confirm the meaning of a treaty resulting from the application of Article 31 or where the meaning is ambiguous or leads to a result which is manifestly absurd or unreasonable. According to a report by the International Institute for Sustainable Development on Chapter Eleven there is no specific drafting record to elaborate on the precise scope of Article 1110 and, according to some government officials, there is no collated drafting record in relation to Chapter Eleven at all.[24]

Article 1136 provides that an award made by a tribunal under Chapter Eleven has no binding force except between the disputing parties and in respect of the particular case. Interpretations by a particular tribunal of the provisions of Chapter Eleven are not binding on subsequent tribunals. While decisions are not binding, arbitrators often refer to previous arbitral decisions as persuasive authorities where similar issues arise.

---

[22]Ethyl Corporation's claim was never heard on its merits as a result of the settlement between the Government of Canada and Ethyl Corporation.

[23]*Award on Jurisdiction in the NAFTA/UNCITRAL Case Between Ethyl Corporation (Claimant) and The Government of Canada (Respondent),* 24 June 1998, (UNCITRAL, Arbitrators: K. Böckstiegel, C.N. Brower and L. Lalonde) [hereinafter Award on Jurisdiction] at 55 (on file with author).

Article 102(1) sets out the objectives of the NAFTA. These include the promotion of "conditions of fair competition in the free trade area" and to "increase substantially investment opportunities in the territories of the Parties". Article 102(2) provides that the Parties shall interpret and apply the NAFTA in light of the objective and in accordance with the applicable rules of international law. With respect to Chapter Eleven, Article 1131 provides that:

> (1) A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.
>
> (2) An interpretation by the Commission[25] of a provision of this Agreement shall be binding on a Tribunal established under this Section.

As discussed in Section 4.4, Article 1131(2) provides a process for interpretative statements of Chapter Eleven. Such a statement could address many of the substantive concerns with Chapter Eleven.

Article 1110 provides little guidance on when a measure is tantamount to expropriation.[26] The definition of expropriation in Chapter Eleven is similar to provisions in BITs.[27] As Johnson notes, Canadian, US and customary international law all distinguish between expropriation and regulation. The NAFTA drafters attempted to craft a definition for expropriation, but because of the complexity of the issues, left the expression undefined.[28] He continues:

> there is very little international jurisprudence dealing with the difficult question of where a state action implemented for clear public policy reasons crosses over the line from non-compensable regulation to compensable taking. An example would be the creation of a monopoly to provide an essential service such as health or automobile insurance.[29]

The scope of expropriation in Article 1110(1) has two elements. The first condition in Article 1110(1) is that "No Party may directly or indirectly nationalize or expropriate". It is reasonable to interpret indirect expropriation as a type of government action, such as in *Norweigian Shipowners' Claims*,[30] where the government indirectly appropriates property or obtains the benefit of property through a measure not specifically directed at taking ownership or control.

---

[24]IISD Chapter Eleven Report, *supra* note 2 at 45.

[25]The "Commission" is the Free Trade Commission established under Article 2001(1).

[26]See Section 4.3, below, in the discussion of Ethyl Corporation's claim for the meaning of "measure".

[27]See Section 2.1.6, above.

[28]Johnson, *supra* note 4 at 289.

[29]Johnson, *supra* note 4 at 290.

Article 1110(1) does not refer to a *measure* that indirectly expropriates, rather the reference is to a Party indirectly expropriating. The first part of the obligation imposes state responsibility for direct and indirect acts of expropriation or nationalization, for example, where the state appropriates property or cancels a state contract, but not for the effect of general regulatory measures. The second part of the obligation "a measure tantamount to nationalization or expropriation" widens the scope of the meaning of expropriation to include a measure that has the effect of expropriation. The effect of expropriation from the perspective of the investor is that the measure deprives the investors of its property. Nevertheless, this provision must be read in accordance with international law. As discussed in the previous chapters, certain deprivations of property under the police power are not considered compensable expropriations.

Dearden suggests that the interpretation of "nationalize", "expropriate" and "tantamount to nationalization or expropriation" should be influenced by Canadian, American and Mexican jurisprudence.[31] However, Articles 1131(1) and 102(2) explicitly state that the NAFTA is to be interpreted in accordance with international law. Given the different legal traditions of the NAFTA Parties and the lack of a pre-existing regional framework, there is no customary regional law, for example, a mixture of Canadian, American and Mexican legal principles, that serves as a basis for interpreting Article 1110. Article 1110 must be interpreted in accordance with international law.[32]

There are two express exemptions to the obligations in Article 1110. First, Article 1110(7) provides that Article 1110 "does not apply to the issuance of compulsory licenses granted in relation to intellectual property rights, or to the revocation, limitation or creation of intellectual property rights, to the extent that the issuance, revocation, limitation or creation is consistent with Chapter Seventeen (Intellectual Property)." Hertz notes that Canadian negotiators were concerned about the difference in the meaning of expropriation under Canadian law and the NAFTA and sought an exemption for intellectual property to ensure that there was discretion to

---

[30]See Section 2.1.2, above.

[31]R.G. Dearden, "Arbitration of Expropriation Disputes between an Investor and the State under the North American Free Trade Agreement" (1995) 29 J. World T. 113.

[32]See also Schneiderman, *supra* note 2 who argues that international law applies to the interpretation of Article 1110 but who argues that the applicable international law is deeply influenced by US takings law.

control intellectual property rights consistent with the disciplines in Chapter 17.[33] The relationship between intellectual property rights and Article 1110 is considered in more detail in Chapter Five with respect to claims by US cigarette manufacturers that a requirement for plain packaging of cigarettes would be an expropriation of an investment.

Second, Article 1110(8) provides that "[f]or the purposes of this Article and for greater certainty, a non-discriminatory measure of general application shall not be considered a measure tantamount to an expropriation of a debt security or loan covered by this Chapter solely on the ground that the measure imposes costs on the debtor that cause it to default on the debt." Since Article 1110(8) refers only to "a measure tantamount to an expropriation" and not also to indirect expropriation, it supports an interpretation that "a measure tantamount to nationalization or expropriation" has a broader meaning than "directly or indirectly nationalize or expropriate". This interpretation is also supported by the argument that the drafters would not have included the phrase if it was redundant. Article 1110(8) only qualifies the effect of measures relating to a debt security or loan, raising a presumption that the drafters did not intend to exempt other "non-discriminatory measure[s] of general application" from the discipline of Article 1110. Article 1110(8) likely means that responsibility could arise under Article 1110(1) where the government, while not directly or indirectly expropriating, takes non-discriminatory measures of general application. For example, section 1110(8) does not exempt non-discriminatory environmental measures of general application that have the effect of making a business no longer profitable. I do not suggest that the failure of Article 1110(8) to explicitly exempt such measures is determinative of the question of liability. Whether a measures amounts to an expropriation must be determined based on the international law reviewed in Chapter Two. But since Article 1110(8) exempts only one specific measure among many, it can be interpreted to suggest that liability must arise in other circumstances. It is unclear why the drafters felt that the particular situation in Article 1110(8) had to be addressed while not addressing similar effects for other forms of police power regulation. As a result, Article 1110(8) creates significant uncertainty in the scope of the Article 1110(1).

[33]A.Z. Hertz, "Shaping the Trident: Intellectual Property under NAFTA, Investment Protection Agreements and at the World Trade Organization" (1997) 23 Can.-U.S. L. J. 261 at 301.

Another potential limit on the scope of Article 1110 is Article 1114(1) which provides that:

> [n]othing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns.

Article 1114(1) has limited interpretive value because of the tautology that the Chapter shall not be construed to prevent a party from taking measures that are "otherwise consistent with this Chapter". In the case of a claim of an environmental regulatory expropriation, the question is whether the measure is tantamount to expropriation. While Article 1114(1) expresses a statement of purpose, it does not expressly authorize an arbitration tribunal to give more regulatory room to environmental measures than to health or safety or other police power measures. In addition, in a claim of environmental regulatory expropriation, the issue will typically be whether the investment activity is *prevented or expropriated* by environmental regulation rather than whether it "is undertaken in a manner sensitive to environmental concerns". On the other hand, the NAFTA parties will likely argue that the principle of effectiveness requires that interpretation must give meaning and effect to all terms of the treaty and no clause or paragraph may be reduced to "redundancy or inutility"".[34] Article 1114(2) provides that states should not lower environmental standards to attract investment. However, the only enforcement mechanism is that the state allegedly encouraging investment by lowering environmental standards has an obligation to consult with the complaining state.

The NAFTA has a number of other explicitly environmental provisions, but they do not explicitly widen the permitted scope of environmental measures that have the effect of depriving an investment of value.[35] The Preamble to the NAFTA provides that the Parties resolve to promote sustainable development and strengthen the development and enforcement of environmental laws and regulations. However, there is no mention of the environment or

---

[34]See J. Johnson, *supra* note 21 at 45, with reference to the WTO Appellate Body decision in *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R [footnotes omitted].

[35]In addition to the environmental provisions in Chapter Eleven and the North American Agreement on Environmental Cooperation, the NAFTA has a number of other environmental provisions. Article 104 deals with the relation of the NAFTA to other environmental treaties. Article 1709 allows a Party to exclude inventions from patentability if necessary to protect the environment. Finally, as discussed in Section 4.2, above, Article 2101, provides that, subject to certain limits, Article XX of GATT is incorporated into the NAFTA for the purposes of Part Two and Part Three of the NAFTA.

sustainable development in Article 102. As mentioned above, Article 102(2) provides that the NAFTA is to be interpreted in accordance with its objectives. The NAFTA also disciplines standards-related measures in a similar manner to the WTO's *Technical Barriers to Trade Agreement* (the "TBT Agreement") and the *Agreement on the Application of Sanitary and Phytosanitary Measures* (the "SPS Agreement"). Article 712 of NAFTA confirms a state's right to take sanitary and phytosanitary ("SPS") measures and the right to establish its appropriate level of protection and Article 723(6) puts the burden of proof on the Party challenging SPS measures. Article 904 confirms a state's right to take standards-related measures and the right to establish its appropriate level of protection and Article 914(4) puts the burden of proof on the Party challenging standards-related measures. The explicit disciplines in Chapters 7 and 9 provide a well-developed set of rules and presumptions for disciplining illegitimate and trade-distorting standards. As proposed in the previous chapter, where a trade-restrictive measure falls within the scope of one of these chapters or the other trade disciplines in NAFTA, the investment rules and process in Chapter Eleven should not apply. Whether it does is considered in the review of the Chapter Eleven claim by Ethyl Corporation below.

4.3 Claims under Chapter Eleven

As of June 1999, there is a public record of twelve claims under Chapter Eleven.[36] Two of these have not been pursued beyond the initial claim.[37] A claim by Sun Belt Water, Inc. ("Sun Belt") of California claims that the conduct of the British Columbia government and its court system violate national treatment, most-favored-nation treatment and the minimum standard of treatment. It does not raise a claim of expropriation under Article 1110. According to the claim, Sun Belt's Canadian partner, Snowcap Water Ltd., held an export licence for bulk water. As a result of a government imposed moratorium on bulk water exports, Snowcap and Sunbelt began proceeding in the British Columbia Supreme Court which resulted in a settlement in 1996

[36]See J. Soloway (Chapter Eleven), *supra* note 2 and telephone conversations between the author and officials with the British Columbia government and the Canadian Department of Foreign Affairs and International Trade in June 1999. Under Article 1120, claims of arbitration are submitted under the ICSID Convention, the Additional Facility Rules of ICSID or the UNCITRAL Arbitration Rules. There is no provision in the NAFTA for investor-state proceedings to be public. Annex 1137.4 governs the publication of arbitration awards. Canada and the US have agreed that the disputing Party or investor may make the award public. Where Mexico is the disputing Party, the applicable arbitration rules govern the publication of the award.

between the government and Snowcap. Sunbelt's claim has not been settled and it alleges misconduct on the part of the BC government and the BC courts that breaches the national treatment, most-favored-nation treatment and minimum standard of treatment obligations of Chapter Eleven.[38] Loewen Group Inc. has claimed that a $US 550 million jury award and an appeal court ruling breach national treatment, the minimum standard of justice and expropriation (it is claimed that the effect of the $US 550 million jury award is an expropriation of property).[39] Seven other claims have been made in which compensation is claimed for expropriation (including contract cancellations). These claims are described below. In addition to these claims, investors, commentators and the US government have argued that a number of other measures proposed by Canadian authorities would amount to expropriation under Chapter Eleven. These measures are discussed in Chapter Five in the context of the effect of Article 1110 on the government policy process.

4.3.1 Ethyl Corp. - MMT Fuel Additives

The most controversial claim to date arose out of the Canadian government's decision to prohibit the import and interprovincial trade of methylcyclopentadienyl manganese tricarbonyl ("MMT"), a fuel additive that increases the level of octane in unleaded gasoline. In 1997, Ethyl Corporation ("Ethyl") claimed $US 250 million in damages for the Canadian government's ban. In July 1998, the Canadian government agreed to pay Ethyl $US 13 million, to lift the ban and issued a statement that current scientific information fails to demonstrate that MMT harms emissions systems and that there is no new scientific evidence to suggest that MMT is a health

---

[37]Hachette Distribution Services made a claim against Mexico relating to airport ship concessions and Signa S.A. de C.V. made a claim against Canada regarding Canadian regulation of generic pharmaceuticals. See J. Soloway (Chapter Eleven), *supra* note 2.

[38]See Sun Belt Water, Inc., Notice of Intent to Submit a Claim to Arbitration, dated 27 November, 1998 (on file with author).

[39]Loewen Group Inc. began a Chapter Eleven claim against the US as the result of a requirement that it post a bond equal to 125% of a $500 million (U.S.) jury award in order to appeal the jury award. Loewen claims that the bonding requirement is a breach of the minimum standard of treatment and that it was discriminated against because it is a foreign investor. See B. McKenna, "Loewen Action Called a Threat to U.S. Justice" *The Globe and Mail* (25 November 1998) B7, H. Scoffield, "Another U.S. firm sues Ottawa under NAFTA" *The Globe and Mail* (16 February 1999) B1, P. Morton, "Washington Cool to Rewriting Key NAFTA Clause" *National Post* (23 January 1999) D9 and IIDS Chapter Eleven Report , *supra* note 2 at 69. *The Loewen Group, Inc. and Raymond Loewen* v. *United States of America* (ICSID Case No. ARB(AF)/98/3, Claim registered 19 November, 1998, Arbitrators: A. Mason, Y. Fortier, A.J. Mikva). See online: World Bank Homepage <http://www.worldbank.org/icsid/cases/pending.htm> (date accessed: 18 June, 1999).

hazard.[40] The Canadian government also stated that the decision to repeal the ban and settle with Ethyl was the result of the government of Alberta's successful challenge to the ban on the interprovincial trade of MMT under the Canadian Agreement on Internal Trade (the "AIT").[41] While the successful challenge under the AIT explains the repeal of the ban, it does not explain the monetary settlement with Ethyl and the public statements made regarding MMT.

The details of Ethyl's claim are well documented and analyzed by Soloway and I will only outline the basic details.[42] At the time of the controversy, Ethyl's subsidiary, Ethyl Canada Inc. ("Ethyl Canada"), operated a MMT blending facility in Ontario processing concentrated MMT and selling it to Canadian petroleum refiners. As part of the Canadian government's Clear Air Agenda and consistent with an election promise, the Canadian government proposed to ban MMT from unleaded gasoline. The Canadian government justified the ban as necessary to protect the health of Canadians, to allow harmonization of fuel standards in North America and to protect jobs and consumers from adverse economic impacts resulting from increased engineering costs for auto companies.[43]

As Soloway describes, the MMT legislation appears to have been designed for both environmental and economic protection.[44] Soloway argues that the fuel additives issue is an example of a complex "Baptist-bootlegger" coalition.[45] The "Baptists", environmental and consumer advocacy groups, promoted a ban on MMT in the belief that it is harmful to the environment and human health, while the bootleggers, the ethanol industry and auto

---

[40]S. McCarthy "Threat of NAFTA Case Hills Canada's MMT Ban" *Globe and Mail* (20 July, 1998) A1, "Free Trade and Good Science Rule" *Globe and Mail* (21 July, 1998) B2.

[41]Department of Foreign Affairs and International Trade, spokeswoman L. Swartman in H. Scoffield, "U.S. Firm Hits Ottawa with NAFTA Lawsuit" *Globe and Mail* (21 August, 1998) B1-B2. See *Report of the Article 1704 Panel Concerning a Dispute between Alberta and Canada Regarding the Manganese-Based Fuel Additives Act*, File No. 97/98-15-MMT-P058, 12 June 1998, online: Agreement on Internal Trade Secretariat Homepage: <www.intrasec.mb.ca/eng (last accessed 24 July 1999).

[42]The background facts are taken from Soloway (MMT Controversy) and Soloway (Chapter Eleven), *supra* note 2. See also S. Ostry and J. Soloway, "The MMT Case Ended Too Soon" *Globe and Mail* (24 July, 1998) A15.

[43]The Honourable Sergio Marchi, P.C., M.P., Minister of the Environment, *Statement to the Senate Committee on Energy, Environment and Natural Resources on Bill C-29: The Manganese Based Fuel Additives Act*, Delivered at Parliament Hill, Ottawa, 20 February 1997 as described by Soloway (Chapter Eleven) *supra* note 2.

[44]Soloway (Chapter Eleven), *supra* note 2.

manufacturers, opposed MMT out of economic self-interest. Soloway concludes that the regulation "was more about the pursuit of a North American-wide fuel standard than environmental and human health effects" and about which industry bears the cost of producing technology to meet the demand for emissions reductions.[46]

The MMT ban was supported by automobile manufacturers, a range of environmental and non-governmental organizations and the Canadian ethanol industry. The Canadian Vehicle Manufacturers Association ("CVMA") claimed that MMT residues affected emission control technology, including onboard diagnostic systems. As a result, manufacturers threatened to withdraw the industry standard automobile warranty if MMT was not removed from gasoline.[47] MMT was banned in the US from 1978 to 1995 when Ethyl was successful in court action against the US Environmental Protection Agency ("EPA") which resulted in removing the prohibition on the use of MMT in unleaded gasoline in the US. But since emission technology is developed for the North American market and US unleaded gasoline remains primarily MMT free, automobile manufacturers have been lobbying the Canadian government for MMT-free gasoline. In addition to alleged damage to emission control systems, environmental groups claim tailpipe emissions of manganese oxides are a health hazard and that MMT increases tailpipe emissions.[48] However, the government did not appear to base the legislation on the direct health effects of MMT. In its claim Ethyl highlighted the fact that a Health Canada risk assessment in 1994 had concluded that "all analysis indicates that the combustion products of MMT in gasoline do not represent an added health risk to the Canadian population".[49] The Canadian government argued that given the evident indirect potential effect, as opposed to direct

---

[45]Soloway (MMT controversy), *supra* note 2 at 59 - 61. Soloway draws on an economic literature on regulation that "posits that industry regulation is a function of the demands of a coalition of two special interest groups." *Ibid.* at 59.

[46]Soloway (MMT Controversy), *supra* note 2 at 95.

[47]Soloway (MMT Controversy), *supra* note 2 at 73.

[48]See Walter Stewart "Fuel deficiency" *Canadian Geographic* (May/June 1999) at 73 on research regarding exposure to manganese.

[49]*Risk Assessment for the Combustion Products of Methylcyclopentadienyl Tricarbonyl (MMT) in Gasoline*. Environmental Health Directorate, Health Canada, December 6, 1994 at 69 as quoted in *Notice of Arbitration Under the Arbitration Rules of the United Nations Commission on International Trade Law and the North American Free Trade Agreement Between Ethyl Corporation (Claimant/Investor)* v. *Government of Canada (Respondent/Party)* dated April 14, 1997 [hereinafter Notice of Arbitration] at §11 (copy on file with author).

toxic effects of fuels with MMT, the *Canadian Environmental Protection Act*[50] ("CEPA") was not the appropriate mechanism to address the regulation of MMT.[51] Finally, since ethanol is a substitute for MMT, Canadian producers of ethanol had much to gain by the ban. According to Soloway there are four plants in Canada where ethanol is produced. In addition, since ethanol is produced from corn, increased used of ethanol would produce a new market for Canadian corn farmers. Environment Canada had provided financial support to Canadian ethanol producers.[52]

As a result of the Canadian government policy, Ethyl made a claim under Chapter Eleven, attempted to institute a challenge under Chapter 20 of the NAFTA and challenged the constitutionality of the *Manganese-based Fuel Additives Act* (the "Act").[53] In addition, the Government of Alberta, joined by other provinces, successfully challenged the Act under Canada's Agreement on Internal Trade ("AIT").[54] With respect to Chapter Eleven, Ethyl claimed a breach of the national treatment, performance requirement and expropriation provisions of the NAFTA. Below I summarize the arguments made on each of the Chapter Eleven issues and then focus on the expropriation claim.

Article 1102 - National Treatment

In its claim, Ethyl argued that the ban on the import of MMT breached the national treatment provisions of Article 1102 because there was no reasonable or plausible explanation why domestically produced MMT was permitted for sale in Canada while imported MMT was banned. The ban resulted in prohibiting the sale of foreign-made MMT in Canada. In addition to discrimination, Ethyl argued that the ban was arbitrary because it did not prevent Ethyl from building plants within each province to supply MMT. Ethyl argued that MMT competes with other octane enhancers, such as ethanol, and that the ban benefited those producers by

---

[50]R.C.S. 1985 (4th Supp.), c. 16.

[51]*Statement of Defence, In the Matter of an Arbitration under Chapter Eleven of North American Free Trade Agreement Between Ethyl Corporation (Claimant/Investor)* v. *Government of Canada (Respondent/Party)*, dated 27 November, 1997 [hereinafter Statement of Defence] at §70 (on file with author).

[52]Soloway (MMT Controversy), *supra* note 2 at 71.

[53]S.C. 1997, c.11 (Bill C-29).

[54]See Soloway (MMT Controversy), *supra* note 2 at 75 - 91. While my comments focuses on the Chapter Eleven claim, Soloway notes that in the constitutional challenge to the Act, the federal government argued that the Act was enacted under the federal trade and commerce power and not under federal health or environmental jurisdiction.

discriminating against Ethyl.[55] Canada argued that the ban applied equally to Canadian and foreign investors and that it did not attempt to target foreign investors or to favour Canadian investors. Specifically, Canadian investors could not enter the MMT market because Ethyl holds the patent for MMT. It further argued that the fact that Ethyl was the sole importer of MMT into Canada cannot give rise to a breach of national treatment because it is a reflection of the industry structure. Further, Canada argued that the fact that MMT may be produced within a province does not breach national treatment because all investors and investments within a province are treated equally by the ban.[56]

Article 1106 - Performance Requirements

Ethyl argued that the ban on the import of MMT, but not its domestic production, breached Chapter Eleven prohibitions on performance requirements. First, Ethyl argued that it effectively requires MMT to have 100% Canadian content. Second, it imposes a requirement to build a MMT facility in every province in order to operate in Canada. Third, it imposes a *de facto* requirement to use domestic supply and labour to complete construction of the MMT manufacturing facilities.[57] Canada argued that the Act does not impose requirements, commitments or undertakings within the meaning of Article 1106, that no level of domestic production is required and that the prohibition does not accord a preference to Canadian goods. Canada argued the Act was intended to be an effective way of removing MMT from all gasoline and therefore no question of future production arises. And Canada argued that applying Ethyl's reasoning would mean that every border measure is a performance requirement. Finally, Canada argued that even if the ban was found to be a performance requirement, it was justified under the environmental exceptions for performance requirements in Article 1106(6).

Article 1110 - Expropriation

Ethyl made a number of claims with respect to expropriation. It argued that the Canadian government knew the ban would only affect Ethyl Canada and that it would cause a significant loss of sales revenue. Ethyl argued that the Canadian government's actions unreasonably

[55]Notice of Arbitration, *supra* note 49 at §§14-24.
[56]Statement of Defence, *supra* note 51 at §§77 - 83.

interfered with the effective enjoyment of Ethyl Canada's property and that, under international law, an expropriation exists where there is a substantial and unreasonable interference with the enjoyment of a property right.[58] Second, it argued that the Act interfered with Ethyl Canada's enjoyment of its goodwill as it removes Ethyl Canada from the octane enhancement market and deprives it of the substantial benefit of its investment.[59] Ethyl alleged that the government's assertion of the harmful effects of MMT and the introduction of the MMT legislation harmed Ethyl's goodwill and that the "defamatory and reckless statements of Canadian officials constitute a measure tantamount to expropriation of the goodwill of Ethyl Corporation and Ethyl Canada."[60] According to its claim, statements of government ministers in the context of their official duties constitute "measures" as they are practices of the government.[61] Ethyl claimed that the government's measures affected Ethyl's goodwill inside and outside of Canada.

Canada argued that the Act is a law of general application. It submitted that Article 1110 deals with the taking of property and not its regulation and that there had been no taking of property. In addition, it argued that the Act does not constitute expropriation because it involves the exercise of regulatory powers and the exercise of health and environmental measures under Article 1114(1) of NAFTA. It further argued that Ethyl's claim of expropriation of intellectual property, reputation and goodwill through out the world is not within the scope of NAFTA.[62] The Tribunal established under Chapter Eleven to hear Ethyl's claim noted in its Award on Jurisdiction that Ethyl's claim was that an expropriation occurred inside Canada, but that the investor's resulting losses were suffered both inside and outside of Canada.[63] In the Award on Jurisdiction, the Tribunal held this was a matter to be determined on the merits.

Analysis of Expropriation Claim

---

[57]*Statement of Claim, Ethyl Corporation (Claimant/Investor)* v. *Government of Canada (Respondent/Party), Statement of Defence*, dated 2 October, 1997 [hereinafter Statement of Claim] at §43 (on file with author).

[58]Notice of Arbitration, *supra* note 49 at §32.

[59]Statement of Claim, *supra* note 57 at §27.

[60]Notice of Arbitration, *supra* note 49 at §§59-60.

[61]Statement of Claim, *supra* note 57 at §25.

[62]Statement of Defence, *supra* note 51 at §§20 - 23.

[63]Award on Jurisdiction, *supra* note 23 at §72.

Ethyl's claim has been used by critics of the MAI and investment liberalization to demonstrate the dangers of the expropriation provisions in Chapter Eleven. Nevertheless, Ethyl's claim of expropriation was weak and likely would not have been successful. First, Ethyl would have to demonstrate it was deprived of property. While a substantial amount of Ethyl's business is the supply of MMT for unleaded gasoline[64] and Ethyl claimed lost profits, loss of value of its investment and loss of world-wide sales, the threshold question of whether it was deprived of an investment would have to be proven. Ethyl would probably be able to substantiate a deprivation. For example, if the ethanol industry was provided with a monopoly on fuel additives in unleaded gasoline the effect on Ethyl would have been similar to the ban. In such a scenatio a claim to compensation would likely exist under international law because there is little authority for applying the police power defence in cases of the establishment of monopolies, particularly if the monopoly is established to favour local producers of a product. Second, as discussed in Chapter Two, under its police powers, a state can regulate property to protect the public from harm. While the Act effectively deprived Ethyl of its business of supplying MMT for unleaded gas, under international law there is a police power defence to any claim of deprivation. Even though there was controversy over the effects of MMT on emission systems, there was some evidence that MMT harmed emission systems. Indeed, absent some reasonable basis for believing that MMT affected emission systems, it is hard to understand why the automobile industry lobbied so vigorously for a MMT ban. In its submissions, the government argued that it had to consider the risks and potential impacts of adverse effects of MMT on catalytic converters, on-board diagnostic systems and spark plug performance; the risk of increased emissions; the effect of malfunctioning systems on the acceptance of new emissions technology; concerns expressed about the potential toxic effects of airborne manganese; the unfairness of requiring new emission technology if MMT interfered with the proper operation of the technology; and Canada's inability to satisfy domestic and international targets for emission reductions if pollution control systems did not work.[65] These risks and potential impacts had to be weighed against the claims by Ethyl that MMT was environmentally beneficial and the cost to

[64]An Industry Canada document suggests that the sale of MMT represents 50% of Ethyl's sales revenue. Statement of Claim, *supra* note 57 at §23.

[65]Statement of Defence, *supra* note 51 at §§67-68.

refiners of using a substitute.[66] The Senate Standing Committee that considered the conflicting evidence on whether MMT causes onboard diagnostic systems to malfunction concluded that the evidence is inconsistent but that the government was justified in invoking the precautionary principle.

Counsel for Ethyl Corporation has suggested that under Article 1110(1) there is no police power defence.[67] Counsel argues that the combined effect of state responsibility for "measures tantamount to expropriation" and the inference from Article 1110(8) that non-discriminatory measures of general application can be "tantamount to expropriation" mean that state responsibility arises for all regulatory measures that deprive an investor of substantially all benefit of its investment. Under this approach, the focus is on the effect of the measure; whether a public purpose or goal is served by the measure is irrelevant. This is consistent with Higgins' approach to expropriation, reviewed in Section 2.2.1. Under Higgins' approach, if a measure is tantamount to expropriation, compensation is due with no exceptions. A strict interpretation of the NAFTA provisions in Article 1110 makes this a plausible interpretation since there is no express exception for police power regulation that is tantamount to expropriation. But since the provisions of many BITs are similar to NAFTA, such an interpretation would mean that not only NAFTA but also the Energy Charter Treaty and BITs have rejected a police power justification for some property deprivations. By using the term "expropriation" in Article 1110, it is reasonable to assume that the NAFTA Parties intended to incorporate international expropriation law into Article 1110(1). As discussed in Chapter Two, international law recognizes an, albeit vague, police power defence for certain regulatory measures. Not recognizing some police power defence would mean that bona fide confiscation of property for the commission of penal offences could be tantamount to expropriation. The provisions in Article 1110 cannot reasonably be interpreted to exclude completely police power regulation. Of course, even if one accepts there is a police power justification implicit in Article 1110, acknowledging the exception does not resolve the central issue - when does police power regulation amount to expropriation?

---

[66]Soloway (MMT Controversy), *supra* note 2 at 75.

There was some evidence (although admittedly not conclusive) of the adverse effects of MMT. Given that there was a rational basis for the ban, the ban and a zero risk policy on MMT likely could be justified by the police power defence. It is unlikely that Ethyl would have been successful in arguing that the ban could not be justified under the police power. Ethyl would have to prove the ban was arbitrary or enacted in bad faith. Under customary international law states exercise wide discretion under the police power. Unlike international trade law where measures that are trade-restrictive are typically subject to a stringent least-trade restrictive test, customary international law is deferential to state sovereignty.

The difficulty with defending the Canadian government's actions is that, as Soloway argues convincingly, there appear to have been other non-environmental considerations for the ban. In its Notice of Arbitration Ethyl quotes the Parliamentary Secretary to the Minister of Environment who stated: "When we are talking about banning MMT and replacing it, we are talking about a variety of substances being used in ways that all parts of this country can benefit [sic] instead of giving all of the money to an American firm."[68] While this statement indicates that the MMT ban included an element of environmental regulatory protectionism, there is not sufficient evidence to indicate that the primary aim of the MMT ban was protectionism. On the contrary, the vigorous lobbying of the CMVA suggests that the ban was primarily aimed at a legitimate government objective - ensuring pollution abatement technology did not malfunction and maintaining low emissions - even if it also conveniently served other protectionist interests. Provided that a measure is primarily aimed at a legitimate government objective to prevent harms to health, the environment, safety, public order and there is a rational basis for the measure, a requirement to compensate would not arise under Article 1110(1) for Ethyl's claim.

Under the framework proposed in Chapter Three, Ethyl's claim would not give rise to a claim of regulatory expropriation for two reasons. First, as I consider below, the ban on the import of MMT was primarily a trade in goods related measure and should have been reviewed as a potential breach of Canada's trade obligations under the NAFTA. Second, the ban was not an appropriation of property and would not give rise to a claim of expropriation under the

---

[67]Conversations between the author and Barry Appleton, Appleton & Associates.

framework proposed in Chapter Three. MMT is a quintessential case of a regulatory transition that should not create state responsibility for expropriation in international law.

The Relationship Between Chapter Eleven and Trade Obligations in NAFTA and WTO Agreements

NAFTA is the first plurilateral trade agreement to include investment provisions. The Ethyl claim illustrates the potential overlap between the investment and trade regimes and how measures relating to trade in goods can have investment effects. For example, under a wide interpretation of Chapter Eleven many domestic policies (such as agricultural supply-side management) can be viewed as performance requirements, since they effectively require the purchase of domestic products.[69] As I argued in the previous chapter, specific and elaborate international trade obligations have been created to discipline measures relating to trade in goods. The complex balancing tests in trade agreements have been designed to discipline exercises of the police power that are discriminatory or have disproportionate and unjustifiable impacts on trade. As a matter of principle, investors should not be able to challenge measures relating to trade in goods under an investor-state arbitration process. Allowing private investors to challenge trade-restrictive measures through investor-state arbitration establishes a second parallel process for disciplining trade-restrictive measures that has less well-defined rules. The investment disciplines in NAFTA are not as well-developed as the complex balancing tests in the international trade regime and ill-suited for determining whether trade-restrictive measures are justifiable. Review of trade-restrictive measures by investment tribunals privileges investors over traders by establishing a right of action (and to compensation) for trade-restrictive measures that have investment effects. Subjecting trade-restrictive measures to investment disciplines would result in investment protection being extended beyond its appropriate scope and would produce asymmetries between the two systems.[70] In addition, if trade-restrictive measures are reviewable through investor-state arbitration, countries may be less willing to pursue further trade and investment liberalization because of a concern that investors will be able to use new trade and investment disciplines against states in investor-state arbitration. A system allowing private interests to initiate complaints for measures that restrict trade should not be created

---

[68]Notice of Arbitration, *supra* note 49 at 44.

[69]Converations between author and Jon Johnson, Goodman Phillips & Vineberg, Toronto, Ontario.

indirectly through investment disciplines and investor-state arbitration. The issue of private parties initiating trade complaints in the WTO is a matter of considerable controversy and should be addressed on its own merits. While these arguments suggest the importance of distinguishing when trade rules should apply and when investment rules should apply, as I acknowledge in the previous chapter, making this distinction is a matter of considerable difficulty.

The relationship between Chapter Eleven and trade obligations in the NAFTA is unclear. Article 1101 provides that the chapter applies to measures adopted or maintained by a Party relating to: (a) investors of another Party; (b) investments of investors of another Party in the territory of the Party; and (c) with respect to performance requirements and environmental measures, all investments in the territory of the Party. It could be argued that measures "relating" to investment means measures primarily aimed at investment. If a wider scope was intended, the drafters could have stated that the chapter applies to measures *affecting* investment. It could be argued that "relating to" should be interpreted restrictively, for example, through a requirement that the measure be "primarily aimed at" investment and not just "incidentally affect investment".

The interaction between Chapter Eleven and the other chapters of the NAFTA is complicated by Article 1112 which provides that "[i]n the event of any inconsistency between this Chapter and another Chapter, the other Chapter shall prevail to the extent of the inconsistency." For example, Chapter 3 of the NAFTA has provisions on investment in the automotive sector. In the event of an inconsistency between Chapter Eleven and Chapter 3, the more specific provisions in Chapter 3 would prevail. In the Ethyl claim, Canada claimed that the ban on the importation of MMT fell within Chapter 3, Trade in Goods, as the ban on the importation of MMT was a border measure and, therefore, did not fall within the scope of Chapter Eleven.[71] In its Award on Jurisdiction, the arbitration tribunal established to hear the Ethyl claim noted that "Canada cites no authority, and does not elaborate any argument, however, as to why the two necessarily are

---

[70]This argument is based on comments from my thesis supervisor, Prof. M. Trebilcock.

[71]Statement of Defence, *supra* note 51 at §75.

incompatible."[72] The tribunal did not make a finding on this preliminary issue and it appears the Canadian government did not press the issue to be determined at the hearing on jurisdiction.

In a legal opinion on a proposal by the Canadian government to require cigarettes be sold in plain packaging (considered in more detail in Chapter Five), Professor Jean-Gabriel Castel of Osgoode Hall Law School at York University commented on the interaction between Chapter Eleven and the other chapters. Castel interprets Article 1112 "as giving precedence to Chapter Nine (standard related measures) and Twenty-One (exceptions) which recognize the health exception to be applicable to the import of goods."[73] According to Castel's argument, since Chapter 21 exceptions apply to trade in goods, provided a import or export restriction is consistent with obligations relating to trade in goods, no question of a violation would arise under Chapter Eleven. This argument supports the position that if a measure affecting trade in goods is justifiable under another NAFTA chapter, Chapter Eleven would not apply.

In *Canada - Certain Measures Concerning Periodicals*,[74] Canada argued that the obligations in GATT 1994 and GATS should be interpreted to avoid overlaps. The panel and Appellate Body rejected this argument and held that obligations under the two agreements can co-exist. A similar interpretation could be made with respect to the relationship between Chapter Eleven and the other chapters of the NAFTA; that is, there can be overlapping obligations under different chapters of the NAFTA. Given that the Parties have not expressly excluded measures falling under other chapters from Chapter Eleven and the drafters could have provided otherwise in Article 1112, a NAFTA investment tribunal may find that even if a trade in goods measure is consistent with NAFTA trade obligations, it may still have investment effects and within the scope of Chapter Eleven. Under this interpretation the trade and investment obligations co-exist and a measure can fall afoul of both trade and investment obligations.

---

[72]Award on Jurisdiction, *supra* note 23 at §63.

[73]Legal Opinion dated 11 May 1994 from J.-G. Castel to Fasken Campell Godfrey at 10 on file with the author.

[74]WT/DS31/R, Panel Report; WT/DS31/AB/R, Appellate Body Report (AB-1997-2). See Johnson, *supra* note 21 at 47.

The ban on MMT may have violated trade disciplines under NAFTA and the WTO. A letter dated February 23, 1996 from the Minister for International Trade to the Minister of Environment states in part:

> An import prohibition on MMT would be inconsistent with Canada's obligations under the WTO and the NAFTA: (1) it would constitute an impermissible prohibition on imports, particularly if domestic production, sale or use is not similarly prohibited; and (2) it could not be justified on health or environmental grounds, given current scientific evidence.
>
> ...Also, Ethyl Corp. may try to advance an argument that such a ban would be a measure tantamount to expropriation of Ethyl's investment in Canada. Thus, Canada may also be susceptible to an investor-state challenge under Chapter Eleven of the NAFTA.
>
> In conclusion, let me stress my department's belief that Bill C-94 should not be re-introduced as it could have many adverse implications for Canadian trade, without compensating environmental benefits.[75]

Ethyl had requested the US government to initiate a Chapter 20 panel to determine whether the ban breached NAFTA trade obligations but the US government refused, probably because of its own history of banning MMT and its interest in limiting the use of MMT in the US.[76] On its face, an import restriction would have violated NAFTA Article 309 (Import and Export Restrictions) and GATT Article XI (General Elimination of Quantitative Restrictions) and the Canadian government may not have been able to justify the MMT importation ban under the general exceptions in Chapter 21 of NAFTA (Chapter 21 incorporates an amended Article XX of GATT into NAFTA), particularly where domestic production in a province was still permitted. Provided Canada could justify a prohibition on MMT under Article XX(b) (human, animal or plant life or health) or XX(g) (conservation of exhaustible natural resources),[77] it would have to argue that even though domestic production was allowed, the MMT ban did not constitute arbitrary or unjustifiable discrimination because it was intended to effectively bar MMT from the market. The Canadian government may have argued that the method of banning MMT was not arbitrary because it was one of the few means available to the government under Canada's federal legal structure.

---

[75]Appendix to Notice of Arbitration, *supra* note 49.

[76]See Soloway (MMT Controversy), *supra* note 2 at 90.

[77]In *U.S. - Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, the Panel found that the clean air is an exhaustible natural resource.

Assuming Chapter Eleven also applies to measures that fall within the scope of other chapters, a violation of Article 309 on export prohibitions that could not be justified under the general exceptions in Article 2102 would not be determinative of a Chapter Eleven expropriation claim. There is a higher degree of scrutiny of measures that restrict trade under GATT Article XX than to justify the exercise of the police powers under customary international law. While a government measure may be a violation of a trade agreement, the public international law standard of arbitrariness has traditionally been higher. While there is authority for the principle that states are responsible for arbitrary measures that cause economic injury to foreigners, international public law has traditionally set a high threshold for actions that are arbitrary or an abuse of rights. For example, there is no duty in customary international law to adopt the least restrictive measures available. Therefore, even if a measure does not comply with NAFTA trade provisions, no presumption should arise of a breach of an obligation under Chapter Eleven.

Another interpretive issue is whether the violation of a trade obligation, for example a finding that a measure fails to satisfy the requirements in Chapter 7 for sanitary and phytosanitary ("SPS") measures or violates Article 309, creates responsibility under Chapter Eleven. This could arise, for example, by arguing that the breach of an obligation in NAFTA amounts to a breach of Article 1105. It could be argued that by failing to comply with its international obligations, a Party has failed to accord "treatment in accordance with international law, including fair and equitable treatment and full protection and security". Since this interpretation would allow private parties a right of compensation for losses suffered because of the violation of *any* provision of the NAFTA, GATT or another trade treaty that has an investment effect, this would be an entirely novel and far-reaching right that could only be exercised by investors. It would be an unreasonable interpretation of Article 1105 to allow investors to obtain damages for losses suffered as a result of a breach of international trade obligations. As discussed in the previous chapter, the requirement for "fair and equitable treatment and full protection and security" is designed to provide due process and to protect investors from abusive state conduct. A mere breach of a trade obligation does not breach the minimum standard of justice embodied in the concept of denial of justice and international human rights.[78]

[78]See R.B. Lillich, ed., *International Law of State Responsibility for Injuries to Aliens* (Charlottesville: University Press of Virginia, 1983), C.F. Amerasinghe, *State Responsibility for Injuries to Aliens* (Oxford:

The Meaning of Measures and Remedying Procedural Irregularities

One further aspect of the Ethyl claim relating to the scope of Article 1110 is the definition of "measure". At the hearing on jurisdiction in the Ethyl claim Canada argued that the Tribunal was without jurisdiction, because in addition to procedural irregularities,[79] the Notice of Intent to Submit a Claim to Arbitration and the Notice of Arbitration were delivered prior to the Act coming in force (June 24, 1997) and there was no "measure" for which a claim could be submitted. Article 201 defines "measure" broadly as including "any law, regulation, procedure, requirement or practice." But Articles 1803(1) and (2) and Article 2204 of the NAFTA refer to proposed or actual measures which suggests that proposed legislation cannot be a "measure".[80] In addition, Article 1101 provides that Chapter Eleven applies to measures "adopted or maintained". In its Statement of Defence, Canada argued that only a duly passed statute constitutes a measure.[81] While a statement of legislative intent or government policy, in itself, cannot amount to an expropriation, the extent to which statements could be measures under Chapter Eleven is less clear. In the Ethyl claim, Ethyl argued that statements by the Canadian government were defamatory. It is extremely unlikely that the investment protection in Chapter Eleven extends to defamatory statements, but it is still possible that a statement could create state responsibility under Chapter Eleven. For example, if government officials through statements incited citizens to destroy an investor's property, the obligation under Article 1105 to provide fair and equitable treatment and full protection and security would likely be breached.

At the hearing on jurisdiction Ethyl argued that, by the time of the hearing, it had complied with all requirements for submission of its claim and the jurisdictional question was essentially

---

Clarendon Press, 1967), A. Freeman, *The International Responsibility of States for Denial of Justice* (New York: Kraus Reprint Co. 1970), G. Fitzmaurice, "The Meaning of the Term "Denial of Justice"" (1932) 13 B.Y.I.L. 93 and S. Verosta, "Denial of Justice", R. Bernhardt ed., *Encyclopedia of Public International Law*, (1992) Volume I at 1007.

[79]Canada argued Ethyl failed to submit waivers in accordance with the requirements in Article 1121.

[80]In Ethyl, Canada conceded that a bill becomes a measure upon the giving of Royal Assent even though it may not come in force until later. Award on Jurisdiction, *supra* note 23 at note 28.

[81]Statement of Defence, *supra* note 51 at §22. The Tribunal noted that Canada's *North American Free Trade Agreement: Canada's Statement on Implementation* states that measure "is a non-exhaustive definition of the ways in which government impose discipline in their respective jurisdictions." See Canada Gazette Part I, vol. 128, no.1 (January 1, 1994) at 80. The statement sets out "Canada's general approach to trade policy, the role of NAFTA and the Government's interpretation of the rights and obligations in NAFTA." *Ibid.* at 68.

whether procedural regularities could be remedied. The Tribunal held that dismissal of the claim would not serve the object and purpose of the NAFTA because it was undisputed that the Act constituted a measure and that Ethyl could immediately recommence its claim. The Tribunal noted that Ethyl probably "jumped the gun" for tactical reasons to put pressure on the Canadian government and to affect debate on the legislation. This ruling effectively allows Chapter Eleven to be used as a strategic mechanism to put pressure on governments when proposed legislation or policies may violate Chapter Eleven.

4.3.2 S.D. Myers Inc. - PCB Waste Disposal

In July 1998, Ohio based S.D. Myers, a waste disposal company, submitted a claim that Canada breached its obligations under Chapter Eleven as a result of a 1995 *Interim Order* made under the CEPA that banned the export of PCB wastes to the United States.[82] At the time the *Interim Order* was made, few options were available in Canada for disposal of wastes with high concentrations of PCBs. With the support of the Albertan government, a permanent PCB treatment facility had been established in Swan Hills, Alberta. In addition, there were a number of mobile incinerators located in Quebec. Because of the lack of disposal facilities in Eastern Canada, export to US disposal companies in the United States was seen as a cost effective solution. While the border between Canada and the United States has traditionally been closed to shipments of PCB wastes, in 1995 S.D. Myers obtained EPA approval to import PCBs from Canada for disposal. While the EPA decision was overturned in 1997, there was a window of 15 months during 1995 - 1997 where Canadian firms could have exported PCBs to S.D. Myers. The result of the *Interim Order* and other succeeding regulation was to prohibit such exports. S.D. Myers claims $US15 million in damages as a result of the ban. Weiler notes that concerns were expressed by officials that regulatory action to close the border would violate NAFTA because there was a lack of compelling environmental or health concerns for the ban and that protection of the economic interests of the Swan Hills and the Montréal, PCB disposal facilities

---

[82]This summary is based on T. Weiler, "Application of the Federal Regulatory Policy to Regulatory Decision-Making: The Curious Case of the 1995 *PCB Waste Export Interim Order*" (1998) 4 J. Env. L & Prac. 181, H. Scoffield, "U.S. Firm Hits Ottawa with NAFTA Lawsuit" *Globe and Mail* (21 August, 1998) B1-B2 and H. Scoffield, "NAFTA Process 'Unacceptable'" *Globe and Mail* (25 August, 1998) A4, H. Scoffield, "U.S. Firm Up in Arms Over Toxin Ban" *Globe and Mail* (22 October, 1998) B8 and International Institute for Sustainable Development, *NAFTA's Chapter Eleven and the Environment: Addressing the Impacts of the Investor-State Process on the Environment*, *supra* note 2.

could not be justified under the CEPA. Weiler argues that the benefits of allowing export to the United States (faster and cheaper disposal and the discouragement of long-distance shipments) far outweighed the benefits of supporting the domestic waste disposal industry.[83] It is unclear what investment in Canada S.D. Myers is claiming was expropriated by the government regulation.

4.3.3 Pope & Talbot Inc. - Softwood Lumber Exports

Pope & Talbot Inc., a Portland based forest products company with lumber operation in Canada, is claiming damages because of an alleged breach of the minimum standard of treatment, national treatment, most favored nation treatment, performance requirements and expropriation obligations resulting from the implementation of the 1996 *Softwood Lumber Agreement* (the "Agreement") between Canada and the US. Pope & Talbot, claim, among other things, that Canada discriminated against companies in British Columbia by unfairly distributing lumber quota under the export control regime with which Canada implemented the Agreement.[84] Pope & Talbot claims that it has lost 6.3% in allocated fee-free quota over the first three years of the Agreement. Pope & Talbot claims Canada acted inconsistently with its obligations under Article 1110(1) because it deprived Pope & Talbot of its ability to carry out its otherwise legal business operations on a discriminatory basis, failed to act in accordance with due process of law and Article 1105(1) and failed to provide compensation.[85]

4.3.4 Methanex Corporation - Ban on MTBE

In a claim strikingly similar to Ethyl's, Methanex Corporation of Vancouver announced on June 15, 1999 that it intends to make a claim for $US970 million under Chapter Eleven as the result the State of California's decision to ban the sale of MTBE (methyl tertiary butyl ether) by 2002, a fuel additive used to reduce tailpipe emissions. MTBE represents 30% of methanol demand. Methanol is Methanex's only product and is the basic input that American refiners use in MTBE.

---

[83]Weiler, *ibid.* at 199 - 213.

[84]*Executive Summary: NAFTA Investor State Dispute Claim by Pope & Talbot, Inc.*, dated March 25, 1999 [hereinafter Executive Summary] online: Appleton & Associates Homepage <www.appletonlaw.com> (date accessed: 15 June, 1999), Heather Scoffield, "Another U.S. firm sues Ottawa under NAFTA" *The Globe and Mail* (16 February 1999) B1 and I. Jack and D. Hasselback, "Canada Heading into a Double Round of Lumber Battles" *National Post* (26 March 1999) C4.

The decision to ban MTBE is related to claims that MTBE contaminates ground water supplies as the result of the release of gasoline into the environment.[86] Methanex's news release quotes the company president Pierre Choquette as stating "Our claim is related to expropriation. The NAFTA requires that an expropriating party meet certain obligations including fair and equitable treatment and the payment of compensation, which California did not meet."[87] This claim raises a number of issues. Since the full ban is proposed for 2002, it is unclear whether there is a measure that can serve as the basis for a claim. Second, since methanol is only a raw material for MTBE, Methanex will have to argue that a ban on MTBE is tantamount to an expropriation of its business supplying methanol to US refiners.

4.3.5 The Four Mexican Claims

Four claims have been initiated against Mexico. Metalclad Corp., a California based hazardous waste disposal company, filed a claim in January 1997, alleging that after being invited by state officials to set up a landfill, the state government of San Luis Potosi expropriated its hazardous-waste landfill located in Guadalcazar.[88] News reports suggest that Metalclad took over the facility from a previous owner, but that after an environmental impact assessment was done, the Governor refused to allow Metalclad to open the facility. Second, Desechos Solidos de Naucalpan's ("DESONA") three principals have claimed that DESONA bid on a 15 year management contract for a solid-waste landfill project in Naucalpan de Juarez and incurred $US 3 million of costs. After the contract was signed, DESONA alleges that the Naucalpan county council nullified the agreement, violating Chapter Eleven.[89] Third, USA Waste Services, Inc. a

---

[85]*Ibid.* Executive Summary at 7.

[86]Methanex News Release, "Methanex Seeks Damages Under NAFTA for California MTBE Ban" (15 June 1999) online: Methanex Corporation Homepage: <http://www.methanex.com> (last accessed June 22, 1999) [hereinafter Methanex News Release], P. Morton "Damage Claims Upset NAFTA" *National Post* (17 June 1999), A. Duffy "Methanex Lawsuit Raises Ire of NAFTA Foes" *The Vancouver Sun* (17 June 1999) F5, "A New Role for a Trade Deal", editorial, *Globe and Mail* (18 June 1999) A14 and B. McKenna, "Fight Against Methanex's Fuel Additive May Spread" *Globe and Mail* (28 June 1999) B8.

[87]*Ibid*., Methanex News Release.

[88]*Metalclad* v. *United Mexican States* (ICSID Case No. ARB(AF)/97/1, Claims registered 13 January, 1997, Arbitrators: E. Lauterpacht, B.R. Civiletti, J.L. Siqueiros). See online: World Bank Homepage <http://www.worldbank.org/icsid/cases/pending.htm> (date accessed: 18 June, 1999).

[89]M. Nolan & D. Lippoldt, "Obscure NAFTA Clause Empowers Private Parties" *The National Law Journal* (6 April 1998) B8; *Robert Azinian and others* v. *United Mexican States* (ICSID Case No. ARB(AF)/97/2, Claims registered 24 March, 1997, Arbitrators: J. Paulsson, B.R. Civiletti, C. von Wobeser Hoepfner). See online: World Bank Homepage <http://www.worldbank.org/icsid/cases/pending.htm> (date accessed: 18 June, 1999).

Houston based company is seeking $US 60 million for an alleged breach of an agreement to grant a street cleaning concession in Acapulco and to develop a landfill.[90] Most recently, Marvin Feldman, an individual involved in an export business in Mexico, has claimed $US 50 million for lost profits, for denial of excise tax rebates on cigarette exports and of loss of goodwill. Feldman claims a breach of the minimum standard of treatment and expropriation for the refusal of the Mexician authorities to rebate excise taxes.[91]

4.4 Clarifying the Scope of Chapter Eleven

As noted above, Article 1131(2) provides that an interpretation of the NAFTA Commission of a provision of the NAFTA is binding on an investor-state arbitration tribunal. As part of the five year review of the NAFTA and also as a result of the Chapter Eleven claims described above, the NAFTA Parties have begun discussions on clarifying Chapter Eleven. The United States and Mexico do not appear to share Canada's eagerness to clarify certain aspects of Chapter Eleven. The EPA and Justice Department in the US are supportive of changes while the Treasury Department, the Department of Commerce, the State Department and the Office of the US Trade Representative are less supportive. Mexican reaction has likewise been mixed.[92] At a meeting of trade ministers in April 1999, Mexico expressed opposition to retroactively narrowing the interpretation of the NAFTA. Mexican Minister of Trade and Industrial Investment, Herminio Blanco said that the interpretation of Chapter Eleven should be left to the dispute settlement process established under the NAFTA.[93] There has been some discussion that the Commission for Environmental Co-operation ("CEC") may take a role in reviewing investment claims under the NAFTA that involve environmental laws.[94] However, it is unclear what role the CEC can play once a claim is submitted to arbitration under Chapter Eleven, given that Chapter B sets out

---

[90]"New NAFTA Investor-State Case Against Mexico to be Filed" *Americas Trade*, vol. 5/12, June 11, 1998. *USA Waste Services, Inc.* v. *United Mexican States* (ICSID Case No. ARB(AF)/98/2, Claims registered 18 November, 1998, tribunal not yet constituted. See online: World Bank Homepage <http://www.worldbank.org/icsid/cases/pending.htm> (date accessed: 18 June, 1999).

[91] *Marvin Roy Feldman Karpa* v. *United Mexican States* (ICSID Case No. ARB(AF)/99/1, Claim registered 27 May, 1999). See online: World Bank Homepage <http://www.worldbank.org/icsid/cases/pending.htm> (date accessed: 18 June, 1999) and IISD Chapter Eleven Report, *supra* note 2 at 67.

[92]"Canadian, Mexican Ministers Differ on Investor-State Clause" *Americas Trade*, vol. 6/4, February 25, 1999 at 3 and "Administration Split on Changes to NAFTA Investor-State Provisions" *Inside U.S. Trade*, vol. 17/2, January 15, 1999 as described by Soloway (Chapter Eleven), *supra* note 2.

[93]"NAFTA Ministers: Canada Proposes to Narrow Investor-State Provision", *Bridges Weekly Trade News Digest*, Vol. 3, No. 17 (3 May 1999), online: ICTSD Homepage <http://www.ictsd.org>.

a legally binding framework for the resolution of investment disputes. A recent report by the International Institute for Sustainable Development that analyzes the impacts of Chapter Eleven on the environment suggests that the CEC could facilitate public and private meetings on developing an interpretive statement by the NAFTA Parties on Chapter Eleven.

In November, 1998 the Canadian Department of Foreign Affairs and International Trade ("DFAIT") sent issues papers on expropriation and transparency to American and Mexican government officials.[95] The issue paper on expropriation states that the expropriation provisions in Chapter Eleven are similar to those in other BITs and that the NAFTA parties never intended the provisions to limit the legitimate rights of governments to regulate. The paper suggests that the phrase "No party may directly or indirectly...nationalize or expropriate an investment" must involve the taking of ownership. Turning to a "measure tantamount to nationalization or expropriation", the paper suggests that the phrase may mean something more than "indirect" expropriation or it may be redundant.[96] It notes that as a result of Article 1110(8) which exempts certain non-discriminatory measures of general application, it can be argued the phrase "measures tantamount to expropriation" should be given a full and unlimited interpretation.

The issue paper suggests that "[a]ll types of regulatory practice should be excluded from the ambit of these provisions to the extent they are legitimate and reasonable"[97] but argues that any test to distinguish between compensable and non-compensable measures could be arbitrary. In addition, any carve out for certain government activities could undermine the object of effective investor protection and, as a result of under-inclusiveness, could put legitimate government regulation at risk of claims of compensation. The issue paper asks:

> …how can an interpretation confirm that the regulatory actions of government are not covered to the extent that the [sic] such actions or measures are reasonable on their face? Could we confirm that it is up to the challenger of an act or measure to demonstrate an

---

[94]B. McKenna, "More clout sought for NAFTA green watchdog" *Globe and Mail* (11 December 1998) B5.

[95]"Canada Memo on Investor-State Provisions", *Americas Trade* (11 February 1999) 20. The issue paper on transparency canvasses the following issues: confidentiality of the hearing process, public announcements, release of arbitration documents and amicus briefs. See *ibid.* at 22 - 25.

[96]The paper notes that older US BITs provide examples of measures tantamount to expropriation, such as the levying of taxation, the compulsory sale of all or part of an investment, or the impairment or deprivation of the management, control or economic value of the investment. *Ibid.* at 21.

[97]*Ibid.* at 21.

> absence of *bona fides*, or an abuse of governmental powers or that the effect of the government actions or measures is truly expropriative?
>
> Is it feasible to define a list of government activities not requiring compensation? Are there other means by which compensable and non-compensable regulation may be distinguished?[98]

In attempting to derive an appropriate interpretation, the paper asks whether the Parties can agree on the following assumptions based on international law:

> i) that liability for expropriation does not require a transfer of title to the State;
> ii) that liability may arise whenever acts attributable to a State deprive a foreign investor of property rights of value, irrespective of whether the State has obtained anything of value;
> iii) that liability may be found where a State subjects a foreign investor or investment to such unreasonable interference with the effective enjoyment of property notwithstanding that the acts or measures in question are not labelled expropriations or nationalizations;
> iv) that the intent to expropriate or the absence thereof on the part of the State is not necessarily determinative of a finding of liability; and
> v) that customary law recognizes that acts or measures that may have an impact on the value of property rights are not expropriatory where such acts or measures are non-discriminatory and within the normal exercise of a State's regulatory prerogative.[99]

The above statements of international law are generally consistent with the conclusion in Chapter Two. But they have limited practical utility in furthering an understanding of the scope of Article 1110(1). Paragraphs (ii) and (iii) refer to "liability" and not "liability for expropriation" and therefore do not specify when liability arises for expropriation.

As discussed in Section 4.2, under Article 1131, an interpretation by the NAFTA Commission of a provision of the NAFTA is binding on an investor-state arbitration tribunal. While the extent of the Commission's power to interpret provisions is not unlimited, the vagueness of Article 1110(1) and customary international law provide substantial discretion to the Commission to propose an interpretation of the NAFTA. In addition to Article 1131, Article 31(3)(a) of the *Vienna Convention on the Law of Treaties* provides that "[a]ny subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions" shall be taken into account in the interpretation of the treaty. Provided that an interpretation of Article 1110(1) is not expressly inconsistent with the NAFTA such as to amount to an amendment under

---

[98] *Ibid.* at 21.
[99] *Ibid.* at 21.

Article 2202, the Commission could provide a binding interpretation of the provisions of Chapter Eleven. While for legal certainty an amendment under Article 2202 may be preferable, especially if changes consistent with the framework in Chapter Three were to be made, an amendment to the NAFTA may not be possible given the current political environment in the US and Mexico.[100] Until there is an opportunity to do so, a binding interpretation under Article 1131 should be issued.

An interpretive statement could resolve much of the ambiguity and uncertainty regarding the scope and interpretation of Chapter Eleven. With respect to the scope of Chapter Eleven, an interpretative statement under Article 1131 could provide a restrictive interpretation of Article 1101 and provide, as recommended above, that Chapter Eleven does not cover trade-restrictive measures that have an incidental effect on investment. Second, an interpretative statement could recognize a police power defence to claims of expropriation under Article 1110. This would not go as far as the proposed framework in Chapter Three suggests but would eliminate the most significant uncertainties. While an interpretive statement that limits claims under Article 1110(1) to appropriations of property is most desirable, this may amount to an amendment of Article 1110 and is also unlikely to be acceptable to the US because of its traditional adherence to an effects based test of expropriation. The second best solution is to provide for a police power exception to Article 1110(1).

A recent report by the International Institute for Sustainable Development recommends that an interpretive statement be adopted by the NAFTA Parities to reduce uncertainties over the scope of Chapter Eleven and to restore certainty and predictability for government regulatory activities. It recommends clarification of the application of the national treatment provision to environmental measures to ensure that investment specific regulation often used for environmental protection is not held to violate the requirement for national treatment "in like circumstances". It suggests a clarification of the relationship between environmentally-based measures that restrict trade (such as bans imports and exports) and the performance requirements

[100]The IISD Chapter Eleven Report *supra* note 2 at 59 argues that a NAFTA amendment is not likely to be successfully negotiated until after the next Mexican and US presidential elections.

prohibitions in Chapter Eleven. Third, it recommends that the scope of Article 1110(1) be clarified as follows:

> For greater certainty, and without prejudice to any other interpretational issues, Article 1101(1) as a matter of definition, does not include within any of the terms set out in that Article, including, "directly or indirectly nationalize or expropriate," and "measure tantamount to nationalization or expropriation," non-discriminatory measures taken for a public purpose consistent with a legitimate objective as defined in Chapter 9 of NAFTA, and in accordance with due process of law and Article 1105. This interpretation does not create any other implications or applications to the interpretation of Article 1110 beyond its express words.

Article 915 of NAFTA provides that "legitimate objective" includes an objective such as:

> (a) safety;
> (b) protection of human, animal or plant life or health, the environment or consumers, including matters relating to quality and identifiability of goods and services, and
> (c) sustainable development,
>
> considering, among other things, where appropriate, fundamental climatic or other geographical factors, technological or infrastructural factors, or scientific justification but does not include the protection of domestic production.

This statement is both over-inclusive and under-inclusive. The creation of park-like status for land may be necessary for the protection of plant life, but should not justify non-compensation if the regulation amounts to appropriation of the property for public use as in the *Tener* case.[101] Regulations that amount to acquisitions of property should be compensable. The statement is under-inclusive because it does not cover other legitimate regulatory objectives, particularly the maintenance of public order.

Clearly drafting an interpretative statement acceptable to all NAFTA Parties will be a difficult process. But there is already substantial agreement that "normal" or "reasonable" government regulatory measures should not give rise to compensation for expropriation. Foreign insurance contracts and draft codifications can also be used as precedents for the drafting of the statement. The NAFTA parties should proceed with preparing an interpretative statement immediately.

4.5 Conclusion

[101]See Section 3.2.1, above, and Section 5.1, below.

The scope of expropriation under Chapter Eleven of the NAFTA is not wider than that under customary international law. Unlike the draft codifications reviewed in Chapter Two, NAFTA and BITs do not refer to takings or deprivations of property, they refer to measures tantamount to expropriation. And as the ICJ noted in the *ELSI* case, the word taking has a wider and looser meaning than "espropriazione".[102] The use of the term "expropriation" suggests that its meaning is to be determined based on existing authorities in international law as discussed in Chapter Two.

Customary international law and the NAFTA do not unduly restrict government authority to protect the public from harms caused by investments or to establish an appropriate levels of protection and risk. The Ethyl claim does not justify the conclusion that the NAFTA unjustifiably constrains governments from passing environmental legislation. It is likely that the Ethyl case was settled because of the concern that evidence that the ban on MMT had some protectionist intent raised the possibility that a Tribunal may have been inclined to favour Ethyl's interpretation of the expropriation provision. In addition, it is less certain whether the MMT legislation could be justified under other provisions of NAFTA and GATT. With respect to the S.D. Myers claim, there is insufficient information to be able to assess the claim. Assuming S.D. Myers had an investment in Canada, the facts suggest there may have been an unjustified breach of national treatment because of discrimination in favour of a Canadian PCB facility. Discrimination is also strongest element of the Pope & Talbot claim. With respect to the claims in Mexico, at least three involve breaches of contract and resolution of those disputes will likely depend on the specific contractual provisions in place. The strongest elements of the Loewen and Feldman claims are breaches of the minimum standard of treatment, and in the case of Loewen, also a breach of national treatment. In addition to a police power justification for a ban on MTBE, it is unclear whether the Methanex claim comes within the scope of Chapter Eleven. No government measure has been adopted that can be the subject of a claim and Methanex is only the supplier of a raw material used in the production of MTBE.

[102]See, above, Section 2.1.2.

The above comments do not suggest that concerns over the potential scope of the expropriation provisions should disregarded. The lack of clear precedents in international law and the lack of clarity in Article 1110(1) create legitimate concerns that an investment tribunal will adopt a wider interpretation of the provisions that I have argued is warranted. An interpretative statement, and possible amendment, of Chapter Eleven should be pursued. A recent report from the International Institute of Sustainable Development on Chapter Eleven Report argues that:

> …the substantive uncertainties of interpretation in Chapter Eleven are so great as to unacceptably impair the ability of governments to effectively regulate in the public interest. The uncertainty finds concrete expression as the risk that governments may be forced to pay foreign investors in order to be able to effectively regulate the environment, no matter how sound the science and non-discriminatory the measure…
> …
> It is important for investment agreements to provide security and predictability to foreign investors. But security and predictability are equally important to public purpose regulators.[103]

As the report suggests, security and predictability are important for government and investors. An interpretative statement is required in order to remedy the uncertainty of the scope of expropriation in Chapter Eleven and international expropriation law. It would be preferable to have an amendment of the NAFTA which would adopt the approach to investment protection proposed in Chapter Three. However, given the traditional US approach to takings in its domestic law and BITS, it would likely reject any attempt to limit the meaning of expropriation to appropriation of property. An interpretative statement and eventual amendment which provides an express exception for regulatory measures for police power regulation represents a second best solution to the uncertainty and unpredictability of the expropriation provisions in Article 1101 of the NATFA.

[103]IISD Chapter Eleven Report, *supra* note 2 at 6-7.

5. INVESTMENT PROTECTION AND DOMESTIC REGULATORY AUTHORITY

Introduction

In this chapter I examine how domestic regulatory authority in Canada with respect to regulatory measures that deprive investors of property rights may be affected by investment protection agreements, customary international law and investment liberalization. The first section provides an overview of Canadian expropriation law. In the second section I review a number of measures proposed by the Canadian government that investors claimed did not comply with Canada's international obligations for the treatment of foreign-held property. I then analyze the potential impact of Canada's international obligation's on domestic regulatory authority. In this last section I argue that the scope of expropriation is wider under international law than Canadian law. As a result domestic sovereignty with respect to property rights is constrained by international law.

5.1 Regulatory Expropriation in Canadian Law

Expropriation of land and interests in land is governed in Canada by federal and provincial expropriation legislation.[1] Constitutional protection of property rights was explicitly rejected during the debates in the early 1980's on amending the *Constitution Act, 1867*. The leading cases and authorities establish that the right to compensation is entirely statutory and that there is no common law or constitutional right to compensation.[2] The traditional approach to expropriation is summarized by Marceau J. in *La Ferme Filiber Ltée* v. *The Queen*:

> An expropriation implies the dispossession of the expropriated party and appropriation by the expropriating party; it necessarily requires a transfer of property rights from one party to the other. It is generally accepted there is no common law substantive right to compensation for expropriation - entitlement to compensation is purely statutory. However, there is a rule of statutory interpretation that, unless the words of a statute clearly require it, a statute is not to be construed as taking away property without compensation.[3]

The Ontario Court of Appeal recently confirmed the above principles with respect to the impact of rent control legislation on landlords and also confirmed there is no constitutional right to compensation for expropriation of property in the Canadian *Charter of Rights and Freedoms*:

> The 1991 Act is not an act of expropriation by the Crown. Rather it is an exercise of its regulatory authority. There is no principle of statutory interpretation that would presume that those adversely affected by a statute regulating their affairs are entitled to compensation unless the statute says otherwise. No policy basis is readily apparent for such a rule. Indeed, such a policy would severely hamper the operation of the modern state where most regulatory legislation, however remedial, adversely affects someone. Moreover, if regulatory legislation voiding but not expropriating property rights triggered a presumed right to compensation from the state, the effect would be to give property rights the equivalent of the protection accorded by s.7 of the *Charter* despite the clear exclusion of such rights from the *Charter of Rights and Freedoms* by its drafters. In other words, an individual would have the right not to be deprived of his property by regulatory legislation except with compensation or with an explicit over-ride of that right by legislative language. This would seem to do indirectly something the framers of the *Charter* declined to do.[4]

---

[1] See generally, E. Todd, 2nd ed., *The Law of Expropriation in Canada* (Toronto: Carswell, 1992).

[2] See R.J. Bauman, "Exotic Expropriations: Government Action and Compensation" (1994) 52 Advocate 561 for a discussion of case authority that could support a common law right to compensation.

[3] *La Ferme Filiber Ltée* v. *The Queen*,[1980] 1 F.C. 128 (F.C.T.D.) at 130. In this case a rainbow trout hatchery had operated for two years under a government license. A regulation was passed prohibiting the rearing of trout in the area in which the hatchery was located, effectively putting the hatchery out of business. Marceau J. held there was no basis for claiming expropriation.

[4] *A & L Investments* v. *Ontario* (1997), 36 O.R. (3d) 127 (O.C.A.) at 135.

Although the leading cases suggest that the right to compensation for expropriation is entirely statutory, there is an older line of cases which suggests there is a common law right to compensation for expropriation.[5] Even if there is a common law right to compensation for expropriation, there must be an appropriation of property for a claim of expropriation to arise. A regulatory prohibition or restriction resulting in a deprivation or the loss of the use of a property right without a corresponding appropriation of property by the state is not compensable:

> A mere negative prohibition, although it involves interference with an owner's enjoyment of property, does not, I think, merely because it is obeyed, carry with it at common law any right to compensation. A subject cannot at common law claim compensation merely because he obeys a lawful order of the State.[6]

Claims that government regulation is tantamount to an expropriation of property have been largely unsuccessful. Canadian courts have denied claims of expropriation in the following circumstances: the designation of a hotel as a heritage building and a prohibition on redevelopment;[7] a city bylaw for the provision of municipal waste collection to apartment buildings that required apartment owners to pay a waste collection fee to the city and that effectively destroyed the apartment building waste disposal business of the existing operator;[8] rent control legislation that retroactively voided orders already obtained by landlords giving them the right to charge rent increases in the future;[9] changes to bingo gaming policy by the government that prohibited a private operator from running a bingo hall;[10] and the government assuming direct responsibility for the provision of home health care services that destroyed a private home health care business that derived almost all of its business from the government.[11]

Federal and provincial legislation provide a statutory scheme for the expropriation of land and interests in land. In cases of claims of expropriation for non-land property interests, the court will look to the legislation authorizing the measure. If the court finds that the government measure is an expropriation of property, as opposed to regulation, the court will apply the

---

[5]See Bauman, *supra* note 2.

[6]*France Fenwick and Co.* v. *The King*, [1927] 1 K.B. 458 (K.B.D.) at 467 per Wright J.

[7]*Harvard Investments Ltd.* v. *Winnipeg (City)*, [1996] 2 W.W.R. 267 (Man. C.A.).

[8]*WMI Waste Management of Canada Inc.*v. *Edmonton (City)* (1996), 31 M.P.L.R. (2d) 251 (Alta. C.A.).

[9]*A & L Investments* v. *Ontario*, *supra* note 4.

[10]*Keystone Bingo Centre Inc.* v. *Manitoba Lotteries Foundation* (1990), 76 D.L.R. (4th) (Man. C.A.).

presumption that a statute, unless so required, is not to be construed to take away property without compensation. This does not mean that if an expropriation is found and the legislation is silent as to compensation, compensation is always granted. The rule is not a matter of mechanical application; the intention of the legislature will be sought by interpreting the legislation according to the rules of statutory interpretation. It may be evident that the legislature did not intend to provide compensation even if there is no explicit provision denying compensation.[12]

There are two leading Supreme Court of Canada (the "Court") cases on what amounts to an expropriation of property. In *Manitoba Fisheries Ltd.* v. *R.*,[13] the Court held that the goodwill of Manitoba Fisheries had been expropriated by the establishment of a government fish exporting corporation. Under the *Fresh Water Fish Marketing Act*, the federal government had established a fish marketing corporation with a commercial monopoly on the export of fish. The legislation establishing the government corporation provided compensation for privately-held physical assets that had became redundant as a result of the state monopoly, but the legislation did not explicitly provide compensation for the value of the business as a going concern. Manitoba Fisheries had been in the fish marketing business for over forty years and was forced out of business by the legislation. It claimed compensation for the loss of its goodwill. The Court held that Manitoba Fisheries' goodwill had been acquired by statutory compulsion since the legislation in question gave the Crown corporation a commercial monopoly on fish exporting. Having found an appropriation of property by the government, the Court applied the presumption that a statute is not to be construed to take away property without compensation. Since there was no express provision in the legislation regarding compensation for goodwill, the Court held that compensation was due.

The Court has also held that a regulatory restriction can amount to expropriation.[14] In *British Columbia* v. *Tener*,[15] the Court found an expropriation had occurred where the government

---

[11]*Home Orderly Services* v. *Government of Manitoba* (1987), 32 D.L.R. (4th) 755, aff'd 43 D.L.R. (4th) 300 (Man. C.A.).

[12]See *British Columbia Medical Association* v. *British Columbia* (1984) 15 D.L.R. (4th) 568 (B.C.C.A.).

[13]*Manitoba Fisheries Ltd.* v. *R.*, [1979] 1 S.C.R. 101, [1978] 6 W.W.R. 498 (S.C.C.)

[14]See Barry Barton, *British Columbia* v. *Tener* Case Comment (1987) 66 C.B.R. 145.

denied the holder of Crown-granted mineral claims access to the land in which the claims were located. The Court determined that denial of access to the lands under the *Park Act* amounted to the recovery by the Crown of a part of the mineral rights that it had previously granted.[16] *Tener* was recently applied in a Nova Scotia decision with remarkably similar facts to the United States Supreme Court's decision, *Lucas* v. *South Carolina Coastal Council*.[17] In *Mariner Real Estate Ltd.* v. *Attorney General of Nova Scotia*,[18] the court used *Tener* as a basis for finding an expropriation where the government did not permit the building of single family residences on beach lands. The plaintiffs' lands had been designated as beach under Nova Scotia's *Beaches Act*. As a result of the designation, ministerial approval was required for any development of the lands, development being widely defined to include almost any alteration of the lands. The plaintiffs applied to build single family residences on the lands and ministerial approval was denied on the basis that maintaining the integrity of the adjacent sand dunes was critical to ensure that widespread flooding did not occur. The trial judge, Tidman J., accepted that three of the plaintiffs lost virtually all economic value in their lands as a result of the refusal. Tidman J. considered the case analogous to *Tener* where the Court had found that government action prohibiting access to mineral claims had enhanced the value of a public park and resulted in the reacquisition of acquired rights. In *Mariner Real Estate* the government action was taken to protect and enhance beach lands held in trust for the use and enjoyment of the public in general. Tidman J. found that the government had acquired an interest in the plaintiffs' land; held that the provisions in the *Beaches Act* barring compensation only applied to regulatory restrictions on the use of designated beach lands and not to expropriation; and ordered that compensation be paid.

Manitoba Fisheries, *Tener* and *Mariner Real Estate* suggest that Canadian courts will apply the concept of appropriation of property flexibly to ensure that property owners are compensated for

---

[15]*British Columbia* v. *Tener*, [1985] 1 S.C.R. 533.

[16]A similar result occurred in *Casamiro Resource Corp.* v. *British Columbia* (1991) 55 B.C.L.R. (2d) 346 (B.C.C.A). *Contra* see *Cream Silver Mines Ltd.* v. *British Columbia* (1993) 75 B.C.L.R. (2d) 325 (B.C.C.A.) where the prohibition on the exploitation of mineral claims in Strathcona Park did not give rise to an obligation to compensate. In *Cream Silver* the mineral claims in question were bare mineral claims, known as recorded or located claims, and not interests in land, as in *Tener* and *Casamiro*. The British Columbia Court of Appeal held that on a construction of the applicable legislation, the legislature had not intended to provide compensation for the prohibition.

[17]Section 1.1, above.

[18](1998), 165 D.L.R. (4th) 727, 171 N.S.R. (2d) 1 (N.S.T.D.).

particularly onerous forms of government regulation that completely deprive the property owner of any economic benefit from its property and where there is a corresponding benefit to public property. But this is a limited exception to the guiding principle of Canadian law that regulatory prohibitions or restrictions that limit the possession, use or disposition of property are generally non-compensable. It is arguable that the decision in *Mariner Real Estate* extends the scope of what amounts to an appropriation beyond existing case authorities.[19] In *Tener*, government regulation prohibiting entry into the park prevented the use of a government-granted property interest to the minerals in the park. The government regulation effectively resulted in the government reacquiring the minerals without payment. In *Mariner Real Estate*, the court held that the government acquired a property interest in the plaintiffs' lands but did not specify the nature of the property interest acquired. The property interest appears to be similar to a restrictive covenant over the plaintiffs' land which had the effect of sterilizing the use of the land except for passive recreational uses such as camping. From this perspective the case is analogous to cases where compensation is required because private land is effectively zoned for park use. But in those cases there is typically a specific prohibition in planning legislation that prohibits private land from being zoned for park uses. The weakness of the approach taken in the case is that, unlike *Lucas*, where the US Supreme Court sets out a series of tests to determine if a taking has occurred, *Mariner Real Estate* (and indeed the other leading cases) provide little guidance on when a regulatory prohibition amounts to an appropriation of property. The decision in *Mariner Real Estate* does not analyze what damage would be potentially caused by the proposed construction of the residences and whether such damage could justify a complete prohibition on development. For example, if the ecosystem was so fragile that any development would cause irreparable damage to adjoining lands, a restriction to prevent such damage may be justified on the basis of the nuisance defence set out in *Lucas*.

5.2 International Investment Protection and Domestic Regulatory Authority

[19]The decision has only been considered in one case, *Alberta* v. *Nilsson* (6 June 1999) A.J. No. 645, Action No. 9503-25991 (Alta. Q.B.) and was used as an example of the application of *Tener*.

The Chapter Eleven claims reviewed in Chapter Four, particularly the claims by Ethyl Corporation, S.D. Myers Inc. and Pope & Talbot Inc. illustrate the potential conflict between Canada's investment protection obligations and domestic regulatory measures. To the extent that international law provides greater property rights protection than Canadian law, foreign investors may be in a unique position to challenge domestic regulation. The foreign investor is also uniquely entitled to challenge government measures using a binding investor-state arbitration process which bypasses domestic courts and is governed by the arbitration rules set out in the NAFTA and BITs.

Before assessing the extent to which the scope of regulatory expropriation is wider under international law than Canadian law and the effect of Canada's international investment obligations on domestic regulatory authority, I review a number of other situations where investors have claimed that proposed or adopted government measures were inconsistent with Canada's international obligations.

5.2.1 An Overview of Other Expropriation Related Claims by Foreign Investors

Prior to the FTA and the NAFTA, a number of initiatives by provincial and federal governments were targeted at foreign-held property interests. These include the nationalization of the potash industry by the Saskatchewan government in 1975 and 1976[20] and Canada's National Energy Program.[21] Under the FTA, there was one high profile claim that a domestic policy initiative would amount to an expropriation. During the 1990 Ontario election, the New Democratic Party led by Bob Rae proposed to establish a system of public automobile insurance. When elected, the new government considered a number of options for public auto insurance, including a complete public monopoly on automobile insurance services. In 1991, Carla Hills, the US Trade Representative, argued that the creation of a public monopoly would violate the investment

[20]M. Molot and J. Laux, "The Politics of Nationalization" (1979) 12 Can. J. Pol. Sci. 227.

[21]American oil interests argued that the National Energy Program constituted an expropriation under customary international law. See R. Higgins, "The Taking of Property by the State: Recent Developments in International Law" (1982) 176 Rec. des Cours 259 at 347- 352, R. Dolzer, "Indirect Expropriation of Alien Property" (1988) 1 ISCID Rev. 41 at 53-54, E. Mendes, "The Canadian National Energy Program: An Example of Assertion of Economic Sovereignty or Creeping Expropriation in International Law" (1981) 14 Vand. J. Transnat'l L. 475 and C.J. Olmstead , E.J. Krauland & D.F. Orentlicher, "Expropriation in the Energy Industry: Canada's Crown Share Provision as a Violation of International Law" (1984) 29 McGill L.J. 439.

protection provisions in the FTA (Article 1605) as it would be "tantamount to expropriation" of American-held insurance enterprises. Public auto insurance was never pursued and the extent to which potential claims for compensation played in the decision not to proceed with the policy is unclear.[22] But obviously the potential requirement to pay compensation for expropriation would have been an important consideration in assessing the viability and cost-effectiveness of a government run insurance system.

In addition to the NAFTA claims described in Chapter Four, a number of other Chapter Eleven claims have been threatened. In 1994, the Canadian Radio-television and Telecommunications Commission (the "CRTC") removed American-held Country Music Television ("CMT") from the list of programming services that Canadian cable operators were authorized to distribute. CMT was removed from the eligibility lists after a Canadian company was granted a licence to offer a Canadian country music station. The authorization for cable operators to distribute CMT had been subject to the stipulation that, if a comparable Canadian service was licensed in the future, the American station would be replaced by the Canadian station. In addition to a court challenge to the CRTC decision on procedural grounds,[23] CMT claimed that the CRTC decision was an expropriation of its business although it did not pursue a Chapter Eleven claim.[24] The basis for such a claim appears to have been weak because of the threshold issue of whether CMT's inclusion on the eligibility list for cable distribution is an "investment" under Chapter Eleven. It is unclear how a CRTC decision could amount to an "investment", particularly when the eligibility of CMT for distribution was conditional. More recently Time Warner Inc. claimed that the original Bill C-55, the *Foreign Publishers Advertising Services Act*, introduced by the Canadian government as a result of the WTO decision in *Canada - Certain Measures Concerning Periodicals*,[25] violated Chapter Eleven of the NAFTA because the wording of the grandfathering provision was too narrow and could amount to an expropriation under Chapter Eleven. The provision was changed to clarify that grandfathered foreign publications could

---

[22]"Rae Defends Insurance Plan: Doesn't Violate Free Trade Pact, Ontario Premier Says" *Globe and Mail* (20 August 1991) B4.

[23]*Country Music Television Inc.* v. *Canada (Canadian Radio-television and Telecommunications Commission)* [1994] F.C.J. No. 1957 DRS 95-07518 (F.C.A.), leave to appeal to S.C.C. refused (26 January, 1995).

[24]H. Enchin, "U.S. Country Channel Vows to Fight Expulsion" *Globe and Mail* (21 December 1994) B1.

[25]WT/DS31/R, Panel Report; WT/DS31/AB/R, Appellate Body Report (AB-1997-2).

continue to supply advertising services.[26] A prohibition on providing advertising services would have severely affected the viability of the affected publications.

There have been two other high profile cases where proposed measures by the Canadian government were alleged to have violated the NAFTA: plain packaging of cigarettes and the cancellation of the Pearson airport contracts.

Plain Packaging of Cigarettes

In order reduce tobacco consumption, the Canadian government in 1994 considered requiring that cigarettes sold in Canada be packaged in generic plain packages.[27] Under one proposal, packaging would consist of only the brand name, risk warnings and product content information, all in a standard font.[28] Complete plain packaging would mean tobacco companies could not use their existing trademarks on packaging, other than brand names.

Whether a plain packaging requirement would amount to an expropriation of the use of trademarks under NAFTA was a matter of controversy.[29] American tobacco companies claimed plain packaging requirements would breach a number of provisions of the NAFTA. During hearings on plain packaging, representatives of US tobacco companies argued before the House of Commons Standing Committee on Health (the "Committee"), that plain packaging would be a measure tantamount to expropriation under Chapter Eleven.[30] At the Committee's hearings, tobacco companies presented a legal opinion from former US trade representative Carla Hills, prepared for R.J. Reynolds Tobacco Company and Philip Morris International Inc.[31] Hill's opinion argues that cigarette manufacturers have branded their products with distinctive

---

[26]"Time NAFTA Suit Adverted by Commons Bill Amendment", *The Globe and Mail* (2 December 1998) B5.

[27]This summary is based primarily on the description of the events in D. Schneiderman, "NAFTA's Takings Rule: American Constitutionalism Comes to Canada" (1996) 46 U.T.L.J. 499 and A.Z. Hertz, "Shaping the Trident: Intellectual Property under NAFTA, Investment Protection Agreements and at the World Trade Organization" (1997) 23 Can.-U.S. L. J. 261. Also see Canada, House of Common Standing Committee on Health, *Towards Zero Consumption: Generic Packaging of Tobacco Products Standing Committee Report* (21 June 1994).

[28]Schneiderman, *supra* note 27 at 524.

[29]Hertz, *supra* note 27 at 303 at footnote 190.

[30]Canada, House of Commons, Minutes of Proceedings and Evidence of the Standing Committee on Health (April 14, 1994).

[31]Legal Opinion dated 3 May 1994 from Mudge Rose Gutherie Alexander & Ferdon to R.J. Reynolds Tobacco Company and Philip Morris International Inc. on file with the author.

trademarks and that the trademarks are investments under the NAFTA. The opinion argues that under Article 1708(10) a party may not encumber the use of a trademark, the plain packaging requirement would prohibit the use of trademarks and thus violate Chapter 17 and would also amount to an expropriation under Article 1110(1). The legal opinion asserts that the proposed legislation would amount to expropriation in categorical terms and provides no legal authority or argument for the assertion.

A legal opinion was also sought by those supporting plain packaging legislation. The Non-Smokers' Rights Association sought a legal opinion from Fasken Campbell Godfrey of Toronto, Ontario on whether plain packaging would violate Canada's international trade obligations. Fasken Campbell Godfrey in turn consulted Professor Jean-Gabriel Castel of Osgoode Hall Law School at York University. In his opinion, Castel argued that the proposed legislation would not breach Canada's trade obligations and, in relation to investment obligation, argues that "[I]nternational law recognizes confiscation without compensation of products harmful to health."[32]

A number of questions arise as to whether plain packaging would be an expropriation under Chapter Eleven.[33] First, a threshold question arises whether there is an affirmative right to use a trademark under Canada's *Trademarks Act*. If there is no right to use, it is arguable there is no "investment" with respect to the right to use. Second, as described in Chapter Four, Article 1110(7) provides that Chapter Eleven does not apply to the revocation, limitation or creation of intellectual property rights otherwise consistent with Chapter 17. The exception in Article 1110(7) could be used to argue plain packaging restrictions are consistent with Chapter 17. This would include the arguments that: (i) there is no affirmative right to use a trademark under Chapter 17; (ii) the prohibition in Article 1708(10) on "encumbering" a trademark's use in commerce does not prevent a Party from prohibiting the trademark's use; and, alternatively, (iii) the measure is justified under Article 1708(12) as a "limited exception to the rights conferred by the trademark". Third, plain packaging could be characterized as a police power regulatory measure for the protection of health which is non-compensable. My analysis of international

[32]Legal Opinion dated 11 May 1994 from J.-G. Castel to Fasken Campell Godfrey at 4 on file with the author.

expropriation law in Chapter Two suggests that a state would be able to justify a plain packaging requirement under the police power to protect health. While it is unclear what standard of review would be applied by an investment tribunal in reviewing the reasonableness of a police power regulation, it is likely that plain packaging legislation could be upheld provided the measure is not in some sense "arbitrary". This amounts to a requirement that there be a rational connection between the measure and the objective and that the measure is not patently unreasonable.

Pearson Airport

In August 1993 an agreement was reached between Transport Canada and the Pearson Development Consortium (the "Consortium") for the redevelopment and operation of Terminals 1 and 2 of Toronto's international airport.[34] During the federal election in August, the leader of the opposition Liberal Party, Jean Chrétien, stated that any airport deal would be subject to review as a result of allegations that the winning consortium had ties to the Conservative government in power. Chrétien was subsequently elected and, after a review of the contract, the Liberal government introduced legislation to cancel the contract and to settle the Consortium's claims against the Government of Canada. The bill only allowed compensation for out-of-pocket expenses and barred any court claims for compensation. The Consortium began legal action and the bill was later amended to allow claims for losses and lobbying expenses. While there was disagreement over the constitutionality of the proposed legislation, one of the parties to the consortium, US based Lockheed Corp., may have been able to make a claim under Chapter Eleven alleging an expropriation of the contract by the Canadian government. Assuming the proposed legislation was upheld under domestic law and a Chapter Eleven claim was successful, the government would have been in the untenable situation of paying limited compensation to the Canadian partner as set out in legislation while potentially having to pay greater compensation to the US partner under the NAFTA.

---

[33]Hertz, *supra* note 27 at 302 -303 and Schneiderman, *supra* note 27 at 523 - 537.

[34]This summary is based on the chronology and description in E. Atwood & M.J. Trebilcock, "Public Accountability in an Age of Contracting Out" (1996) 27 Can. Bus. L.J. 1.

The Pearson contract scenario demonstrates how international investment protection constrains government action. While a state may be able to immunize itself from claims under domestic law, a state cannot avoid state responsibility under customary international law or the NAFTA through domestic legislation. In the Pearson case, if the claim was successful, the government would have been bound to pay the American partner in the Consortium compensation based on the "fair market value of the expropriated investment" (Article 1110(2)) and this may well have been higher than that under the proposed legislation.

5.2.2 Impact of International Expropriation Law on Domestic Regulatory Authority

The impact of international expropriation law (customary or treaty based) on domestic regulatory authority is affected by two interrelated issues. First, to what extent is the scope of expropriation in international law wider than the scope of expropriation in Canadian law? In other words, are there situations in which a foreign investor would obtain compensation for expropriation under international law where a Canadian national would not receive compensation under domestic law? Second, what is the impact on domestic regulatory authority of investors having access to investor-state arbitration to bring claims?

As discussed in Chapter Two, most international legal authorities agree that state responsibility for expropriation arises where a state deprives a person of substantially all benefit of its property and there is no police power justification for the taking. I have argued in Chapter Two that there appear to be no precedents in international law where a state has been held responsible for a regulatory expropriation because of the effect of measures taken to protect the environment, public health or public order. States may exercise broad discretion in regulating uses of property that a state deems to be harmful or injurious to health, the environment or public order. In contrast, in assessing government liability for expropriation, Canadian law looks to whether there has been an appropriation of the property by the government.

There are important differences between Canadian and international expropriation law. First, the type of government measures that are expropriatory are potentially wider under international law. As discussed in Chapter Two, international law focuses on the effect of government

measures - whether the property owner has been deprived of the right to possess, use, benefit and dispose of its property but allows an exception for police power regulation relating to health, safety, the environment, land use planning, taxation, public order, morals and the enforcement of court orders even where these measures significantly affect property rights. However, the international authorities reviewed in Chapter Two do not suggest that there is a police power justification for other forms of government regulation that substantially deprive an investor of the value of its property without compensation. Clearly there is no police power justification for nationalizations of industries or other policies that are intended to divest foreign investors of ownership without compensation. In the case of economic regulation, such as a regional development strategy where government regulation prohibited an economic activity in one area in order to induce it in another area, police power regulation could probably not justify the expropriatory effect of such a policy on an investment.[35]

Depending on the circumstances, international law may require compensation where Canadian law does not. For example, in *La Ferme Filiber Ltée* v. *The Queen*[36] a rainbow trout hatchery had operated for two years under a government license. A regulation was passed prohibiting the rearing of trout in the area in which the hatchery was located, effectively putting the hatchery out of business. The Canadian trial court held that there was no basis for making a claim of expropriation in such circumstances. Under international law, if such a regulation could not be justified as necessary to protect public health or the environment and, instead, was motivated by a government policy to relocate trout hatcheries to another region in order to foster economic development, a claim of expropriation would likely arise under international law. Under international law, investors may be able obtain compensation for regulatory expropriation resulting from various forms of economic regulation particularly where the measure is motivated by economic nationalism or where the state intends to establish a monopoly. Under Canadian law such claims would be unsuccessful unless the claimant could establish that the regulation in question, such as in *Manitoba Fisheries,* amounts to an appropriation of property.

---

[35]I do not mean to suggest that all forms of economic regulation require compensation. The economic regulation would have to substantially deprive an investor of the benefit of its investment before a question of police power justification would arise.

Second, since there is no explicit constitutional protection of property rights in Canada, the leading Canadian cases suggest that the government does not have to pay compensation where there is a clear legislative intent that compensation is not to be paid, even where there is an appropriation of property. For example, in *Cream Silver Mines Ltd.* v. *British Columbia*,[37] the British Columbia Court of Appeal denied a claim for compensation in a case very similar to *Tener* on the basis that the legislature had not intended to provide compensation for the expropriation of a particular type of chattel interest mining claim. In contrast, the explicit purpose of the international minimum standards in NAFTA, BITs and customary international law is to constrain states from expropriating property without compensation. Therefore, while the Canadian government may through legislation expressly cancel or amend acquired rights (contracts, licences, leases etc.) and deny or limit rights to compensation, if the domestic legislation amounts to an expropriation under international law (or breaches a treaty-based "fair and equitable treatment" provision) responsibility would arise under international law notwithstanding any provision in domestic law. The most extensive impact of international expropriation law on domestic regulation is likely to be claims of regulatory expropriation that result from regulation that cancels or amends various forms of government contracts, authorizations (permits or licences) or natural resource interests that investors obtain under regulatory regimes. For example, legislative changes to natural resources property rights (leases and licences) that deprive a foreign investor of rights may give rise to a claim of regulatory expropriation. Even though Canadian law has recognized that regulatory prohibitions can amount to the expropriation of state-granted property interests, international law may require compensation in a wider variety of circumstances. Under international law, state responsibility may arise for the cancellation of contracts or the voiding of state-granted property interests. Cancellation or a measure tantamount to cancellation that is confiscatory is a form of expropriation of property for which state responsibility may arise, unless there is some commercial or police power justification for the cancellation.[38]

---

[36]*Supra* note 3.

[37]*Supra* note 16.

[38]See discussion in I. Brownlie, *Principles of Public International Law*, 5th ed. (Oxford: Clarendon Press, 1998) at 549 – 555.

Clearly, an international minimum standard of investment protection provides foreign investors special investment protection rights. For this reason, David Schneiderman makes a persuasive case that trade and investment agreements such as the NAFTA can be likened to a constitutional document in its importance for Canada.[39] As with other constitutional documents, the NAFTA constrains government regulation in a wide variety of legislative domains.[40] With respect to Chapter Eleven of the NAFTA, Schneiderman argues that while previously unbound, Canadian legislative power in regard to the regulation of property is now legally constrained.[41] He argues that Chapter Eleven of the NAFTA incorporates the US Fifth Amendment law of takings and the Fourteenth Amendment law of due process and that NAFTA draws Canada into the US constitutional orbit by requiring State parties to view expropriation in terms of US constitutional principles.[42] Schneiderman's argument that the NAFTA shares similarities to a constitutional like document is compelling. The NAFTA commits the parties to principles of trade and investment liberalization that will constrain economic nationalism and "constitutionalizes" a policy of investment liberalization and protection. However, given the assessment of international expropriation law and the NAFTA in this thesis, claims about the scope of international expropriation law and their affect on domestic sovereignty must be treated with caution. First, it must be acknowledged that theoretically, and with respect to American investments in Canada, politically, the Canadian government has always been bound by customary international law, even if it was often impossible for the investor to exercise its rights directly under customary international law. Before the NAFTA, claims based on customary international law were advanced with respect to the National Energy Program. The US government suggested that public automobile insurance could be an expropriation under the FTA. Second, while US takings jurisprudence has influenced the approach to expropriation in international law, there is little authority in international law to suggest that international law imposes the same limits on state regulation that the Takings Clause does in the US. As I argue in Chapter Two, the standard of review of state measures under international law cannot be equated with the stringent doctrinal tests that are used in US takings jurisprudence. Third, while

---

[39]D. Schneiderman, "Canadian Constitutionalism and Sovereignty After NAFTA" (1994) 5 Constitutional Forum 93 [hereinafter Schneiderman (1994)] and Schneiderman, *supra* note 27.

[40]Schneiderman (1994), *ibid.* at 93.

[41]Schneiderman, *supra* note 27 at 501.

[42]Schneiderman, *supra* note 27 at 515.

Scheiderman is justified in emphasizing that international investment protection imposes fetters on the regulation of property rights held by foreign investors, the essential question becomes whether such constraints can be justified.

An international minimum standard of protection as proposed in Chapter Three can be justified as a reasonable balance between fairness for foreign investors and state regulatory autonomy, sustainable development and respect for domestic policy choices. In Chapter Three, I argued that states should have a significant degree of discretion in regulating property rights because it is more likely to be economically efficient, it allows states to pursue welfare-maximizing policies and that contractual provisions and insurance allow foreign investors to identify and allocate risks. State autonomy in the regulation of property rights is also a fundamental recognition of the legitimacy of democratic choices. Any international minimum standard of investment protection limits domestic sovereignty and the range of democratic policy measures available. But where the international standard is limited to the scope set out in Chapter Three, rather than being a sword to challenge general domestic regulation it provides a shield from oppressive, opportunistic or arbitrary government measures.

However, given the uncertainty in the scope of expropriation in customary international law and in the NAFTA, there is justifiable concern with the impact of international law on domestic regulatory authority. Chapter Four reviewed the uncertainty surrounding the scope of Article 1110(1) of the NAFTA and recommends that an interpretative statement be issued to clarify the meaning of expropriation. In addition, the NAFTA Parties should clarify the interrelationship between trade obligations and investment obligations under Chapter Eleven. While greater predictability is required, the review of NAFTA and international expropriation law in this thesis suggests that the scope of what government measures amount to expropriation under Article 1110(1) in NAFTA is not wider than in customary international law. Given the uncertainty in international expropriation law, NAFTA, in common with BITs, uses an open-ended formulation for defining expropriation. This reflects the concern with the myriad ways that states can interfere with property rights. It does not raise a presumption that the scope of expropriation under NAFTA is wider than that under customary international law.

As a result of my assessment of the lack of merit in the existing or threatened expropriation claims under Chapter Eleven, my analysis suggests that the threat or danger of claims of regulatory expropriation under Chapter Eleven is inflated. Nevertheless the settlement of Ethyl Corporation's Chapter Eleven, the increasing number of Chapter Eleven claims and the lack of clear precedent or authority as to what amounts to expropriation under international law raises significant concerns. Given the level of uncertainty in how general principles of international expropriation law will be applied and unpredictability inherent in Chapter Eleven of NAFTA, there is legitimate and justifiable concern that expropriation will be given a wider interpretation than advanced in this thesis. In addition, given the uncertainty and vagueness of the existing standards in NAFTA and BITs, the level of investment protection provided in investment agreements may be interpreted to be higher than the framework for an international minimum standard of investment protection proposed in Chapter Three. The uncertainty and unpredictability of the scope of investment protection creates unpredictability for investors and governments unlike. A decision maker faced with a potential claim for hundreds of millions of dollars from tobacco manufacturers for proposed plain packaging of cigarettes is likely to adopt another regulatory instrument to meet the policy objective, even if that instrument is less effective and efficient. In addition, it is clear that investors are using threat of claims, or in the case of Ethyl Corporation and Methanex Corporation submitting notices of intention to submit claims, as part of their strategy to influence legislators and government decision-makers. To provide certainty and predictability with respect to the scope of investment obligations, clarification of the scope of investment protection is undoubtedly in the public interest.

Investor-State Arbitration

Since under Chapter Eleven of the NAFTA claims of regulatory expropriation are subject to investor-state arbitration, the investor-state arbitration process has been a particularly contentious aspect of the NAFTA. While addressing the appropriateness of investor-state arbitration for the resolution of investment disputes in a comprehensive manner is beyond the scope of this thesis, below I address some of the concerns with the investor-state arbitration process and make some general comments on the Chapter Eleven process.

A systemic weakness of many areas of international law as a set of binding obligations on states is the lack of judicial processes for the enforcement of rights. Prior to the use of investor-state arbitration provisions, even where a state was willing to make an international claim on behalf of an investor, the investor lacked an enforcement mechanism for its claim. Prior to the NAFTA, Canadian, American and Mexican investors had to rely on diplomatic protection by their home states for the enforcement of international law and therefore lacked any assurance that an effective legal remedy was available for breaches of international law. In a state-to-state dispute resolution process, states have a general interest in maintaining plenary authority for police power regulation. For example, it is extremely unlikely that the US would have taken up Ethyl Corporation's expropriation claim if Chapter Eleven did not exist because of the US Environmental Protection Agency's previous bans on MMT.

In order to provide a more effective process for dispute resolution and because of concerns with the fairness of judicial processes in developing countries, capital-exporting countries have included provisions for investor-state arbitration in BITs.[43] As described in above in Section 2.1.4, in 1965, the *Convention on the Settlement of Investment Disputes between States and Nationals of Other States* established the International Centre for Settlement of Investment Disputes ("ICSID") to provide a neutral forum for the resolution of investment disputes in an attempt to "depoliticize" the settlement of investment disputes.

NAFTA's investor-state arbitration provisions are modeled on the practice developed in BITs. Section B of Chapter Eleven of the NAFTA includes provisions for binding international arbitration. As a result American and Mexican foreign investors become uniquely entitled (as compared to domestic investors) to bypass the domestic court system, to challenge state measures before an international arbitration tribunal and to enforce any resulting award through the domestic legal system. Unlike the judicial process in domestic courts, the process is private,

[43]See discussion of arbitration in R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995).

there is no provision for public interest standing and the right to challenge an arbitration award is extremely limited.[44]

Investor-state arbitration and the scope of expropriation are the most widely criticized aspects of Chapter Eleven. These two aspects of Chapter Eleven are intimately linked. The scope of expropriation under international treaties has only become a source of controversy because investors have begun to use investor-state arbitration to challenge general government regulation. A recent report by the International Institute for Sustainable summarizes the concern with Chapter Eleven as follows:

> The original purpose of investor-state protections and the remedies to enforce them can be understood as defensive; to protect against arbitrary and unreasonable government actions against foreign companies. Today, however, the use of the rights and remedies has been drastically changed. Part of a new pattern of the "privatization" of trade and investment law, these rights and remedies have now increasingly been used by foreign investors in a strategic manner to shield themselves from the adoption of new laws or policies that would have an economic impact on them. This strategic development has changed, and arguably misappropriated, the investor-state provisions for their traditional role as a defensive investment protection mechanism to a potent offensive tool.[45]

The ability of investors to use the investor-state arbitration process as a "potent offensive tool" to challenge government regulation arises more from the ambiguity of the scope of investment protection than from the process itself. The analysis in this thesis suggests that expropriation is and should be defined quite narrowly in international law. But given the absence of clear authority and jurisprudence, there is a legitimate concern that tribunals could give far reaching interpretations to expropriation provisions such as Article 1110(1) of the NAFTA. Uncertainty with respect to the scope of Article 1110(1) and rights to compensation may have a chilling effect on social regulation. Potential or actual claims of expropriation may result in less optimal forms of regulation. However, these concerns do not justify the conclusion that investor-state

---

[44]For a discussion of arbitration under Section B of Chapter Eleven of the NAFTA, see C.D. Eklund, "A Primer on the Arbitration of NAFTA Chapter Eleven Investor- States Disputes" (1994) 11 J. Int'l Arb. 135, R.C. Levin & S.E. Marin, "NAFTA Chapter Eleven: Investment and Investment Disputes", (1996) II:3 NAFTA: L. & Bus. R. Amer. 83 and and J. Soloway, "NAFTA's Chapter Eleven: The Challenge of Private Party Participation" (1999) 16 J. Int'l Arb. 1.

[45]International Institute for Sustainable Development, *NAFTA's Chapter Eleven and the Environment: Addressing the Impacts of the Investor-State Process on the Environment* (Winnipeg: International Institute for Sustainable Development, 1999) online: IISC homepage <http:iisd1.iisd.ca/trade/chapter11.htm> (last accessed: 22 July, 1999) [hereinafter IISD Chapter Eleven Report] at 6.

arbitration is an inherently flawed process. If investment protection is to be meaningful, investors require effective remedies for violations of investment protection obligations. The flaw with investor-state arbitration in NAFTA and BITs is that it combines a powerful mechanism for investors to challenge government regulation with uncertain state obligations. Clarification of the obligations in Chapter Eleven, particularly with respect to the scope of expropriation, would address the concern that investor-state arbitration is a threat to domestic sovereignty.

Even if the scope of investment obligations is clarified, does effective investment protection necessarily require an automatic right to investor-state arbitration to challenge all forms of government measures? Dispute resolution in international trade law has traditionally used a state-to-state dispute resolution model. Unlike investors, who under investment agreements have access to investor-state arbitration, importers and exporters rely on their national governments to challenge breaches of international trade law by other states. In Chapter Three I argued that foreign investors should not be able to indirectly challenge measures that are trade-restrictive through investment protection provisions. This begs the broader policy question of whether the differential treatment of investors and traders can be justified. An investor-focused dispute resolution process is justifiable in cases of expropriations of property and violations of "fair and equitable treatment". For state commitments to be credible in this area, investors must be able to enforce state obligations. Requiring investors to exhaust local remedies before proceeding to arbitration would result in duplicated hearing, delays and high costs. In addition, where domestic law does not incorporate international law, the issue in dispute – compliance with international law – would not be determined.

Another option for consideration is to provide some discipline on the type of claims brought before investor-state arbitration tribunals. In addition to clarifying the scope of Chapter Eleven, a process similar to that used for taxation measures could be used for all investment claims. Under Article 2103(6) of the NAFTA an investor must refer the question of whether a taxation measure is expropriatory to the taxation authorities listed by the Parties. If these authorities do not agree to consider the measure or fail to agree that the taxation measure is not an expropriation within six months, then the investor may proceed with its claim. Using such a

model for all investment claims would provide a screening mechanism or what the IISD Chapter Eleven Report refers to as a "gatekeeper" model.[46] As in the case of taxation measures, it would allow the Parties to retain the right to collectively determine the scope of investment obligations. A number of weakness with the gatekeeper approach are readily apparent. Claimants will likely lobby their national governments to permit claims to proceed and national governments will not lightly deny their nationals the opportunity to have a claim heard. Second, the decision by the Parties to allow or not allow a claim to proceed could become a mini-arbitration in itself because of requirements for procedural fairness. But, even acknowledging these flaws, it does not appear unreasonable to have some mechanism to prevent obviously unmeritorious claims from proceeding to arbitration.

Even if the scope of investment obligations are clarified, changes are required to the arbitration process under Chapter Eleven to provide greater public access to information regarding the claims. International commercial arbitration has traditionally occurred between two private parties with contractual obligations. In such circumstances, maintaining confidentiality is often a matter of significant concern for both parties. Different considerations apply where government legislation, regulation and decisions are challenged by foreign investors. As described in Chapter Four, in November 1998 the Canadian Department of Foreign Affairs and International Trade sent an issue paper on transparency to American and Mexican government officials. The issue paper on transparency canvasses the following issues: confidentiality of the hearing process, public announcements, release of arbitration documents and amicus briefs.[47] Where government measures that are presumably made in the public interest are challenged there should access to the material submitted to the arbitral tribunal. This access should probably be broad as that available under domestic legal systems.[48] While a balance must be maintained between public disclosure and some privilege with respect to confidential information, the secrecy of Chapter Eleven proceedings cannot be justified. The NAFTA Parties should address this issue immediately. Lack of access to information on claims made under the NAFTA disserves the aim of investment liberalization because it creates suspicion and misinformation

[46]*Ibid*. at 58.

[47]"Canada Memo on Investor-State Provisions", *Americas Trade* (11 February 1999) 20 at 22-25.

about the effect of investment obligations. Finally, the Parties should address the appropriateness of allowing third parties to submit amicus briefs or appear before investment tribunals, particularly where the claimant challenges a government measure and where the claim would have significant public policy implications if the claim were successful. In such cases, third parties may be able to play an important in presenting evidence or legal argument that would assist the tribunal making its award.

---

[48]See Soloway, *supra* note 44 and IISD Chapter Eleven Report, *ibid.*, for a discussion of and proposals for changes to the Chapter Eleven process.

CONCLUSION

Investor-state arbitration under Chapter Eleven of the NAFTA has focused attention on the potential impact of international investment law on domestic regulation. BITs and international investment agreements, rather than establishing clear and predictable obligations with respect to state responsibility for expropriation and the treatment of foreign investment, have incorporated vague provisions and an uncertain international law. Uncertainty is compounded by the increasing number of international agreements imposing investment obligations. Although negotiations for the proposed MAI have been abandoned, a multilateral framework on investment may be negotiated in the future, perhaps under the auspices of the WTO. For its part, the Canadian government has announced plans to proceed with negotiations to establish the Free Trade Agreement of the Americas and to participate in a further round of negotiations at the World Trade Organization. Both of these negotiations may result in further investment protection obligations. As a result of existing obligations and future investment liberalization, governments will increasingly have to consider whether proposed legislation, regulation, decisions and policies are consistent with their obligations under international investment law.

The focus throughout this thesis has been the extent to which international law constrains and should constrain domestic regulatory authority with respect to the protection of foreign investment. Chapter One focused on the policy basis for compensation for expropriation. Chapter Two focused on state responsibility under customary international law with respect to the treatment of foreign-held property. Chapter Three examined the level of investment protection that international law should require that states provide foreign investors. Chapters Four and Five focused on the NAFTA and its impact on domestic regulatory authority.

The review of US takings law and academic commentary in Chapter One illustrates that many arguments for compensation for regulatory takings are rooted in conceptions of political theory and justice. As discussed in the chapter, according to Epstein, the obligation to pay compensation for takings of property has a tangible political purpose – in his words, to "clip the wing of the modern welfare state."[1] Radin stresses the political dimensions of the Takings Clause from a different perspective. According to Radin, the US Supreme Court's recent takings cases provide reinvigorated property rights protection. She argues that this has been achieved through the "conceptual severance" of property rights. Once property is viewed as a bundle of rights, it is possible to sever just those strands that government regulation affects, and to construe those strands as separate property interests.[2] Taken to its extreme, this approach would result in many forms of regulation amounting to regulatory expropriation. For example, under this approach, zoning restrictions on building height can be seen as a taking of air space rights. The divergent views of Epstein and Radin emphasize the explicitly political nature of the scope of property rights and the potential constraints on domestic regulatory authority associated with stringent property rights protection and rights to compensation.

International investment law should not be the vehicle for the institutionalization of a certain conception of property rights or the globalization of a Lockean conception of property rights and the state. It is tempting to rely on principles of respect for private property or acquired rights as a basis for compensating foreign investors. It is also tempting to use US takings law as a model for international law as it provides an extensive jurisprudence and a ready-made analytical

[1]Section 1.1.2 above at note 53.

framework for analyzing questions of expropriation. As a matter of principle, simply transferring or adopting a specific property rights theory or US takings jurisprudence to international law is clearly inappropriate. These only represent particular conceptions of the appropriate balance between private property and public rights. This is not to deny that parallels exist between US takings law and international law. As discussed in Chapter Two, most international authorities suggest that the doctrinal approach for determining whether a state is responsible for expropriation requires an analysis of whether the regulation in question can be justified under the state's police powers. This is essentially the approach used in US takings jurisprudence. While international law may approach the question of expropriation in the same manner as the US, the rationales for and the scope of investment protection in international law should be based on a rationale that can be defended without reference to a particular conception of property rights.

The level of investment protection in international law for foreign investment should be based on a policy of promoting investment flows that are welfare maximizing for both host states and foreign investors. In Chapter Three I argued that states should determine compensation policy for government measures that affect the value of investments. The review of economic literature on expropriation in Chapter One suggests that, with respect to government measures that affect the value of an investment, a policy of non-compensation maintains appropriate investment incentives by not encouraging over-investment in activities that are not welfare-maximizing. An international standard requiring compensation in all cases of regulatory expropriation is unlikely to be economically efficient. Second, a policy of non-compensation retains flexibility for host country welfare-maximizing regulation. Third, more effective and efficient risk allocation mechanisms are available to foreign investors, such as contractual risk allocation, stabilization clauses and foreign investment insurance. For these reasons, compensation policy for government measures that affect the value of investments, including claims of regulatory expropriation, should generally be a matter of domestic policy and international law should not require an international minimum standard of compensation. In other words, compensation policy should not be harmonized to an international minimum standard and investors should treat

---

[2]Section 1.2.1 above.

each state's compensation policy for regulatory and property rights transitions as another factor in assessing the suitability of the host state for investment.

While the analysis in this thesis favours significant domestic autonomy in determining compensation policy for government policies that affect the value of investments, in order to promote flows of foreign investment that will be welfare-maximizing to investors and host states over the long-term, investment protection policy must strike a balance between stability, security, predictability and fairness for the foreign investor and the ability of states to determine domestic policy and to regulate the economy and property uses. An approach promoting domestic regulatory autonomy is not intended to licence arbitrary, opportunistic or oppressive state conduct. In these circumstances a non-compensation policy is inappropriate. Such measures are unlikely to be based on welfare-maximizing policies or be designed to maximize the flows of and benefits from foreign investment over the long-term. Foreign investors are particularly vulnerable to opportunistic state conduct because they lack effective political representation (voice) and, often, cannot leave the state without losing the benefit of their investment (exit). An international minimum standard of investment protection is required to protect foreign investors from such conduct.

The international minimum standard of treatment for foreign investment proposed in this thesis protects against several different forms of economic injury. First, and most significantly, it requires compensation for appropriations of an investment by a state. There are sound rationales for compensation where the government acts as a participant and enterpriser in acquiring and enhancing public goods. Compensation in these cases disciplines the most egregious forms of opportunistic and discriminatory conduct and fiscal illusion. Assuming the standard of compensation is market value, requiring governments to pay compensation for acquisitions of property, including *de facto* appropriations of property, is unlikely to deter wealth-maximizing policies. It simply requires that governments factor in the cost of transferring private property to public ownership.

Second, under a national treatment principle, once a state has allowed a foreign investor to establish in the country, the investor should receive effective equality of treatment. A national

treatment provision would require that a state accord the investor and the investment no less favourable treatment than the state accords to its own investors and their investments in like circumstances with respect to the management, operation, maintenance, use, enjoyment or disposal of investments. Certain exceptions to national treatment, for example, such as in NAFTA with respect to state subsidies to domestic companies, are justifiable. But as a general principle, foreign investment should obtain non-discriminatory treatment.

Third, states must respect their contractual commitments and any legislated commitments they make in investment codes. If contractual risk allocation and reliance on investment codes are to be used and be effective, the international law governing the enforceability of state contracts, stabilization clauses and commitments made in foreign investment codes should be clarified. With respect to contractual commitments and stabilization clauses, while there is academic debate regarding the enforceability of contractual obligations and stabilization clauses against sovereign states, arbitral cases have consistently held that these state obligations are enforceable. With respect to investment codes, since the codes are based on domestic legislation, these commitments may be changed by subsequent state legislation. Until this matter is addressed in BITs or a multilateral framework for investment (for example, by providing that a state must comply with commitments in a foreign investment code where a foreign investor has relied on such commitments) investors should rely on specific contractual provisions. State responsibility to foreign investors under foreign investment codes deserves further study.

Fourth, I have argued that investment protection policy should ensure that foreign investors are treated fairly and equitably. However, the "fair and equitable" treatment standard used in BITS is too vague and subject to wide variations of interpretation. Therefore, the requirement for fair and equitable treatment should be limited to fair and equitable procedural treatment. In order to discipline state measures that damage and injure foreign investment, the minimum standard of treatment should require compensation in cases of "clearly unreasonable" measures. This deferential standard of review should be further elaborated to affirm a positive right of governments to regulate and to clarify that government measures need not be the least-investment restrictive. Whether a government measure is clearly unreasonable could be assessed based on a number of factors including: the nature and purpose of the government measure;

whether there is a rational connection between the purpose of the measure and the treatment of the foreign investor; the level of protection against risks to health, the environment or public order that a state deems is appropriate; whether the measure is specifically directed at the investor; the impact of the measure on the reasonable investment-backed expectations of the investor; and whether the state is attempting to avoid investment-backed expectations that the state created or reinforced through legislated commitments or other official acts. An interpretative note could accompany the above articles to provide guidance on what constitutes a clearly unreasonable measure and what type of measures would violate the minimum standard of treatment. This is a preliminary list of factors to consider. Future investment liberalization should consider more elaborated standards for reviewing when government measures cause economic injury to foreign investment and whether these government measures are in some sense arbitrary. These negotiations could result in an investment agreement with provisions for investment similar to those in the WTO's SPS Agreement and TBT Agreement.

In Chapter Four, I examined claims of expropriation under Chapter Eleven of the NAFTA. I argue that the scope of expropriation in Chapter Eleven of the NAFTA is not wider than that under customary international law. Although customary international law on expropriation is vague, the existing authorities do not suggest that government authority to protect the public from harms caused by investments or to establish appropriate levels of protection and risk is unduly restricted. In addition, I argue that expropriation claims made to date under NAFTA should not be successful. However, I acknowledge there is disagreement and uncertainty in this area, and that the scope of expropriation in the NAFTA is potentially wider than the framework for expropriation proposed in this thesis. The lack of clear precedents in international law and the lack of clarity in Article 1110(1) create legitimate concerns that an investment tribunal will adopt a wider interpretation of the provisions that I argue is warranted. Given the uncertainty in the scope of Article 1110(1), the NAFTA parties should proceed with preparing an interpretative statement to NAFTA immediately. While it would be preferable to have an amendment of the NAFTA that would adopt the approach to investment protection proposed in Chapter Three, this is unlikely to be acceptable to the US or Mexico. An interpretative statement and eventual amendment of the NAFTA that provides an express exception for regulatory measures to protect

the environment, public health and public order represents a second best solution to the uncertainty and unpredictability of the expropriation provisions in Article 1101 of the NATFA.

The domestic impact of the expropriation provisions in Chapter Eleven of the NAFTA should be measured by the extent to which the meaning of expropriation is wider in international law than in Canadian law. I have emphasized how international law focuses on the effect of government measures on property rights but provides an exception for police power regulation. Since government liability for expropriation in Canadian law only arises where the government acquires private property, international law may require compensation for expropriation where such a claim would not arise under Canadian law. As discussed in Chapter Five, this may arise in cases of economic regulation that prohibit an economic activity and where there is no police power justification for the regulation. Second, since there is no explicit constitutional protection of property rights in Canada, under Canadian law the government does not have to pay compensation where there is a clear legislative intent to expropriate without paying compensation.

The differences between Canadian law and international law result in foreign investors obtaining wider investment protection than that available to domestic investors. Since international expropriation law is imprecise, the first impact could be significant, particularly if the scope of the police power regulatory exception is not as wide as my analysis of international law suggests. This points to the need for an elaborated framework for an international minimum standard of investment protection and for clarification of Chapter Eleven. The second difference between international expropriation law and Canadian law (the inability of domestic law to override the requirement to pay compensation) is a justifiable restriction. If international law did not require states to pay compensation for expropriation, foreign investors would lack any investment security and would be deprived of the ability to allocate risks contractually.

The concern with the effect of investment protection obligations on domestic sovereignty has arisen primarily because of the enforcement of investment protection obligations through investor-state arbitration. Much of the criticism of Chapter Eleven has focused on how the investor-state arbitration process allows investors to bypass domestic courts and challenge

democratically enacted legislation through a private process. This thesis has not addressed the investor-state arbitration process in detail. Rather, I have focused on the substantive rules of international law to protect foreign investment. The primary flaw with investor-state arbitration in the NAFTA and BITs is that investors have obtained a powerful mechanism to challenge government regulation while state obligations to investors are imprecise. Clarification of investment obligations would go a long way to address the concern that investor-state arbitration is a threat to domestic sovereignty. With respect to the process itself, I have made a number of suggestions for improvement. First, there should be a mechanism to prevent clearly unmeritorious claims from proceeding to arbitration. Second, the process itself should become more transparent by making the pleadings and hearings public and potentially allowing third party access to the process where there are important public policy questions at stake.

As a result of the investor-state arbitration provisions in Chapter Eleven, claimants, such Ethyl Corporation, have challenged import and export restrictions under investment obligations. Prior to the NAFTA, these type of measures were traditionally disciplined under international trade law. The claims under Chapter Eleven of the NAFTA raise the issue of the interrelationship between international investment and trade obligations because, depending on the structure of trade and investment, any form of government regulation may potentially adversely impact trade or investment. This raises complex jurisdictional questions about which body of law, international trade law or international investment law, applies and which dispute resolution process is the most appropriate forum for the resolution of the dispute. I have argued that, as a matter of general principle, investors should not have a privileged status (compared to traders) to challenge and obtain compensation for measures that are trade-restrictive. International investment rules, and investor-state arbitration, should apply only to government measures that are primarily aimed at investment regulation. However, as noted above, at a conceptual level it is very difficult to distinguish between measures that impact trade and investment by reference to nature of the measure. Defining the precise rules to implement this principle in practice requires that a framework be developed to govern the interrelationship between international trade law and international investment law. This is an area that deserves further study and needs to be pursued in future international trade and investment liberalization discussions.

Domestic regulation of foreign investment remains a matter of special political sensitivity. Critics of the NAFTA argue that not only does the NAFTA require national treatment of foreign investors but provides special rights and treatment to foreign investors that are unjustifiable. It is true that foreign investors have special rights under the NAFTA that domestic investors do not. With respect to compensation policy for regulatory expropriation, I have argued throughout this thesis that compensation policy should be determined domestically and that, as a matter of principle, investors should only receive national treatment. In certain core areas, however, to the extent that national treatment falls below the international minimum standard of treatment for foreign investment, it is justifiable to provide foreign investors "supranational treatment". Given the low threshold for the international minimum standard proposed in this thesis, the domestic regulatory impact of such "supranational treatment" is likely to be limited. But since international expropriation law does not provide a clear answer to when government action is expropriatory, the extent of this impact remains vague and uncertain. Until the issues raised in this thesis are clarified, there will continue to be legitimate concern that international investment law is a threat to domestic regulatory authority.

BIBLIOGRAPHY

Books

G.H. Aldrich, *The Jurisprudence of the Iran-United States Claims Tribunal* (Oxford: Clarendon Press, 1996).

American Law Institute, *Restatement (Second) of the Foreign Relations Law of the United States* (Washington: American Law Institute Publishers, 1965).

American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States* (Washington: American Law Institute Publishers, 1987).

C.F. Amerasinghe, *State Responsibility for Injuries to Aliens* (Oxford: Clarendon Press, 1967).

B. Appleton, *Navigating NAFTA* (Toronto: Carswell, 1994.)

C.N. Brower & J.D. Brueschke, *The Iran-United States Claims Tribunal* (The Hague: Martinus Nijhoff Publishers Publishers, 1998).

I. Brownlie, *Principles of Public International Law*, 5th ed. (Oxford: Clarendon Press, 1998).

J.G. Castel *et al.*, *The Canadian Law and Practice of International Trade*, 2d ed. (Toronto, Edmond Montgomery Publications Limited, 1997).

P.E. Comeaux & N.S. Kinsella, *Protecting Foreign Investment Under International Law* (New York: Oceana Publications, 1997).

Commission of Inquiry into Compensation for Taking of Resource Interests, *Report of the Commission into Compensation for the Taking of Resource Interests* (Victoria: Queen's Printer for British Columbia, 1993).

V.D. Degan, *Sources of International Law* (The Hague: Kluwer Law International, 1997).

R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff Publishers, 1995).

J.H. Dunning, *Globalization, Trade and Foreign Direct Investment* (Oxford: Elsevier, 1998).

R.A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (Cambridge: Harvard University Press, 1985).

W.A. Fischel, *Regulatory Takings: Law, Economics and Politics* (Cambridge: Harvard University Press, 1995).

I. Foighel, *Nationalization: A Study in the Protection of Alien Property in International Law* (London: Stevens & Sons Limited, 1957).

S. Friedman, *Expropriation in International Law* (London: Stevens & Sons Limited, 1953).

F.V. García-Amador *et al.*, *Recent Codification of the Law of State Responsibility for Injuries to Aliens* (New York: Oceana Publications, Inc., 1974).

F.V. García-Amador, *The Changing Law of International Claims* (New York: Oceana Publications, Inc., 1984).

S. Globerman & M. Walker, eds., *Assessing NAFTA: A Trinational Analysis* (Vancouver: The Fraser Institute, 1993).

G.C. Hufbauer & J. Schott, *NAFTA: An Assessment*, rev. ed. (Washington, Institute for International Economics, 1993).

International Law Commission, *Yearbook of the International Law Commission 1959* (New York, United Nations, 1959).

International Lawyer, *Commentaries on the Restatement (Third) of the Foreign Relations Law of the United States* (US: ABA Section of International Law and Practice, 1992).

J. Johnson, *The North American Free Trade Agreement: A Comprehensive Guide* (Aurora: Canada Law Book Inc., 1994).

P.M. Johnson & A. Beaulieu, *The Environment and NAFTA* (Washington, D.C.: Island Press, 1996).

R.B. Lillich, ed., *The Valuation of Nationalized Property in International Law* (Charlottesville: University Press of Virginia, 1972).

R.B. Lillich, ed., *International Law of State Responsibility for Injuries to Aliens* (Charlottesville: University Press of Virginia, 1983).

R. Khan, *The Iran-United States Claims Tribunal: Controversies, Cases and Contribution* (Dordrecht: Martinus Nijhoff Publishers, 1990).

J.L. Knetsch, *Property Rights and Compensation* (Toronto: Butterworths, 1983).

P. Malanczuk, ed., *Akehurst's Modern Introduction to International Law*, 7th ed. (London: Routledge, 1997).

W. Mapp, *The Iran United States Claims Tribunal: The First Ten Years 1981 - 1991* (Manchester: Manchester University Press, 1993).

R. Miller & R. Stanger, eds., *Essays on Expropriation* (Ohio: Ohio State University Press, 1967).

Organisation for Economic Co-operation and Development, *Draft Convention on the Protection of Foreign Property* (Paris: O.E.C.D. Publications, 1962).

Organisation for Economic Co-operation and Development, *OECD Working Papers Vol. V: The OECD Declaration and Decisions on International Investment and Multinational Enterprises Basic Texts* (Paris: OECD, 1997).

Organisation for Economic Co-operation and Development, *The OECD Report on Regulatory Reform: Synthesis* (Paris: O.E.C.D. Publications, 1997).

R.K. Paterson *et al.*, *International Trade and Investment Law in Canada*, 2d ed. (Toronto: Carswell, 1994).

R. Posner, *Economic Analysis of Law*, 5th ed. (New York: Aspen Law & Business, 1998).

R. Pritchard, ed., *Economic Development, Foreign Investment and the Law* (London: Kluwer Law International, 1996).

R.J. Rabalais Jr., ed., *International Regulation of Finance & Investment*, looseleaf (New York: Oceana Publications Inc., 1995).

M.J. Radin, *Reinterpreting Property* (Chicago: The University of Chicago Press, 1993).

C. Rose, *Property & Persuasion: Essays on the History, Theory and Rhetoric of Ownership* (Boulder: Westview Press, Inc., 1994).

A.M. Rugman, ed. *Foreign Investment and NAFTA* (Columbia: University of South Carolina Press, 1994).

P. Sauvé & D. Schwanen, eds., *Investment Rules for the Global Economy* (Toronto: C.D. Howe Institute, 1996).

N. Schrijver, *Sovereignty Over Natural Resources* (Cambridge: Cambridge University Press, 1997).

G. Schwarzenberger, *Foreign Investment and International Law* (New York: Frederick A. Praeger, 1969).

I.F.I. Shihata, *Towards a Greater Depoliticization of Investment Disputes: The Roles of ICSID and MIGA* (Washington: International Centre for Settlement of Investment Disputes, 1993).

J.G. Sidak & D.F. Spulber, *Deregulatory Takings and the Regulatory Contract* (Cambridge: Cambridge University Press, 1997).

M. Sornarajah, *The International Law of Foreign Investment* (Cambridge: Cambridge University Press, 1994).

M. Sornarajah, *The Pursuit of Nationalized Property* (Dordrecht: Martinus Nijhoff Publishers, 1986).

M.J. Trebilcock & R. Howse, *The Regulation of International Trade* 2nd ed., forthcoming, (New York: Routledge, 1999).

J. Waldron, *The Right to Private Property* (Oxford: Clarendon Press, 1988).

G. White, *Nationalisation of Foreign Property* (London: Stevens & Sons Limited, 1961).

B.A. Wortely, *Expropriation in Public International Law* (Cambridge: Cambridge University Press, 1959).

World Bank, *Legal Framework for the Treatment of Foreign Investment* (Washington D.C.: The World Bank, 1992).

World Bank, *The Private Sector in Infrastructure: Strategy, Regulation and Risk* (Washington D.C.: The World Bank, 1997).

Articles

A. Akinsanya, “International Protection of Direct Foreign Investments in the Third World” (1987) 36 I.C.L.Q. 58.

G.H. Aldrich, “What Constitutes a Compensable Taking of Property? The Decisions of the Iran-United States Claims Tribunal” (1994) 88 A.J.I.L. 585.

T. Allen, “Commonwealth Constitutions and the Right Not to Be Deprived of Property” (1993) 42 I.C.L.Q. 523.

B.S. Amor, “International Law and National Sovereignty: The NAFTA and the Claims of the Mexican Jurisdiction” (1997) 19 Houston J. Int'l L. 565.

E. J. de Aréchaga, “State Responsibility for the Nationalization of Foreign Owned Property” (1978) 11 N.Y.U. J. Int'l L. & Pol. 179.

S.K.B. Asante, “International Law and Foreign Investment: A Reappraisal” (1988) 37 I.C.L.Q. 588.

E. Atwood & M.J. Trebilcock, “Public Accountability in an Age of Contracting Out” (1996) 27 C.B.L.J. 1.

J.P. Byrne, “Ten Arguments for the Abolition of the Regulatory Takings Doctrine” (1995) 22 Eco. L. Q. 89.

I. Brownlie, “Legal Status of Natural Resources In International Law (Some Aspects)” (1979) 162 Rec. des Cours 245.

E.M. Burt, “Developing Countries and the Framework for Negotiations on Foreign Direct Investment in the World Trade Organization” (1997) 12 Am. U. J. Int'l L. & Pol'y.

S.K. Chatterjee, “The Convention Establishing the Multilateral Investment Guarantee Agency” (1987) 56 I.C.L.Q. 76.

G.C. Christie, “What Constitutes a Taking of Property under International Law” (1962) 33 B.Y.I.L. 307.

D. Cohen & B. Radnoff, “Regulation, Takings, Compensation, and the Environment: An Economic Perspective” in C. Tollefson, ed., *The Wealth of Forests: Markets, Regulation, and Sustainable Forestry* (Vancouver: UBC Press, 1998).

M.W. Cordes, “Leapfrogging the Constitution: The Rise of State Takings Legislation” (1997) 24 Eco. L. Q. 187.

J.J. Curtis, Jr., “Comparison of Regulatory Takings Under the United States Constitution and the European Convention on Human Rights” (1989) 14 Eur. L. Rev. 67.

J. Daly, “Has Mexico Crossed the Border on State Responsibility for Economic Injury to Aliens? Foreign Investment and the Calvo Clause in Mexico After the NAFTA” (1994) 25 St. Mary's L.J. 1147.

D. Dana, “Natural Preservation and the Race to Develop” (1995) 143 U. Pa. L. Rev. 655.

R.G. Dearden, “Arbitration of Expropriation Disputes between an Investor and the State under the North American Free Trade Agreement” (1995) 29 J. World T. 113.

R. Dolzer, “New Foundations of the Law of Expropriation of Alien Property” (1981) 75 A.J.I.L. 553.

R. Dolzer, “Indirect Expropriation of Alien Property” (1988) 1 ISCID Rev. 41.

J.L. Dunoff & J. P. Trachtman, “Economic Analysis of International Law” (1999) 24 Yale J. Int'l L. 1.

L.B. Ederington, “Property as a Natural Institution: The Separation of Property from Sovereignty in International Law” (1997) 13 Am U. Int'l L. Rev. 262.

A. Eisenberg, “'Public Purpose' and Expropriation: Some Comparative Insights and the South African Bill of Rights” (1995) 11 S. African J. Hum. Rts. 207.

C.D. Eklund, “A Primer on the Arbitration of NAFTA Chapter Eleven Investor- States Disputes” (1994) 11 J. Int'l Arb. 135.

R.A. Epstein, “Takings” in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 3 (New York: Stockton Press, 1998) at 561.

D.C. Estey & B.S. Gentry, “Foreign Investment, Globalisation, and Environment” in *Globalisation and Environment: Preliminary Perspectives* (Paris: OECD, 1997).

A.P. Fachiri, “Expropriation and International Law” (1925) 6 B.Y.I.L. 159.

W.A. Fischel, “Eminent Domain and Just Compensation” in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 2 (New York: Stockton Press, 1998).

W.A. Fischel, “Introduction: Utilitarian Balancing and Formalism in Takings” (1988) 88 Colum. L. Rev. 1601.

T.M. Franck, “Legitimacy in the International System” (1988) 82 A.J.I.L. 705.

T.M. Franck, “Fairness in the International Legal and Institutional System” (1993) 240 Rec. des Cours 11.

F.V. García-Amador, “Fourth Report of the Special Rapporteur - Responsibility of the State for Injuries Caused in its Territory to the Persons or Property of Aliens - Measures Affecting Acquired Rights” (1959) 2 Y.B. Int'l Law Comm. 1.

F.V. García-Amador, “The Proposed New International Economic Order: A New Approach to the Law Governing Nationalization and Compensation” (1980) 12 Law. Americas 1.

R.C. Gardner, “Taking the Principle of Just Compensation Abroad: Private Property Rights, National Sovereignty, and the Cost of Environmental Protection” (1997) U. Cin. L. Rev. 539.

S. Ghosh, “Takings, the Exit Option and Just Compensation” (1997) Int'l Rev. L. & Econ. 157.

E.M. Graham, “Regulatory Takings, Supernational Treatment, and the Multilateral Agreement on Investment: Issues Raised by Nongovernmental Organizations” (1998) 31 Cornell Int'l L. J., 599.

A.T. Guzman, “Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties” (1998) Va. J. Int'l L. 639.

A.Z. Hertz, “Shaping the Trident: Intellectual Property under NAFTA, Investment Protection Agreements and at the World Trade Organization” (1997) 23 Can.-U.S. L. J. 261.

J.H. Herz, “Expropriation of Foreign Property” (1941) 35 A.J.I.L 243.

R. Higgins, “The Taking of Property by the State: Recent Developments in International Law” (1982) 176 Rec. des Cours 259.

L. Kaplow, “An Economic Analysis of Legal Transitions” (1986) 99 Harv. L. Rev. 511.

P.T.B. Kohona, “Investment Protection Agreements: An Australian Perspective” (1987) 21 J. World T. L. 79.

V.R. Koven, “Expropriation and the “Jurisprudence” of OPIC” (1981) 22 Harv. Int'l L.J. 269.

E. Lauterpacht, “Issues of Compensation and Nationality in the Taking of Energy Investments” (1990) 8 J. Energy & Nat. Resources L. 241.

R.C. Levin & S.E. Marin, “NAFTA Chapter Eleven: Investment and Investment Disputes”, (1996) II:3 NAFTA: L. and Bus. Rev. Amer. 83.

B. Levy & P.T. Spiller, “Regulation, Institutions, and Commitment in Telecommunications: A Comparative Analysis of Five Country Studies” in *Proceedings of the World Bank Annual Conference on Development Economics 1993* (Washington: The World Bank, 1994).

T. Levy, “NAFTA's Provision for Compensation in the Event of Expropriation: A Reassessment of the 'Prompt, Adequate and Effective' Standard” (1995) 31 Stan. J. Int'l L. 423.

R.B. Lillich & B.H. Weston, “Lump Sum Agreements: Their Continuing contribution to the Law of International Claims” (1988) 82 A.J.I.L. 69.

D.S. Macdonald, “Chapter Eleven of NAFTA: What are the Implications for Sovereignty” (1998) 24 Can.-U.S. L.J. 281.

A. McEvoy, “Markets and Ethics in U.S. Property Law” in H.M. Jacobs, ed., *Who Owns America?* (Madison: The University of Wisconsin Press, 1998).

O. McIntyre & T. Mosedale, “The Precautionary Principle as a Norm of Customary International Law” (1997) 9 J. Envtl. L. 221.

T.W. Merrill, “Compensation and the Interconnnectedness of Property” (1998) 25 Eco. L. Q. 327.

T.M. Miceli & K. Segerson, “Compensation for Regulatory Takings” in P. Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, vol. 1 (New York: Stockton Press, 1998) at 360.

F.I. Michelman, “Property, Utility, and Fairness: Comments on the Ethical Foundations of “Just Compensation” Law” (1967) 80 Harv. L. Rev. 1165.

F.I. Michelman, “Takings, 1987” (1988) 88 Colum. L. Rev. 1601.

P.M. Norton, “A Law of the Future or a Law of the Past? Modern Tribunals and the International Law of Expropriation”, (1991) 85 A.J.I.L. 474.

A. Ogus, “Property Rights and Freedom of Economic Activity” in L. Henkin & A. Rosenthal, eds., *Constitutionalism and Rights: The Influence of the United States Constitution Abroad* (New York: Columbia University Press, 1990).

C.J. Olmstead, E.J. Krauland & D.F. Orentlicher, “Expropriation in the Energy Industry: Canada's Crown Share Provision as a Violation of International Law” (1984) 29 McGill L.J. 439.

M. Pellonpää & M. Fitzmaurice, “Taking of Property in the Practice of the Iran-United States Claims Tribunal” (1988) Netherl.Y. Int'l. L. 53.

S. Picciotto, “Linkages in International Investment Regulation: The Antinomies of the Draft Multilateral Agreement on Investment” (1998) U. Pa. J. Int'l Econ. L 731.

J. Quinn & M.J. Trebilcock, “Compensation, Transition Costs, and Regulatory Change” (1982) 32 U.T.L.J. 117.

P.M. Robin, “The *BIT* Won't Bite: The American Bilateral Investment Treaty Program” (1984) 33 Am. U. L.Rev. 931.

N. Roht-Arriaza, “Shifting the Point of Regulation: The International Organization for Standardization and Global Lawmaking on Trade and the Environment” (1995) 22 Ecology L. Q. 479.

C.M. Rose, “*Mahon* Reconstructed: Why the Takings Issue Is Still a Muddle” (1984) S. Cal. L. Rev. 561.

C.M. Rose, “A Dozen Propositions on Private Property, Public Rights, and the New Takings Legislation” (1996) 53 Wash. & Lee L. Rev. 265.

A.M. Rugman, J. Kirton & J. Soloway, “NAFTA, Environmental Regulations, and Canadian Competitiveness” (1997) 31 J. World T. 129.

R.A. Salgado, “Protection of Nationals' Rights to Property Under the European Convention on Human Rights: *Lithgow v. United Kingdom*” (1987) 27 Va J. Int'l L. 865.

J.L. Sax, “Takings and the Police Power” (1964-5) 74 Yale L.J. 36.

J.L. Sax, “Takings, Private Property and Public Rights” (1971) 81 Yale L.J. 149.

J.L. Sax, “Takings Legislation: Where It Stands and What is Next” (1996) 23 Eco. L. Q. 496.

D. Schneiderman, “Canadian Constitutionalism and Sovereignty After NAFTA” (1994) 5 Constitutional Forum 93.

D. Schneiderman, “NAFTA's Takings Rule: American Constitutionalism Comes to Canada” (1996) 46 U.T.L.J. 499.

J. Soloway, “Environmental Trade Barriers Under Nafta: The MMT Fuel Additives Controversy” (1999) 8 Minnesota J. of Global Trade 55.

J. Soloway, “NAFTA's Chapter Eleven: The Challenge of Private Party Participation” (1999) 16 J. Int'l Arb 1.

S.R. Swanson, “Iran-U.S. Claims Tribunal: A Policy Analysis of the Expropriation Cases” (1986) 18 Case W. Res. J. Int’l L. 307.

J.P. Trachtman, “International Regulatory Competition, Externalization, and Jurisdiction” (1993) 34 Harv. Int'l L. J. 47.

M. Trebilcock & R. Howse, “Trade Liberalization and Regulatory Diversity: Reconciling Competitive Markets with Competitive Politics” (1998) 6 Eur. J. L. & Eco. 5.

D.F. Vagts, “Coercion and Foreign Investment Rearrangements” (1978) 72 A.J.I.L. 17.

J.D. van der Vyer, “Property in International Human Rights Law” in G.E. van Maanen & A.J. van der Walt, eds., *Property Law on the Threshold of the 21st Century* (Antwerpen: Maklu, 1996).

K.L. Vandevelde, “The Political Economy of a Bilateral Investment Treaty” (1998) 92 A.J.I.L. 621.

K.L. Vandevelde, “Sustainable Liberalism and the International Investment Regime” (1998) 19 Mich. J. Int'l L. 373.

W. D. Verway & N.J. Schrijver, “The Taking of Foreign Property Under International Law: A New Legal Perspective” (1984) Netherl.Y. Int'l. L. 3.

J. Voss, “The Protection and Promotion of Foreign Direct Investment in Developing Countries: Interests, Interdependencies, Intricacies” (1982) 31 I.C.L.Q. 686.

G. Verhoosel, “Foreign Direct Investment and Legal Constraints on Domestic Environmental Policies: Striking a “Reasonable” Balance between Stability and Change” (1998) 29 Law & Pol'y Int'l Bus. 451.

J.A. Westberg, “Applicable Law, Expropriatory Takings and Compensation in Cases of Expropriation; ICSID and Iran-United States Claims Tribunal Case Law Compared”, (1993) 8 ICSID Rev. 1.

B.H. Weston, ““Constructive Takings” under International Law: A Modest Foray into the Problem of Creeping Expropriation” (1975) 16 Va. J. Int'l L. 103.

B.H. Weston, “The Charter of Economic Rights and Duties of States and the Deprivation of Foreign-Owned Wealth” (1981) 75 A.J.I.L. 437.

J.F. Williams, “International Law and the Property of Aliens” (1928) 9 B.Y.I.L. 1.

E.D. Williamson, “U.S. - EU Understanding on Helms-Burton: A Missed Opportunity to Fix International Law on Property Rights” (1999) 48 Cath. U. L. Rev. 293.

B.A. Wortely, “Some Early But Basic Theories of Expropriation” (1977) German Y.B. Int'l L. 236.