Dissertation Title:

How to improve the application of proportionality test in terms of finding the proper balance between states' right to regulate and investor protection in indirect expropriation claims?

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Abstract:

The thesis sets out how indirect expropriation is defined in Bilateral Investment Treaties (BITs), why and how important is to strike the balance between states' right to regulate and foreign investment protection in indirect expropriation claims, which interests should be considered in that balance and how to achieve the balance by eliminating the problems about the application of the proportionality test in investment disputes. It is highlighted that a balance between foreign investors' rights and host states' right to regulate should be achieved in the indirect expropriation claims which is considered very important as there has been no common way to obtain this balance and while BITs stay silence about it. There have been different tests to determine whether indirect expropriation has occurred or not, however this thesis examines only the proportionality test as it is the most useful and successful one to achieve the balance between states' right to regulate and foreign investment protection. As the proportionality test is adopted from European Court of Human Rights (ECtHR) and World Trade Organization (WTO) cases, this thesis sets out that some problems have occurred relating the lack of guidance for investment tribunals on how to apply the test in investment disputes. This is why, the problems about the application of the proportionality test are determined after examining some cases, and the solution is found out as establishing explicit provisions in BITs which consists of clear intentions of the parties about indirect expropriation and guidance on how to solve indirect expropriation disputes by referring to proportionality test.

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INTRODUCTION:

International investment law is a system that administers the relationship between states and foreign investors. These relations between host states and foreign investors are built by the Bilateral Investment Treaties (BITs) which are signed between countries in order to improve their political and economic relations. Today, 2353 BITs are in force all over the world,[1] aiming to provide protection for foreign investors from states' acts. This protection is ensured by certain concepts such as state's obligation to establish non-discriminatory acts, fair and equitable treatment (FET) to a foreign investor and a guarantee of compensation if a state takes any assets of the foreign investor[2] which is defined as 'expropriation.' Furthermore, BITs provide dispute-settlement provisions which allow foreign investors to bring a claim against host states at arbitration tribunals and ask for compensation for the loss caused by the acts of the state.

One of the main claims brought by foreign investors is against expropriation, which can occur in two ways; direct and indirect. 'Direct expropriation' happens when the title of the foreign investors' property is directly transferred to the host state.[3] Indirect expropriation occurs when a state's regulatory acts lead to deprivation of the foreign investor's property or benefits. The protection from indirect expropriation is provided in the International Investment Agreements (IIAs) under the 'expropriation' provisions however, neither IIAs nor

[1] UNCTAD, 'Investment Policy Hub' < https://investmentpolicyhub.unctad.org/IIA > Accessed: 03.08.3019.
[2] Jürgen Kurtz, 'Adjudging The Exceptional At International Investment Law: Security, Public Order And Financial Crisis' (2010) 59(2) ICLQ 331.
[3] UNCTAD, 'Expropriation, UNCTAD Series on Issues in International Investment Agreements II' (2012) United Nations, 6 <https://unctad.org/en/Docs/unctaddiaeia2011d7_en.pdf > Accessed: 10.07.2019.

BITs explicitly define or refer to 'indirect expropriation'.[4] However, the parties' intentions in the assessment of indirect expropriation should be clear in order to guide tribunals in their assessments. Thus, parties should clearly define indirect expropriation provisions by outlining situations that may not amount to expropriation and laying out criteria to assess the existence of indirect expropriation. Consequently, due to the lack of clarity in BITs about how indirect expropriation should be examined[5], tribunals have used different approaches to assess whether the measure taken by the government has led to expropriation or not. Moreover, there are mainly three approaches; sole-effect, police power and proportionality.[6]

When assessing indirect expropriation, tribunals consider whether the measure taken for the sake of the public interest has led to a deprivation of foreign investor's rights and interests. Thus, they need to weigh the public interests against private ones, which leads to a balanced assessment [7] as it considers both the purpose and effect of the measure. Therefore, achieving a balance between states' right to regulate and foreign investment protection must be the main objective when deciding on cases of indirect expropriation. Among the different tests used by the tribunals to assess whether a measure led to an expropriation or not, the proportionality test has proven to be the best one to strike the proper balance between the states' right to regulate and foreign investment protection. This dissertation will only focus on the proportionality test and will not make a comparative study on all tests. On the other hand,

[4] Andrew Newcombe and Lluís Paradell , *Law and Practice of Investment Treaties: Standards of Treatment*, Kluwer Law International (2009) 325.
[5] Ursula Kriebaum, 'Regulatory Takings: Balancing the Interests of the Investor and the State '(2007) 8(5) J. World Investment & Trade 722.
[6] Caroline Henckels, 'Indirect Expropriation and The Right To Regulate: Revisiting Proportionality Analysis and The Standard of Review in Investor-State Arbitration' (2012) 15(1) JIEL 225.
[7] L. Yves Fortier and Stephen L. Drymer, 'Indirect Expropriation in the Law of International Investment: I Know It When I See It, or Caveat Investor' (2005) 13(1) Asia Pac. L. Rev. 83.

in order to understand how the proportionality test provides the proper balance by combining the sole-effect and police powers doctrines[8], brief information about these tests will be given.

A definition of the balance between the states' right to regulate and foreign investment protection must be outlined before examining how the proportionality test achieves this balance. Therefore, first, the concepts of foreign investment protection and states' right to regulate will be examined based on their interpretation by investment tribunals. Furthermore, this study will try to find answers to questions like; "which interests need to be balanced, why balance is necessary and how it should be achieved." Thus, this thesis will conclude by stating that the balance between states' right to regulate and foreign investment protection for indirect expropriation claims can best be achieved by applying the proportionality test.

The proportionality approach comes from German administrative and constitutional law [9] and has been adopted in international jurisdictions. In domestic jurisdictions, it has been used to define the relationship between the state and individuals in case of a conflict.[10] In international investment law, the proportionality test was applied to find a balance between public and private interests in indirect expropriation claims for the first time in *Tecnicas Medioambientales Tecmed SA v Mexico*[11] case, by adopting it from the jurisprudence of European Court of Human Rights (ECtHR). [12] This is why the *Tecmed* case is considered

[8] Erlend M. Leonhardsen, 'Looking for Legitimacy: Exploring Proportionality Analysis in Investment Treaty Arbitration'(2012) 3(1) Journal of International Dispute Settlement 122.
[9] Benedict Kingsbury and Stephan W. Schill, 'Public Law Concepts To Balance Investors' Rights With State Regulatory Actions In The Public Interest-The Concept Of Proportionality' in Stephan W.Schill(ed), *International Investment Law and Comparative Public Law* (Oxford University Press 2010) 80.
[10] Ibid.
[11] Tecnicas Medioambientales Tecmed SA v Mexico, ICSID Case No. ARB (AF)/00/2, Award, 29 MAY 2003 ("***Tecmed v Mexico***").
[12] Han Xiuli, 'The Application of the Principle of Proportionality in Tecmed v. Mexico' (2007) 6(3) Chinese J. Int'l L. 640.

important and is a leading case for other tribunals in applying the proportionality test in indirect expropriation claims. Moreover, the *Continental Casualty Company v Argentina*[13] case also has significant importance as it examines the "necessity" concept by relying on the interpretation of World Trade Organization (WTO) case law and referring to General Agreements on Tariffs and Trade (GATT)[14] in the examination of an indirect expropriation claim. Therefore, this dissertation will look at the *Tecmed* and *Continental* cases in order to examine how the proportionality test is applied in investment disputes by adopting it from different jurisdictions, and whether they could be successful both in terms of the application and finding a balance between states' right to regulate and foreign investment protection.

Although the proportionality test is accepted as the most successful tool in finding a balance, there have also been issues with its application in investment disputes. These problems can be determined as; the misinterpretation of the test and lack of clarity and reasoning in decisions.[15] Moreover, the main reason behind these problems is a lack of guidance for tribunals in applying the proportionality test in investment disputes. As the *Tecmed* tribunal adopted the proportionality test from the jurisprudence of ECtHR and the *Continental* tribunal relied on WTO case law, the different legal textures between investment law and these jurisdictions caused problems with its application. For instance, *Tecmed* skipped the suitability and necessity stages of the test which is considered a misinterpretation.[16] Moreover, the *Continental* tribunal decided on the case without considering the proportionality *stricto sensu*

[13] Continental Casualty Company v The Argentine Republic, ICSID Case No.ARB/03/9, Award, 5 SEP 2008 ***("Continental v Argentina")***.
[14] For the text of the Agreement see < https://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm >
[15] Henckels (n 6) 233.
[16] Prabhash Ranjan, 'Using the Public Law Concept of Proportionality to Balance Investment Protection with Regulation in International Investment Law: A Critical Appraisal' (2014) 3(3) Cambridge J. Int'l & Comp. L. 865.

stage[17] and is also criticized for disregarding the BIT and focusing only on GATT.[18] Therefore, the problems related to the interpretation of the test are based on trying to apply concepts from different jurisdictions to investment law without any guidance.

As the main problem is a lack of guidance in applying the proportionality test, this dissertation will present a solution by establishing explicit provisions about indirect expropriation which will guide tribunals in BITS. These provisions are expected to establish the criteria for including a reference to the proportionality test, which will be used by tribunals when assessing indirect expropriation. Additionally, BITs should also set out the situations that do not amount to expropriation. Having explicit provisions will prioritise the parties' intentions and reduce the discretion of tribunals in the interpretation of BITs. In fact, some BITs such as the US and Canada Model have already established explicit provisions about indirect expropriation, which indicate the clear intentions of the parties and guide tribunals in their assessments. Consequently, this solution will improve the application of the proportionality test by providing guidance for tribunals in BITs and preventing the misinterpretation of the test.

This research already accepts the proportionality test as the best tool to find the balance between states' right to regulate and foreign investment protection in indirect expropriation claims. Thus, this research aims to address how to improve the application of the test by finding a solution for the problems in the interpretation of tribunals and missing provisions about indirect expropriation in BITs. Therefore, this dissertation's structure will be as follows:

[17] Caroline Henckels, *Proportionality and Deference in Investor-State Arbitration: Balancing Investment Protection and Regulatory Autonomy* (Cambridge University Press 2015) 95.
[18] Kathleen Claussen , 'The Casualty of Investor Protection in Times of Economic Crisis' (2009) Yale Law J. 118(7) 1549.

the first chapter includes what definition of indirect expropriation, the issue of the lack of explicit definitions in BITs, and the tests applied by the tribunals to decide on indirect expropriation, including sole-effects, police power and proportionality. The second chapter will define foreign investment protection and states' right to regulate, discussing the balance between them in indirect expropriation claims. It will also examine why balance is essential and how it should be achieved. The third chapter comprises of a brief overview of the application of the proportionality test in ECtHR and WTO, the way in which the test is adopted by the *Tecmed* and *Continental* tribunal, and a discussion of the application of the test in investment disputes focusing both on strengths and weaknesses. The fourth chapter will provide a solution to eliminate problems and improve the application of the proportionality test in indirect expropriation claims in order to achieve the balance between states' right to regulate and foreign investment protection.

CHAPTER ONE: INDIRECT EXPROPRIATION IN INTERNATIONAL INVESTMENT TREATIES

This chapter will start with defining indirect expropriation and how it is determined by IIAs and BITs by highlighting the lack of explicit provisions about indirect expropriation. BITs should determine criteria to be followed by tribunals on the assessment of indirect expropriation and set out the situations that will be exempted from it. Otherwise, it can lead tribunals to interpret BITs by considering different tests and criteria. In this chapter, the main approaches of tribunals to decide on expropriation will be given without making any comparison. The proportionality test has already been accepted as the best because it considers both the purpose and the effect of the measure in order to balance public and private interests, as a proper assessment for indirect expropriation claims.

I. The Definition of Indirect Expropriation

In international investment law, an expropriation may occur in two ways; direct and indirect. As Andrew Newcombe defines, direct expropriation occurs when a state deliberately possesses or transfers the title of the private party's property.[19] On the other hand, in indirect expropriation situations, a government measure leads foreign investors to be deprived of its property or benefits without resulting in the transfer of property.[20] In other words; a measure taken under states' legislative power causes foreign investors to suffer in terms of reducing their ability to utilise the benefits that are derived from an investment. Stephen Olynk highlights that in indirect expropriation situations, the investor's legal title over the assets is not changed and their control over the asset is not diminished.[21] Moreover, he suggests that

[19] Newcombe and Paradell (n 4) 323.
[20] Ibid.
[21] Stephen Olynyk, 'A Balanced Approach to Distinguishing between Legitimate Regulation and Indirect Expropriation in Investor-State Arbitration', (2012) 15 Int'l Trade & Bus. L. Rev. 263.

the difference between direct expropriation and indirect expropriation can be understood by examining whether the measure affects the legal title of the owner or not.[22]

II. The lack of explicit definition of indirect expropriation in IIAs

In international investment agreements, indirect expropriation is usually not defined separately or explained under its own title. It is generally mentioned with a reference to direct expropriation by using expressions such as "*equivalent, tantamount, de facto, creeping, constructive, disguised, consequential, regulatory or virtual."*[23] To clarify, indirect expropriation is defined as a measure taken by a government which has the equal effect of expropriation. For instance, NAFTA uses the "tantamount" to define indirect expropriation; "*NAFTA Article 1110(1): '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 an investment ("expropriation")…"*[24] Thus, IIAs actually include the concept of indirect expropriation by defining it through 'expropriation'. However, it should be regulated under a separate provision with an explicit definition.

III. Establishing more explicit provisions about indirect expropriation in BITs

Generally, BITs try to define indirect expropriation by referring to direct expropriation and using expressions such as "equivalent to" or "tantamount to". However, there are BITs that still do not mention it directly, or even refer to indirect expropriation, such as the Lebanon-Malaysia BIT (2002)*; "Neither Contracting Party shall take any measures of expropriation or nationalization against the investments of an investor of the other Contracting Party except*

[22] Ibid.
[23] Newcombe and Paradell (n 4) 325.
[24] NAFTA Article 1110(1), For the full text see <https://www.italaw.com/sites/default/files/laws/italaw8959.pdf>.

under the following conditions…"[25] Some may argue that this kind of definition is broad enough to cover indirect expropriation[26], however it is not sufficient considering today's landscape, as there have been many indirect expropriation claims against host states under BITs. In order to provide a proper assessment of indirect expropriation claims, provisions should define indirect expropriation explicitly and clearly. Moreover, some states have started to establish more explicit provisions in their BITs by indicating some situations that will be exempted from expropriation. For instance, the Colombia-India BIT (2009) states the circumstances in detail that do not amount to expropriation:

> Non-discriminatory regulatory actions by a Contracting Party that are designed and applied to protect legitimate public welfare objectives including the protection of health, safety and environment do not constitute expropriation or nationalization; except in rare circumstances, where those actions are so severe that they cannot be reasonably viewed as having been adopted and applied in good faith for achieving their objectives.[27]

As seen, the intentions of the parties are clear with an explicit provision on the circumstances that will not be considered expropriation. This type of provision came into existence within US and Canada Model BITs and was followed by other states.[28] Furthermore, these BITs provide a guidance for tribunals on how to assess indirect expropriation claims. For instance, Canada Model BIT states:

> b) The determination of whether a measure or series of measures of a Party constitute an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors: i) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has

[25] Lebanon-Malaysia BIT (2002), Article 5, For the full text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/1887/download >.
[26] UNCTAD, 'Expropriation' (n 3) 8.
[27] Columbia- India BIT (2009), Article 6 /2/c, For the full text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/796/download >
[28] Newcombe (n 4), 335.

> occurred; ii) the extent to which the measure or series of measures interfere with distinct, reasonable investment-backed expectations; and iii) the character of the measure or series of measures.[29]

This type of provision explicitly refers to indirect expropriation and sets out the criteria that should be considered by tribunals in their assessment of the measure. Thus, other states should also follow this approach and establish provisions which provide guidance for tribunals.

To conclude, the important and problematic issue is; BITs do not have clear and explicit provisions about indirect expropriation. Thus, the provisions should mention indirect expropriation explicitly with criteria to be followed by tribunals, also setting out the situations that will not amount to expropriation. Moreover, having clear provisions, such as the ones given above, are important in terms of clarifying the parties' intentions and leading tribunals in their assessment. As Ursula Kriebaum states, with rare exceptions, treaties do not explain how to decide whether the regulation of the state will be considered as a non-compensatory or regulatory taking.[30] Consequently, this lack of clarity has led investment tribunals to interpret the terms and expressions used in BITs by applying different tests in order to decide whether indirect expropriation has occurred or not. The different approaches that have been applied by tribunals to decide on the issue will be examined in the next section.

IV. The tests applied by tribunals to assess indirect expropriation:

Investment tribunals have followed different approaches to assess whether the measure taken by the state amounted to indirect expropriation or not. In general, the approaches of tribunals are cumulated under three methods – the sole-effect doctrine, police-powers doctrine and the proportionality approach. These approaches will only be explained briefly

[29] Canada Model BIT, ANNEX B, For the text of the Model BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/2820/download >
[30] Kriebaum (n 5) 722.

and any detail examination or comparison between them will not be made, as the proportionality test has been accepted as achieving the most balanced assessment by considering both the purpose and effect of the measure.

a. Sole-effect Test:

The Sole-effect doctrine only considers the effect of the measure upon the investment. If the interference of the measure on an investor's rights is grave enough, and the duration of the effect is not ephemeral, the existence of indirect expropriation is accepted. [31] According to advocates of the sole-effect doctrine, the qualitative distinction between regulatory interferences and expropriatory measures is made by considering the effect of the measure on the investor's benefits.[32] The *Metalclad v Mexico*[33] case is one of the best examples for the interpretation of the sole-effect test where tribunal applied[34] the test on Article 1110 (expropriation article) of NAFTA.[35] In order to decide whether indirect expropriation had occurred, the tribunal considered the deprivation of the investor's benefits as amounted by the measure. [36]

b. Police powers approach:

In international law, it has been accepted that states will not be liable to pay compensation because of the exercise of police powers in a non-discriminatory manner and with a "public purpose" aim. [37] This doctrine has also been adopted in international investment law, and is

[31]Leonhardsen (n 8) 122.
[32] Fortier (n 7) 94.
[33] Metalclad Corporation v The United Mexican States, ICSID Case No. ARB(AF)/97/1, Award, 30 AUG 2000, ***("Metalclad v Mexico")***
[34] Fortier (n 7) 97.
[35] NAFTA, see (n 24).
[36] *Metalclad* (n 33) para 103.
[37] Fortier (n 7) 84.

reflected in law instruments such as treaties and the practices of tribunals. [38] In international investment law, the radical police power doctrine considers the "public purpose" of the measure while deciding on indirect expropriation. [39] Thus, when a measure is taken to achieve a legitimate purpose in the "public interest", this will not amount to expropriation. In other words, a state will not be required to pay any compensation even when a deprivation of an investor's benefits occurs, because the criteria being assessed is the *purpose* of the measure, not the *effect*. The *Saluka*[40] case can be seen as a radical interpretation of the police powers doctrine.[41] The tribunal found that the non-discriminatory measure taken within due process and in the public interest would not amount to expropriation and therefore there would be no compensation.[42] Therefore, it can be concluded that the police powers doctrine prioritizes states' right to regulate and primarily consider the purpose of the measure.

c. Proportionality approach:

The proportionality approach is a concept that comes from German administrative and constitutional law. [43] This test has been used to resolve conflicts of interests between citizens and states. [44] The proportionality test consists of a three-step analysis; suitability, necessity and proportionality *stricto sensu* which need to be applied cumulatively.[45] The suitability step states that *"whether the measure is suitable for the legitimate purpose."* [46] The next step necessity requires that; *"there must exist no alternative measure that is both less restrictive*

[38] Peter D. Isakoff, 'Defining the Scope of Indirect Expropriation for International Investments' (2013) 3(2) Global Bus. L. Rev. 193.
[39] Kriebaum (n 5) 726.
[40] Saluka Investments BV v Czech Republic, UNCITRAL, Partial Award, 17 MAR 2006, ***("Saluka v Czech republic")***
[41] Kriebaum (n 5) 726.
[42] *Saluka* (n 40) para 262.
[43] Kingsbury and Schill (n 9) 80.
[44] Ibid.
[45] Ranjan (n 16) 856.
[46] Ibid.

than the measure being reviewed and equally effective in achieving the objective pursued." [47] Finally, the proportionality *stricto sensu* step is used to weigh public and private interests and find a balance by considering the purpose and the effect of the measure.[48] Thus, as seen from the structure of the test, it aims to assess both the purpose and effect of the measure, which is the best way to find a balance between the interests of the host state and the investor. Caroline Henckels also claims that the proportionality approach finds a balance by evaluating the relationship between the purpose of the measure and the effect of it on the investor.[49] Erlend Leonhardsen states that, a 'moderate police powers' approach which aims to be 'proportional' finds a middle way by combining the other two approaches and considering the purpose of the measure while also regarding the effect of it upon the investor.[50] This is why it is defined as an approach that finds the middle way between the sole-effect and radical police powers doctrine.

To conclude, the lack of explicit definitions in BITs about indirect expropriation has led tribunals to use different approaches, such as the sole-effect doctrine, police powers doctrine and the proportionality test to decide on a claim. Although comparing the tests is not the aim of this dissertation. A brief overview has been given to show how the proportionality test achieves the balance by combining the sole-effect and police powers doctrine. Thus, it can be stated that the proportionality test is the best approach as it is capable of achieving the balance between states' right to regulate and foreign investor protection in indirect expropriation claims. To clarify how the proportionality test achieves this balance, the next chapter will explain what foreign investor protection and states' right to regulate in

[47] Leonhardsen (n 8) 112.
[48] Ranjan (n 16) 856.
[49] Henckels, 'Indirect Expropriation and The Right To Regulate' (n 6) 225.
[50] Leonhardsen (n 8) 122.

international investment law are, why a balance between them is crucial, and how the balance should be obtained.

CHAPTER TWO: STRIKING THE BALANCE BETWEEN STATES RIGHT TO REGULATE AND FOREIGN INVESTMENT PROTECTION

In this chapter, foreign investment protection and states' right to regulate will be examined by defining them and highlighting how they are referred to in international investment law. Furthermore, the balance between them will be discussed by looking at what ought to be balanced, why it is necessary, and how it should be achieved. After setting out the essentials of the proper assessment to be followed by tribunals, the chapter will end by indicating that the balance can be achieved by applying the proportionality test in indirect expropriation claims due to its features and the assessment it provides.

I. Foreign Investment Protection:

International investment law provides protection for foreign investment in the host states with BITs. These treaties protect foreign investors from host state actions and put obligations on states to act in particular ways. The provisions for protection are found in main principles such as; Fair and Equitable Treatment (FET), National Treatment and the Most Favoured Nation (MFN) principle, and compensation in an event of expropriation. For instance, the principle of "National Treatment and Most Favoured Nation" in the Germany- Jordan BIT (2007) [51] requires a state to not treat a foreign investor less favourably than its own investors or other investors of other nationalities. Moreover, an example of protection for indirect expropriation can be found in the Slovakia-Turkey BIT (2009) [52] which establishes that a state cannot expropriate or enable an act which leads to indirect expropriation of an investor's rights or investments except for a public purpose, and, if that occurs, it must be compensated.

[51] Germany- Jordan BIT (2007), Article 3, For the text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/1347/download>

[52] Slovakia-Turkey BIT (2009), Article 4, For the text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/2266/download >

One of the important characteristics of foreign investor protection is the fact that investment treaties give foreign investors a right to bring a claim through international arbitration platforms. It means that if the investor believes that the state has breached one of its obligations, it can pursue its rights through investment tribunals and claim compensation from the state in relation to the deprivation of the investment. Moreover, the opportunity to bring a claim against a state through arbitration rather than in the host state's national courts, shows an obvious example of how international investment law is built on foreign investment protection. Prabhash Ranjan also highlights that challenging host states is an outcome of the purpose of BITs, which aims to hold states responsible for exercising their regulatory power on foreign investment.[53]

In sum, international investment law provides protection for foreign investors against a host state's acts. These agreements also strengthen protection by providing an arbitration process rather than referring to national courts. Consequently, the host state can be held liable on international platforms and be required to pay compensation to the investor due to a breach of its obligations.

II. Right to Regulate:

States have a basic right to regulate and can take measures in the public interest within their territory due to their sovereignty. The acts of a government are considered broadly, and may be defined as comprising of any act of legislature, public administration or even the decisions of courts that demonstrate the police power of the state. [54] Furthermore, states also use their

[53] Ranjan (n 16) 858.
[54] Vera Korzun, 'Right to Regulate, Margin of Appreciation and Proportionality: Current Status in Investment Arbitration in Light of Philip Morris v. Uruguay' (2016) 8 S.J.D. Dissertations 373.

regulatory power when entering into international treaties such as BITs, and enforcing its rules in their own territory.

This section will examine how a state's right to regulate is mentioned in IIAs, which generally set out this right under the 'General Exceptions' section of the agreements. Furthermore, it will be argued that BITs do not provide explicit reference to the 'right to regulate' which should be mentioned in order to clarify the intentions of the parties. In the conclusion, it will be suggested that an explicit reference to the 'right to regulate' will decrease the possibility of the misinterpretation of BITS and prevent a tribunal's interference with state sovereignty.

a. How is it referred in IIAs?

In international investment law, the 'right to regulate' is also meant to power to regulate or refer to states' police powers doctrine.[55] In international investment treaties, the right to regulate is addressed in different ways. Firstly, it is commonly set out as a general exception to investment protection which allows a state to adopt measure in some circumstances. [56] Aikaterini Titi argues that a state's regulatory power is referred as an exception in investment treaties by precluding some acts from being liable for compensation. [57] For instance, Article XX of GATT[58] provides wide exceptions to states' measures and generally many IIAs have followed the same way as mentioning state's right to regulate as an exception to the investment protection.[59] For instance, Canada-Peru BIT (2006)[60] referred states' right to

[55] Giovanni Zarra, 'Right to Regulate, Margin of Appreciation and Proportionality: Current Status in Investment Arbitration in Light of Philip Morris v. Uruguay' (2017) 14(2) Brazilian Journal of International Law 97.
[56] IISD, A Sustainability Toolkit for Trade Negotiators, < https://www.iisd.org/toolkits/sustainability-toolkit-for-trade-negotiators/5-investment-provisions/5-4-safeguarding-policy-space/5-4-1-right-to-regulate/ > Accessed : 27.06.2019.
[57] Aikaterini Titi, 'The Right to Regulate in International Investment Law' Nomos Verlagsgesellschaft (2014) 33.
[58] Article XX of GATT, For the full text see <https://www.wto.org/english/res_e/booksp_e/gatt_ai_e/art20_e.pdf >
[59] IISD (n 56).
[60] Canada-Peru BIT (2006) Article 10, For the text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/626/download .>

regulate under the title of the 'General Exceptions'. On the other hand, the general exceptions may not cover all provisions when it needs to be specific on which investments will be covered or omitted from the exception. [61] This is why, as many investment law scholars suggest, treaties need to mention the right to regulate more specifically, rather than regulating through the 'general exceptions' of BITs. [62] Moreover, another approach followed by states is mentioning the right to regulate as a pre-existing right without marking it as an exception to investor protection, and thus failing to limit its scope through other clauses in the agreement.[63] An example of this can be found in SADC (South African Development Community) Model BIT (2012) [64] which explicitly refers to 'right to regulate' and reaffirms that a state has a right to regulate in the public interest, which is not altered by the treaty.[65]

b. Considering the right to regulate in indirect expropriation claims:

As mentioned, the system of international investment law is built on the foreign investor protection which is a way of controlling states' right to regulate by holding them liable through their regulatory acts. Foreign investors bring the claim of indirect expropriation against states by demanding compensation for their loss. This raises the importance of how the right to regulate should be considered by tribunals. In indirect expropriation claims, the essential issue for investment tribunals to decide is whether the measure taken by the state has affected the foreign investor to the point of expropriation or not. Furthermore, tribunals are bound to consider BITs and apply the intention of the parties in disputes. However, many BITs do not provide clear provisions about what indirect expropriation is, and in which circumstances a

[61] IISD (n 56).
[62] Korzun (n 54) 374.
[63] IISD (n 56).
[64] SADC Model BIT, Article 10, For the text of the Model BIT see < https://www.iisd.org/itn/wp-content/uploads/2012/10/sadc-model-bit-template-final.pdf >
[65] IISD (n 56).

state will not be held liable for its regulatory acts. Moreover, Vera Korzun highlights the same problem by arguing that very few international legal instruments mention that a state has a right to regulate, and provide little to no guidance to tribunals in deciding whether the measure is subject to compensation or not.[66]

c. Necessity to mention "right to regulate" explicitly:

There has been an increasing concern for tribunals' potential interference on the state's sovereignty[67] as a tribunal's decision can oblige states to pay high amounts of compensation to foreign investors as a result of exercising their regulatory power. Thus, states have started adopting more explicit provisions in BITs which establish circumstances that will not amount to expropriation in order to prevent interference with their sovereignty. For instance, the Canada and US Model BITS established provisions that give superiority to a state's right to regulate in indirect expropriation claims, and it can considered a reflection of their concern over tribunals' interference into their sovereignty.[68] Moreover, some BITs have started to refer to the 'right to regulate' explicitly in order to prevent tribunals disregarding state sovereignty. For instance, Article 23 of Morocco-Nigeria BIT (2016) contains a section which is named 'Right To Regulate' and it states; "*the Host State has the right to take regulatory or other measures to ensure that development in its territory is consistent with the goals and principles of sustainable development, and with other legitimate social and economic policy objectives"*[69]*.* Thus, the provision explicitly mentions states' right to regulate by highlighting the necessity of it for a country's development. Furthermore, having clear and specific provisions about the right to regulate will reduce the discretion of arbitral tribunals in

[66] Korzun (n 54) 374.
[67] Olynyk (n 21) 269.
[68] Ibid.
[69] Morocco-Nigeria BIT (2016), Article 23,For the full text of the BIT see https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5409/download .

assessing measures, and strengthen the intentions of parties. [70] In addition, it will decrease the possibility of misinterpretation by tribunals, reducing the chance of wrongfully holding a state liable when the measure has not amounted to expropriation.

To sum up, in international investment law, many BITs do not mention the 'right to regulate' explicitly and provide provisions that establish situations that preclude states from liability in indirect expropriation claims. Consequently, a lack of clear reference to the 'right to regulate' has increased the intervention of tribunals when considering states' regulatory acts, and this has also created concern about a tribunal's interference with state sovereignty. Many states have thus started to renew their BITs with reference to the right to regulate more clearly, setting out the circumstances to be precluded from expropriation. Thus, prioritizing the intention of parties in BITs will help to achieve a balance between the parties. Therefore, the next section will address why the balance is essential and how this can be achieved.

III. Balance between States Right To Regulate and Foreign Investment Protection:

This section will discuss what the balance should be in indirect expropriation claims, and why and how it should be achieved. This balance is necessary because the international investment law system has already built on the protection of foreign investment and many tribunals have disregarded public interest concerns by following an investor-friendly approach. To find a balance, it will be argued that the public and private interests need to be assessed equally when approaching a states' right to regulate in deference and also considering the effect of the measure on investors. It will be concluded that the proportionality test should be used in the assessment of the measure as it consists of all the necessary features to achieve a balance

[70] Korzun (n 54) 375.

between the right to regulate and foreign investment protection in indirect expropriation claims.

a. What do we balance?

It is important to achieve a balance between states' right to regulate and foreign investment protection in indirect expropriation claims through weighing public private interests. States have to fulfil the needs of society by providing health, education or protection of the environment by taking measures which are accepted as acting in the public interest. Regarding the right to regulate, states may be precluded from paying compensation even when these measures cause loss on the investor. However, even if the measure is taken for the public interest, it may still be possible for a state to be held liable to pay compensation. Therefore, it is important to decide to what extent the measures taken in the public interest can preclude states from liability even when they deprive an investor of their interests.

b. Why do we balance?

Many tribunals have interpreted BITs in favour of investors and failed to consider the right to regulate sufficiently, even when public interest protection was crucial. This is why, in order to achieve a balance between public and private interests in indirect expropriation claims; tribunals should not interpret BITS only in favour of the investors. They also need to consider states' right to regulate in deference.

i. Tribunals' investor friendly approach:

It is claimed that most investment tribunals follow an investor friendly approach by prioritizing the interests of the investor as a result of the foreign investment protection provided by BITs. Following this approach, many tribunals have decided in favour of investors by relying upon the protection provided for the investors by BITS. For instance, the tribunal in *SGS v.*

Philippines stated that *"[t]he BIT is a treaty for the promotion and reciprocal protection of investments … It is legitimate to resolve uncertainties in its interpretation so as to favour the protection of covered investments.*" [71] Thus, the tribunal followed an investor friendly approach by interpreting the BIT in favour of the investor. Moreover, Gus Van Harten argues that one of the reasons behind this protective approach towards investors' rights is because the investment treaties use broad language to define main concepts, leading tribunals to apply the overall presumption, which is investor protection. [72]

The approach to protect investors' interests prevailed even in cases that where public interests should have been privileged. *Santa Elena v Costa Rica*[73], although about direct expropriation,[74] had one of the strictest approaches to the public interest. In this case, Costa Rica declared an area as a preservation site due to the environmental concerns about Santa Elena Company's plans to build a tourist resort. The tribunal stated that:

> Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains.[75]

As it can be seen, the tribunal decided that the matter of public interest does not affect the expropriatory feature of the act. In other words; if expropriation occurred, the compensation must be paid anyway. Moreover, a more recent case about environmental issues is that of

[71] *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines,* ICSID Case No. ARB/02/6, Decision of the Tribunal on Objections to Jurisdiction, 29 JAN 2004, ***("SGS v Philippines")*** para 116.
[72] Gus Van Harten*, Investment Treaty Arbitration and Public Law* (Oxford University Press 2008) 139.
[73] Compañía Del Desarrollo De Santa Elena, S.A. And The Republic Of Costa Rica, ICSID Case No. ARB/96/1, Final Award, 17 FEB 2000, ***("Santa Elena v Costa Rica"***)
[74] Titi (n 57) 285.
[75] *Santa Elena* (n 73) para 72.

Abengoa v Mexico[76] where an investment was planned in a UNESCO World Heritage site, home to indigenous communities. The government of Mexico prevented the company from operating a waste management facility on the grounds of environmental concerns and opposition of the local community.[77] However, the court found the existence of indirect expropriation by disregarding the public interest concern and ordered Mexico to pay more than $40 million plus interest to the investor, Abengoa.[78] Another example of the strict approach to state's right to regulate and prioritizing the investors' rights can be seen in *CMS v Argentina*[79] where Argentina faced an economic crisis, affecting the public deeply through high poverty and unemployment rates, and a rise in unpayable government debts.[80]Although the situation in Argentina was an emergency, the tribunal stated that it was not severe and grave enough to preclude liability and for the necessity defence to apply.[81] Therefore, some tribunals interpreted BITS in favour of investors and eliminated the states' right to regulate even there was an explicit need to protect the public interest. This unbalanced approach must be replaced by interpreting BITS through considering the public interest and states' rights to regulate.

ii. The importance of approaching states' right to regulate in deference:

International investment law protects foreign investors through its treaties and many tribunals have interpreted BITs in favour of investors without considering the public interest

[76] Abengoa S.A y COFIDES S.A v United Mexican States, ICSID Case No. ARB(AF)/09/2, Award, 18 APR 2013, ***("Abengoa v Mexico")***

[77] Investor-State Attacks, <https://www.isdscorporateattacks.org/environment > Accessed: 25.06.2019.

[78] Ibid.

[79] CMS Gas Transmission Co v Republic of Argentina, ICSID Case No.ARB 01/8, Award,12 MAY 2005, ***("CMS v Argentina").***

[80] José E. Alvarez And Kathryn Khamsi, 'The Argentine Crisis And Foreign Investors: A Glimpse Into The Heart Of The Investment Regime',(IILJ Working Paper 2008/5*), Institute for International Law and Justice New York University School of Law* 10.

[81] *CMS* (n 79) para 355.

criteria sufficiently. Thus, in order to find the balance between public and private interests, tribunals need to approach state's right to regulate in deference. Gus Van Harten states that taking a deferential approach is necessary because the treaties already protect investors by enabling them to claim damages against the state which requires them to consider government's liability, not vice versa.[82] Moreover, taking a deferential approach means considering measures taken by governments respecting the sovereignty and a state's duty to act in its own interest. According to Brigitte Stern[83], the *El Paso v. Argentina* tribunal provides a good example to be followed by other tribunals in terms of its understanding of the balance between respecting states' sovereignty and protecting foreign investment.[84]

Moreover, Caroline Henckels also refers to certain cases to highlight the deferential approach.[85] In *Thunderbird* [86]and *Apotex*[87] tribunals considered the circumstances and the measures taken by the government in deference. [88] The *Thunderbird* tribunal stated that tribunals need to approach these measures with a high degree of deference to the regulation taken in order to prevent illegal actions, such as gambling, which was the issue in the instant case. [89] Moreover, the *Apotex* tribunal mentioned the importance of approaching states' right to regulate in deference by stating that tribunals need to be careful while considering states' regulatory actions in sensitive areas such as the protection of public health.[90] Furthermore, in

[82] Harten (n 72) 135.
[83]Brigitte Stern, 'The Future of International Investment Law: A Balance Between the Protection of Investors and the States' Capacity to Regulate' in Jose E.Alvarez and Karl P Sauvant(eds), *The Evolving International Regime: Expectations, Realities, Opinions* (Oxford University Press 2011) 192.
[84] El Paso Energy International Company v. The Argentine Republic, ICSID Case No. ARB/03/15, 27 APR 2016, para. 70 ***("El Paso v Argentina").***
[85] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 131.
[86] International Thunderbird Gaming Corporation v The United Mexican States, UNCITRAL, Award, 26 JAN 2006, ***("Thunderbird v Mexico").***
[87] Apotex Holdings Inc. And Apotex Inc. v United States of America, ICSID Case No. ARB (AF)/12/1, Award, 25 AUG 2014, ***("Apotex v US").***
[88] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 131.
[89] *Thunderbird* (n 86) para 127.
[90] *Apotex* (n 87) paras. 9.37–9.38.

some recent cases, states' actions responding to public concerns over investments were considered legitimate and normal procedure.[91] For instance, in both *Parkerings*[92] and *Electrabel*[93], the tribunals stated that considering public opposition to the investment and responding to it by taking measures is legitimate. [94]

Many scholars have suggested that tribunals should follow the deferential approach in terms of finding a solution and balancing public and private interests in indirect expropriation claims. However, there are different approaches by different scholars as to how investment tribunals should consider the state's right to regulate in deference and what the limits of this should be. For instance, Caroline Henckels states that tribunals may examine the legitimacy of a measure's objective with a deferential approach while considering regulatory and proximity issues, also using the proportionality analysis to decide whether the act of the state is discriminatory.[95] On the other hand, some scholars argue that deference should only be considered when the treaty directly refers to states' regulatory power, for example, within the provisions that set out the exceptions for expropriation or the situations to be accepted as in the public interest.[96] However, Caroline Henckels criticizes this approach by stating that it is too strict to apply deference only where the relevant treaty refers to preserving regulatory autonomy, as it leads tribunals to avoid the deferential approach since most treaties do not mention or detail a state's regulatory power.[97]

[91] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 133.
[92] Parkerings-Compagniet AS v. Republic of Lithuania ICSID Case No.ARB/05/8, Award, 11 SEP 2007("***Parkerings v Lithuania").***
[93] Electrabel S.A. v. Republic of Hungary ICSID Case No.ARB/07/19,Award, 25 NOV 2015 ***("Electrabel v Hungary").***
[94] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 133.
[95] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 171.
[96] Ibid 188.
[97] Ibid 189.

In sum, in order to prevent unbalanced decisions as a result of a tribunal's investor friendly approach, a state's right to regulate should be considered in deference by tribunals. This will achieve the balance between public and private interests in indirect expropriation claims.

iii. Necessity To Consider Limits To The Deferential Approach:

Tribunals should use the deferential approach when examining whether a measure works in the public interest or not. However, some limits to deferential approach need to be considered in order to prevent the disregard of an investor's interests and create a balanced assessment. Thus, while tribunals approach states' right to regulate in deference, they should consider different criteria to assess the measure. For instance, tribunals might consider whether the measure is taken in line with due process. This was considered by the *Methanex* tribunal:

> As a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, inter alias, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.[98]

As demonstrated, the tribunal was not satisfied with assessing the public interest only, it required the measure to be non-discriminatory and be within due-process limits in order to accept it as non-compensable and non-expropriatory.

iv. Legitimate expectations as a limit to deference:

The balance thus lies in looking at states' right to regulate in deference and assessing it with certain criteria to protect the investors' rights. William Burke-White and Andreas von Staden also suggest that the preferable way is the deferential approach while bearing investors rights

[98] Methanex Corporation v The United States of America, UNCITRAL, Final Award, 3 AUG 2005, para 7 ***("Methanex v US")***.

in mind.[99] Thus, in order to find a balance in the assessment of the measure, considering the legitimate expectations of the investor can be a very useful tool alongside the deferential approach. Legitimate expectations are derived from the representations that are made by the host state at the time of investment. [100] They can be considered through asking questions such as; 'to what extent can the negative effect of the measure on legitimate expectations be acceptable?' or 'does the effect of the measure on legitimate expectations precede the public interest or not?'

Many tribunals have considered the effect of a state's actions on an investor's legitimate expectations to decide whether an investor's benefits have suffered or not. For instance, the tribunal in *BG v Argentina* considered legitimate expectations according to the time when the foreign investor decided to invest, stating that *"The duties of the host state must be examined in the light of the legal and business framework as represented to the investor at the time that it decides to invest."* [101] Moreover, legitimate expectations should also be considered within certain limits, as investors should be aware that states may take measures at any time, as a standard business risk. For instance, the *EDF v Romania*[102] case is a good example of the proper interpretation of legitimate expectations. [103] The tribunal stated that *"investors may not rely on a bilateral investment treaty as kind of insurance policy against the risk of any*

[99] William Burke-White and Andreas von Staden , 'The Need For Public Law Standards Of Review In Investor-State Arbitrations' in Stephan W.Schill (ed), International Investment Law and Comparative Public Law (Oxford University Press 2010) 715.
[100] Christoph Schreuer and Ursula Kriebaum, 'At what time must legitimate expectations exist?' (2012) TDM 1. < https://www.univie.ac.at/intlaw/pdf/97_atwhattime.pdf >
[101] BG Group Plc v The Republic of Argentina, UNCITRAL, Final award, 24 DEC 2007, para 298 ***("BG v Argentina").***
[102] EDF (Services) Limited v Romania, ICSID case No. ARB/05/13, Award, 8 OCT 2009 ***("EDF v Romania").***
[103]Anna Kuprieieva, 'Regulatory Freedom And Indirect Expropriation: Seeking Compatibility With Sustainable Development In New Generation Bilateral Investment Treaties' (Master, Thesis University of Ottowa 2015) 18 <https://ruor.uottawa.ca/bitstream/10393/32447/1/Kuprieieva_Anna_2015_thesis.pdf > Accessed: 24.06.2019.

changes in the host State's legal and economic framework",[104] and it also argued that *"[s]uch expectations would be neither legitimate nor reasonable."*[105] Thus, legitimate expectations need to be interpreted with regard to the regulatory changes where states need to take measures to fulfil public needs, as these are part of business risk-taking.

c. Balance comes with applying the proportionality test:

The balance between states' right to regulate and foreign investment protection in indirect expropriation claims can be achieved by assessing the purpose of the measure in deference and considering the effect of the measure, such as the effects on the legitimate expectations of the investors. Moreover, a balanced assessment should consider both the purpose and effect of the measure, which is provided by the proportionality test. The proportionality test approaches states' right to regulate in deference by accepting that states might take expropriatory measures in the public interest. However, the measure has to comply with certain principles such as the expectation that the measure is reasonable, suitable and proportionate for its purpose. Thus, this indicates that the proportionality test generates criteria that limits the deferential approach in order to obtain a balanced assessment of the measure. Moreover, this assessment is achieved through the three steps; suitability, necessity and proportionality *stricto sensu*.

As Praphash Ranjan explains, a tribunal will first examine the purpose of the measure by looking at whether the measure is suitable for a legitimate public purpose. [106] In the second step, if the measure is in the public interest, the necessity of it will be examined by assessing whether less restrictive alternative measures could be taken to satisfy the same interest. If

[104] *EDF* (n 102) para. 217.
[105] Ibid.
[106] Ranjan (n 16) 856.

the measure complies with the necessity step, at the third stage; the tribunal will look at the effect of the measure on the investor's rights and weigh public and private interests by using the proportionality analysis in order to achieve a balance. At this point, Andrew Newcombe[107] suggests that the assessment must consider the proportionality between the *purpose* of the measure that caused harm and the *effects* of it in relation to the legitimate expectations of the investor. Thus, the proportionality test assesses the purpose of the measure in deference and considers the effect of the measure on investors, weighing public and private interests at the end. Consequently, this assessment achieves the balance between states' right to regulate and foreign investment protection.

To conclude, foreign investment protection and states' right to regulate are the main components of indirect expropriation claims that need to be balanced. Achieving this balance is crucial, as many tribunals have interpreted BITS in favour of investors without giving sufficient importance to public interest concerns. Therefore, tribunals need to approach states' right to regulate in deference and also consider investors' rights, weighing public and private interests. Thus, a balance arises by assessing the both the purpose and effect of the measure through the proportionality test. As some tribunals have already applied the test in indirect expropriation claims, a detailed examination of the interpretation of the test and outcomes will be examined in the next chapter.

[107] Newcombe and Paradell (n 4) 363.

CHAPTER THREE: APPLICATION OF PROPORTIONALITY TEST IN INDIRECT EXPROPRIATION CLAIMS

The proportionality analysis has been applied in both municipal and international jurisdictions to review states' measures when it causes investors to suffer a loss. The proportionality test provides guidance which involves considering whether the measure that interferes with investors' rights has amounted to expropriation or not. In international investment law, the first application of the proportionality test was observed at *Tecmed v Mexico* case where the tribunal adopted the test from the ECtHR jurisprudence in order to achieve a balance between states' right to regulate and foreign investment protection in an indirect expropriation claim. Moreover, the case of *Continental Casualty v Argentina* is also very important as it relied on WTO case law and applied provisions of the GATT while examining the measure under the "necessity" concept. Thus, these cases will be examined, assessing their application of the proportionality test and the deferential approach as well as their shortcomings. Before looking at these cases, the interpretation of the proportionality test in jurisprudence of ECtHR and WTO will be discussed in order to understand why investment tribunals rely on different jurisdictions to assess an indirect expropriation claim. Finally, after examining the interpretation of the proportionality test by the *Tecmed* and *Continental* tribunals, the general problems and advantages about the application of the test in investment disputes will be addressed.

I. The Proportionality test in the WTO:

In WTO law, the Article XX of GATT[108] sets out the general exceptions to the treaty, and the situations where a government's measure will not lead to liability. The proportionality test plays an important role in the interpretation of Article XX by balancing issues related to the objectives of trade, such as trade liberalization or providing non-discrimination in any context.[109] Benedict Kingsbury and Stephen Schill claim that there have been several cases that used the proportionality analysis to balance trade and non-trade interests.[110] For instance, *Korea Beef* can be given as a good example, evaluating the "necessity" of the measure under Article XX of GATT to protect public health.[111] Furthermore, the article explicitly requires the measure to be *necessary* in order to be accepted as non-expropriatory and preclude a state from liability.[112]

In order to assess the measure through the necessary concept, the WTO appellate body has used a two-tier test, which consists of both its proportionality and the availability of a less restrictive alternative measure. [113] It creates a balance by weighing the regulatory value and effect of the measure on international trade and then comparing the measure with any other reasonably available measure that is less restrictive.[114] Praphash Ranjan states that it is debatable whether the "necessary" requirement in Article XX really refers to the application of the proportionality test, but it can be argued that the word '*necessary'* forms the basis for a proportionality analysis.[115]

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[108] Article XX of GATT, see (n 58).
[109] Kingsbury and Schill (n 9) 84.
[110] Ibid.
[111]Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef WT/DS161/AB/R, Report of the Appellate Body, 11 DEC 2000, para 164.
[112] Article XX of GATT, see (n 58).
[113] Ranjan (n 16) 876.
[114] Ibid.
[115] Ibid.

To sum up, there is no explicit reference to the proportionality test in the WTO jurisprudence, however it has been applied by the Dispute Settlement Body of the WTO in many cases to find a balance between non-trade and trade values. The Article XX of GATT establishes the "necessary" requirement for measures taken, which can be interpreted as considering whether there had been a less restrictive measure that was reasonably available for that particular time. The proportionality test also provides the same type of assessment as the "necessity" step, and this is why it is accepted that WTO also applies the proportionality test while assessing state liability under Article XX of GATT.

II. The Proportionality test in the ECtHR:

The proportionality test has been used in the jurisprudence of ECtHR to resolve conflicts arising between member states' actions and the rights of individuals as granted under European Convention on Human Rights (ECHR). [116] Arguably, the ECtHR provides useful guidance for the application of the proportionality analysis while considering the deferential approach appropriately in the context of property rights. [117] In order to decide on expropriation claims, the court has applied the proportionality test to interpret Article 1 of the Protocol No.1 in ECHR which establishes the protection of property rights. The article states:

> 1. Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.
>
> 2. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with

[116] Kingsbury and Schill (n 9) 84.
[117] Henckels, 'Indirect Expropriation And The Right To Regulate' (n 6) 242.

> the general interest or to secure the payment of taxes or other contributions or penalties.[118]

The article does not prevent a state from expropriating or using the individuals' property for public interest, but it ensures that any particular interference is non-arbitrary and within due process. [119] As the article requires the measure to be taken in the public interest to preclude a state from liability, the court also added the requirement of proportionality in examining the measure and the aim pursued.[120] Caroline Henckels states that the ECtHR has developed a "sophisticated jurisprudence" by using a deferential approach in assessing whether the measures taken in the public interest have affected property rights disproportionately.[121] Furthermore, ECtHR jurisdiction has considered the proportionality analysis in terms of finding a balance between the public interests and individuals' rights. For instance, 'fair balance' is discussed in the *Sporrong and Ldnnroth* case, where the court states that it is; "*between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights*."[122] Furthermore, in the *James* case, the court also highlighted the proportionality by; "*a measure must be both appropriate for achieving its aim and not disproportionate thereto."*[123] This statement was cited in *Tecmed,*[124] in which the proportionality test was applied for the first time, relying upon ECtHR case law.

To conclude, the jurisprudence of the ECtHR used the proportionality test to balance the conflicting interests of the states and individuals in disputes over the expropriation of

[118] ECHR Protocol No.1, Article 1, For the Full text see <https://www.echr.coe.int/Documents/Guide_Art_1_Protocol_1_ENG.pdf >
[119] Helene Ruiz Fabri, 'The Approach Taken by the European Court of Human Rights to the Assessment of Compensation for Regulatory Expropriations of the Property of Foreign Investors' (2002) 11(1) N.Y.U. ENVTL L.J. 151.
[120] Fabri (n 119) 157.
[121] Henckels, 'Indirect Expropriation And The Right To Regulate' (n 6) 242.
[122] Sporrong & Lonnroth v. Sweden, no. 7151/75 /7152/75 , 69 ECtHR, 1982 Series A No.52.
[123] James v. United Kingdom, no. 8793/79 50 ECtHR, 1986 Series A No.98.
[124] *Tecmed* (n 11) para 122.

individuals' property rights by governments. ECtHR Jurisprudence follows a deferential approach in assessing the public interest, but considers if the measure is proportionate and appropriate to achieve the pursued aim. Consequently, the application of the proportionality analysis in ECtHR jurisprudence could be an example to be followed by investment tribunals in terms of finding a balance between the right to regulate and investment protection.

III. Tecmed v Mexico:

The proportionality test has been applied in both international and municipal jurisdictions to determine the relationship between states and individuals in the case of a conflict regarding the measures adopted by governments and its subsequent effects. In investment disputes, the proportionality test was used for the first time in *Tecmed v Mexico* in 2003. [125] In the case, the company *Tecmed* acquired hazardous waste landfill in Mexico through its Spanish subsidiary, *Cytrar* in 1996 and authorization to operate the landfill was issued for one year.[126] When the government refused to extend permission, *Tecmed* claimed a breach of Spanish-Mexico BIT and asked for compensation by relying on indirect expropriation.[127] The tribunal used the proportionality test in order to decide whether the government's measure had led to expropriation or not. As a result, it decided in favour of the foreign investor by accepting the existence of indirect expropriation.

The tribunal adopted the proportionality test from ECtHR jurisprudence[128] and applied it by considering both the purpose and effect of the measure.[129] Moreover, the *Tecmed* case reflects the first interpretation of the proportionality test in investment disputes and can be

[125] Xiuli (n 12) 641.
[126] Ibid.
[127] Ibid.
[128] Newcombe and Paradell (n 4) 365.
[129] Kribeaum (n 5) 727.

considered successful in terms of finding a balance. As Han Xiuli highlights, some scholars think that this application of proportionality test in *Tecmed* could be a judicial precedent for international investment arbitration as it introduces the proportionality test in deciding whether indirect expropriation occurred or not .[130] Moreover, he states that *Tecmed* can be considered a leading case for indirect expropriation disputes as it was a significant development in ICSID[131] jurisprudence.[132]

a. Application of the proportionality test; combining the purpose and effect of the measure:

As mentioned, the *Tecmed* tribunal assessed both the purpose and effect of the measure by applying the proportionality test. Firstly, the tribunal started its analysis by considering the effect of the measure on the investor and found that ; *'[a]s far as the effects of such Resolution are concerned, the decision can be treated as an expropriation under Article 5(1) of the Spain-Mexico BIT".*[133] However, it stated that it would not only examine the effects of the measure, but also go on to analyse expropriation claim using the proportionality test.[134] The tribunal highlighted it would assess whether the actions or measures taken by the government were proportional to the public interest and consider the effect of the measure on foreign investment protection when deciding on the indirect expropriation claim.[135] Moreover, it continued to use the proportionality analysis when looking at the purpose and the effect of the measure, stating:

[130] Xiuli (n 12) 640.
[131] International Centre for Settlement of Investment Disputes, For further information see <https://icsid.worldbank.org/en/ >
[132] Ibid, 641.
[133] *Tecmed* (n 11) para 117.
[134] Fortier (n 7) 107.
[135] *Tecmed* (n 11) para 122.

> There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure. To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the state and whether such deprivation was compensated or not.[136]

As seen above, the tribunal highlighted the importance of determining the amount of investment deprivation in order to decide whether the measure is expropriatory or not. Moreover, the tribunal quoted a paragraph from ECtHR case; *James v United Kingdom* [137] in order to highlight that a measure must be appropriate to the aim that was to be achieved.[138] As a result, relying on the jurisprudence of ECtHR, the *Tecmed* tribunal considered both public and private interests by weighing them against each other, after looking at the 'proportionality' between the purpose and effect of the measure.

b. Approach in Deference:

The *Tecmed* tribunal took the approach of states right to regulate in deference under Article 5(1) of the Spain-Mexico BIT (1995)[139] which sets out an 'expropriation' provision, but considers whether "*measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation".*[140] Thus, the tribunal highlighted the importance of a states' right to regulate but also chose to balance it by considering limitations such as the legitimate expectations of the investor. Therefore, it can be argued that the *Tecmed* tribunal established a balanced assessment between the

[136] Ibid.
[137] *James* (n 123) para 50.
[138] Henckels, 'Indirect Expropriation And The Right To Regulate' (n 6) 231.
[139] Spain-Mexico BIT (1995), Article 5(1) For the full text of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5618/download>
[140] *Tecmed* (n 11) para 122.

interests of the state and the investor by both examining the purpose of the measure in deference and limiting it by considering its effects on investments.

c. Criticisms of the application of the proportionality test:

The application of the proportionality test by the *Tecmed* tribunal is considered a significant development in ICSID jurisprudence.[141] However, it is argued that the tribunal interpreted the proportionality test by making methodological mistakes, skipping the suitability and necessity steps of the test.[142] Moreover, one of the features of the proportionality test is a clear three-step analysis which must be followed step-by-step. Caroline Henckels argues that the tribunal aimed to adopt a deferential approach while assessing the measures through the criteria of reasonableness and necessity, but it failed to apply strict proportionality (*proportionality stricto sensu* stage) without using the necessity and suitability steps. [143]

The suitability stage assesses whether the measure is suited to the aim pursued, and the necessity stage considers whether there had been any other less restrictive measure that was available and could achieve the same aim. On the other hand, the last stage of the assessment, the proportionality *stricto sensu,* examines the effect of the measure on the investor and also weighs the interest of the measure and interests of the investor against each other. Therefore, skipping the necessity and suitability stages and applying the proportionality *stricto sensu* stage directly would be methodologically very wrong in terms of trying to balance the purpose and the effect of a measure without actually assessing the purpose properly. Caroline Henckels also states that the suitability and necessity steps require an assessment of facts which are not open to value judgements, whereas the proportionality *stricto sensu* step

[141] Xiuli (n 12) 641.
[142] Ranjan (n 16) 865.
[143] Henckels,'Indirect Expropriation And The Right To Regulate' (n 6) 233.

does.[144] Thus, directly engaging with the proportionality *stricto sensu* step will lead tribunals to decide a case using a value judgement only, and without considering the facts. This is why it is argued that the steps need to be applied respectively and properly, as this structure aims to minimize the court's discretion.[145]

In sum, the *Tecmed* case is very important in international investment dispute resolution. Firstly, it is the first case that applies the proportionality test in indirect expropriation claims by adopting it from the jurisprudence of ECtHR, aiming to find the balance between states' right to regulate and investor protection. Secondly, it examines the government measure by assessing the purpose and the effect of it. Moreover, it approaches the right to regulate in deference and still considers the legitimate expectations of the investor, which led the *Tecmed* tribunal to have a balanced analysis. On the other hand, the tribunal is criticized due to its methodologically wrong application, as it skipped certain steps of the test. However, besides this misinterpretation of the test, the *Tecmed* case can be considered successful in terms of achieving a balanced assessment in indirect expropriation claims.

IV. Continental Casualty v Argentina:

The Continental Casualty v Argentina case is another important example in ICSID case law that applied the proportionality test in deciding whether indirect expropriation occurred or not. Furthermore, this case is distinct from other Argentina cases in the way it analysed the measure and referred to WTO case law*. Continental Casualty* was one of the companies that brought an indirect expropriation claim by stating that the measures taken by the Argentinian government led to a deprivation of their benefits.[146] The Argentinian government relied on

[144] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 107.
[145] Ibid.
[146] Claussen (n 18) 1547.

the "necessity defence" through Article XI of US-Argentina BIT[147] as argued in previous cases.[148] This particular article of the BIT indicates that the state will not be liable if the necessary measures was taken to maintain public order, which also includes protecting national security interests. At that point, the tribunal needed to assess whether the action taken was necessary by Argentinian government, and whether there were other available measures that could have interfered less with the investor's interests.[149] Furthermore, the *Continental* case is one of the rare cases that concluded in favour of Argentina by following a strong deferential approach and examining the "necessity" concept through GATT and WTO case law.

a. Approach in Deference:

The *Continental* tribunal showed a high degree of deference to states' right to regulate while assessing the measure. To start with, tribunal cited the *Jahn* [150]case from the jurisprudence of the ECtHR [151] in order to highlight that governments are the only body with the power and knowledge to meet the needs of society and this must be respected. Moreover, as an example of a deferential approach to state's right to regulate, after asking whether Argentina could have adopted different measures to prevent the crisis and a prevent loss of investment, it highlighted that "*the Tribunal is not called upon to make any political or economic judgment on Argentina's policies and of the Measures adopted to pursue them.*"[152] Furthermore, the tribunal mostly relied on the *Korea-Beef and Brazil-Tyres* cases of WTO while applying the

[147] US- Argentina BIT (1991) ,Article XI For the full test of the BIT see <https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/127/download>
[148] Claussen (n 18) 1545.
[149] Kingsbury and Schill (n 9) 99.
[150] Jahn and Others v Germany, no. 46720/99 72203/01 72552/01, ECtHR, 2005 Reports of Judgments and Decisions 2005-VI.
[151] *Continental* (n 13) 80 footnote 270.
[152] Ibid, para 199.

deferential approach.[153] Therefore, it highlighted the sovereignty of the state by indicating that tribunals do not have any discretion to scrutinise governments' decisions.

b. Application of the Proportionality test:

The *Continental* tribunal also applied the proportionality test in order to decide on the indirect expropriation claim. It is claimed that, the *Continental Casualty* tribunal adopted the proportionality analysis in a mature fashion.[154] Furthermore, Alec Stone Sweet and Giacinto Della Cananea argued that the tribunal applied the proportionality test in the 'ECtHR-style' by applying the necessity stage to determine how the government responded to the crisis.[155] Moreover, the tribunal's opinion about the application of the proportionality test was stated clearly: *"the concept of proportionality did not require that 'every sacrifice can properly be imposed on a country's people in order to...ensure full respect towards international obligations in the financial sphere*."[156] Thus, it could be argued that the tribunal's approach in applying the proportionality test was to consider states' right to regulate in deference. Moreover, the tribunal started the assessment with the suitability stage of the proportionality test by considering whether the measures "contributed materially" to achieving the legitimate aims or not.[157] As a result, the tribunal decided that the measure was suitable to achieve the aim and was effective in overcoming the crisis.[158] After completing the suitability step, the tribunal went on to examine the measure on the basis of "necessity", which was the main issue of the case.

[153] Alec Stone Sweet and Giacinto Della Cananea, 'Proportionality, General Principles of Law, and Investor-State Arbitration: A Response to Jose Alvarez '(2014) 46(3) N.Y.U. J. Int'l L. & Pol. 933.
[154] Burke-White and Staden (n 99) 716.
[155] Sweet and Cananea (n 153) 933.
[156] *Continental* (n 13) para 227
[157] Ibid, para 196.
[158] Ibid, para 197.

c. Examination of the "necessity" concept:

The important point with the *Continental* case is that, despite other cases about the Argentinian crisis and indirect expropriation claims, the *Continental* tribunal examined whether there were reasonable alternative measures that may have been available for the government to meet Argentina's policy aims and prevent the contradiction of its international obligations.[159] In order to decide this, the tribunal compared the measures taken by the government with a full range of possible alternatives, and it concluded that the adopted measures were necessary under Article XI of the BIT, stating that; *'such alternatives would not have been reasonably available or would have been impracticable or speculative as to their effects'.*[160] As a result of its analysis, the tribunal decided that Argentinian government, *'struck an appropriate balance' between its international obligations and responsibility to its society"*[161]*.* Consequently, the tribunal found the measures necessary and appropriate to the pursued aim after applying the suitability and necessity steps of the proportionality test, and dismissed the indirect expropriation claim. However, as Caroline Henckels states, the tribunal did not consider the proportionality *stricto sensu* stage[162] which provides the assessment of 'balance' in the proportionality test by weighing public and private interests.

d. Criticisms of referring to WTO case law:

The *Continental* tribunal is mainly criticized because of its examination of the measure under the "necessity" concept in WTO case law, which stated that it was more logical to rely on the "necessity measurement" in GATT rather than in international customary law.[163] The tribunal explained this by claiming that Article XI of the BIT was a reflection of Article XX of the GATT

[159]Burke-White and Staden (n 99) 710.
[160] *Continental* (n 13) para 198.
[161] Ibid, para 227.
[162] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 95.
[163] *Continental* (n 13) para 192.

and that WTO case law has experience with the assessment of economic measures under the "necessity" concept.[164] Kathleen Claussen argues that although there is a similarity between the necessity assessment in both the trade and investment fields, it is wrong to rely on WTO case law alone to resolve an investment dispute. [165] Thus, the main criticism about the *Continental* case is that it considered the necessity test by explicitly relying on WTO case law. Furthermore, it is argued that while the tribunal adopted an interpretation of WTO case law in the investment dispute, it did not pay attention to the "*contextual and textual differences between the WTO agreements and the Argentina-US BIT."*[166] Moreover, the tribunal relied on WTO case law while applying the proportionality test, but it misinterpreted the test by disregarding the last stage of it. Thus, its wrong application of the test was based on attempts to adopt a concept from a different jurisdiction.

Nevertheless, the *Continental* case can be considered as successful in considering the necessity step in detail and states' right to regulate in deference. In other words, it followed a deferential approach while examining the measure under the "necessity" concept, which should also be followed by other tribunals in order to reach a balanced assessment. Additionally, Benedict Kingsbury and Stephen Schill claim that, this approach can reduce the concerns over the unilateral protection that BITs provide to foreign investors over public interests.[167] Therefore, even though the *Continental* tribunal can be criticized for relying on WTO jurisprudence and failing to apply the last step of the proportionality test, it presents a good example of how tribunals should approach states' right to regulate in deference and assess the "necessity" element of the measure.

[164] Ibid.
[165] Claussen (n 18) 1549.
[166] Henckels, *Proportionality and Deference in Investor-State Arbitration* (n 17) 95.
[167] Kingsbury and Schill (n 9) 101.

To sum up, the *Tecmed* and *Continental* cases were examined in order to show how investment tribunals adopted the proportionality test from different jurisdictions; ECtHR and WTO case law. Moreover, both cases applied the proportionality test to assess whether the measure taken by the government led to indirect expropriation or not, even though they reached different results. Furthermore, both of the tribunals are criticized for their problematic applications of the proportionality test. On the other hand, they are also appreciated for approaching states' right to regulate in deference and considering the rights of the investors. Therefore, looking at the *Tecmed* and *Continental* cases, the effect of the adoption of the proportionality test from different jurisdictions in investment disputes will be examined in the next section.

V. The outcomes of the application of the proportionality test in investment disputes:

In this section, the problems with the tribunals' interpretation and the reasons behind their problematic methodology will be examined in detail. The main problem with the proportionality test in investment disputes is that as the test was adopted from different jurisdictions, it led to a misinterpretation of the test due to a lack of guidance for tribunals in applying it. Furthermore, many tribunals which applied the proportionality test have been criticized for giving decisions that lack clear methodology and reasoning. As a result, it will be argued that the proportionality test should be used in indirect expropriation claims to achieve a balanced assessment, but the problems with this application must be eliminated to have the best results.

a. The Problem of Different Legal Bases:

The proportionality test does not have any legal basis in investment law jurisdiction and it has been adopted for investment disputes by relying on different jurisdictions. As *Tecmed* and *Continental* were examined regarding their interpretation of the test from jurisprudence of ECtHR and WTO respectively, this section will focus on differences between these jurisdictions and investment law.

i. ECtHR v Investment Arbitration:

In investment disputes, tribunals' primary sources are investment treaties that are applicable to the particular conflict. For instance, the provisions in BITS will be considered when investors claim a breach by a state under the treaty. On the other hand, the ECtHR relies on provisions in the European Convention of Human Rights (ECHR) while giving its decisions. Thus, the legal sources and the concepts of the two jurisprudences are different. Erlend Leonhardsen states that the main difference between investment disputes and ECtHR jurisprudence is the different structure of legal provisions, where investment tribunals consider *"expropriation clauses in applicable treaties"*[168], and the ECtHR relies on "*the property protection clause of ECHR"*[169]. Moreover, what they aim to assess with the proportionality test is also different. For instance, the *Tecmed* tribunal aimed to determine whether expropriation had occurred or not, but ECtHR jurisprudence was applied to decide whether the deprivations were justifiable.[170] Thus, the jurisprudences of investment law and the ECtHR differs from each other in many ways as a result of having different legal bases. The proportionality test that

[168] Leonhardsen (n 8) 124.
[169] Ibid.
[170] Ibid.

applied in ECtHR is not designed for investment disputes and adopting it to investment disputes may result in misinterpretation of the test.

ii. WTO v Investment Arbitration:

As the *Continental* Tribunal chose to apply the GATT rather than the US-Argentina BIT in considering the "necessity" concept, it is criticized for disregarding the textual and legal differences between the jurisdictions of WTO and investment law. In WTO law, disputes are first considered by the Appellate Body, which only issues reports, not judgments, and these reports need to be adopted by the Dispute Settlement Body (DSB) by consensus in order to have legal consequences on the states.[171] Moreover, the DSB is not an arbitration tribunal, it is comprised of member states, including the parties to the particular dispute.[172] Thus, the WTO is a *"member-driven organization"* where all the decisions are taken by the contracting parties in consensus,[173] and this is why it differs from investment law jurisdiction which provides an arbitration process to resolve the disputes. Moreover, the focus of the GATT and BITs are different, where the former focuses on the protection of free trade, and the latter protects foreign investment.[174] Consequently, concepts in the agreements also show differences. Although both jurisdictions refer to the 'necessary concept', the understanding and the application of it differs as they have different purposes.[175] Therefore, the assessment of the *Continental* tribunal through reliance on GATT and WTO case law can be considered

[171] Georges Abi-Saab 'The Appellate Body And Treaty Interpretation' in Malgosia Fitzmaurice, Olufemi Elias, and Panos Merkouris (eds)**,** *Treaty Interpretation and the Vienna Convention on the Law of Treaties : 30 Years On* (BRILL 2010) 100.
[172] World Trade Organization, 'Dispute Settlement Body' <https://www.wto.org/english/tratop_e/dispu_e/dispu_body_e.htm > Accessed: 13.08.2019.
[173] Abi- Saab (n 171) 100.
[174] Claussen (n 18) 1550.
[175] Ibid, 1551.

problematic due to the differences in purpose, context and methods of dispute resolution between the jurisdictions.

b. Misinterpretation of the test:

The misinterpretation of the test resulted in the adoption of the proportionality test from a different jurisdiction without providing any guidance for tribunals. As mentioned, the *Tecmed* tribunal misinterpreted the test by skipping the necessity and suitability stages, and the *Continental* tribunal did not apply the proportionality *stricto sensu* stage, where all the steps need to be applied cumulatively. Furthermore, this misinterpretation of the proportionality test may be problematic for both states and investors, because the decision can be given without completing the proper assessment. William Burke-White and Andreas von Staden criticize the arbitration tribunals, especially the ICSID tribunals, as being incapable of achieving the balance that could be found through an *"effective and legitimate proportionality analysis."*[176] Praphash Ranjan also points out the importance of the proper adoption of the proportionality test to prevent tribunals applying the test with high discretion.[177] Moreover, it is argued that the tribunals should not be free to apply the proportionality test in all legal contexts without considering the rules and principles for adjudication.[178] To clarify, arbitrators have to decide on the dispute according to the law they are based on, otherwise it would not lead to a fair assessment. Thus, it could be claimed that tribunals fail in their duty to make a balanced assessment if they misinterpret the proportionality test.

[176] Burke-White and Staden (n 99) 716.
[177] Ranjan (n 16) 863.
[178] Leonhardsen (n 8) 119.

c. Lack of clarity and reasoning:

The lack of clarity and reasoning in decisions has also resulted in an adoption of the test from different jurisdictions to investment disputes, without guidance for tribunals in how to achieve this. Caroline Henckels argues that even though there was support for cases that have applied the proportionality test as they considered the balance between interests, these cases did not outline the methodology they used in assessing the measure involved. [179] Moreover, it is claimed that in some cases, the tribunals applied the proportionality test without mentioning it.[180] Therefore, there have been decisions that attempted to apply the proportionality test but they were unclear on the methodology used, failing to ground their reasoning. William Burke-White and Andreas von Staden also criticized the ICSID tribunals for being inconstant in their assessments, as they stated they involved the proportionality test but actually applied something different.[181]

d. Benefits of the proportionality test:

Although there are criticisms about the application of the proportionality test in indirect expropriation claims, the benefits of the test cannot be disregarded. Benedict Pirker expresses the advantages of proportionality test as *"it gives great leeway to courts to assess, weigh and balance all arguments on an equal footage without strict limitation by the text to be interpreted."*[182] According to Anne Hoffman, the proportionality test balances the interests of the state against the investor with a "*methodologically clear and convincing approac*h."[183]

[179] Henckels , *Proportionality and Deference in Investor-State Arbitration* (n 17) 115.
[180] Ibid, 124.
[181] Burke-White and Staden (n 99) 716.
[182] Benedikt Pirker 'Seeing the Forest without the Trees – The Doubtful Case for Proportionality Analysis in International Investment Arbitration' (Highly Commended Essay, University of Fribourg; HSG University of St. Gallen 2011) 2 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1926166> Accessed: 16.04.2019.
[183] Anne K. Hoffmann, 'Indirect Expropriation' in A. Reinisch (ed.), *Standards of Investment Protection* (Oxford University Press 2008) 168.

Moreover, Caroline Henckels argues that the "*Proportionality analysis' main advantage is that it provides a much more transparent analytical structure for decision-making engaging competing public and private interests."*[184] Thus, with its balanced analysis that both considers the purpose and effect of a measure by assessing it via different steps, the proportionality test is the best way for tribunals to decide on indirect expropriation claims. Moreover, the clear structural analysis of the proportionality test may also help tribunals avoid an incoherent assessment which lacks reasoning and clarity.

Although investment tribunals are mainly criticized for applying the proportionality test in a methodologically wrong manner and making decisions which lack clarity and reasoning, this does not mean that they have failed in achieving a balanced assessment. For instance, the *Tecmed* tribunal has been criticized for the misinterpretation of the test by skipping the necessity and suitability steps. However, despite the problems with its application, the *Tecmed* case is seen as an innovation in investment case law as it adopted the concept of proportionality from ECtHR for the first time and applying it in an indirect expropriation claim. Therefore, the *Tecmed* tribunal's attempt to find the balance between the interests of the state and the investor by applying the proportionality test has been welcomed and accepted as a best technique when deciding on indirect expropriation claims by most scholars. Moreover, the *Continental* Tribunal was also criticized for giving its decision without considering the proportionality *stricto sensu* step and relying on WTO case law. However, the tribunal's assessment of "necessity" by approaching states' right to regulate in high degree of deference has been appreciated, in terms of providing an example that balances public and private interests. Nevertheless, even though these tribunals misinterpreted the

[184] Henckels, 'Indirect Expropriation And The Right To Regulate' (n 6) 228.

proportionality test, they achieved balanced assessments in their own ways, and these could provide guidance for other tribunals to consider in indirect expropriation claims.

To conclude, the way investment tribunals have applied the proportionality test to determine the existence of indirect expropriation has been criticized in different ways. In general, the main problem is the application of the test in using the wrong methodologically, which has also led to lack of clarity and reasoning in their decisions. Moreover, the reason behind these problems is a lack of guidance for investment tribunals on how to apply the proportionality test in investment disputes, as both the *Continental* and *Tecmed* tribunals adopted the proportionality test from different jurisdictions, the WTO and ECtHR respectively. Thus, the different legal bases of these jurisdictions and investment law created problems in the test's application. As the function of the proportionality test depends on its application, the test needs to be applied properly in order to achieve a balanced assessment. Therefore, the next chapter will look at possible ways to improve the application of the proportionality analysis in investment disputes by eliminating current problems.

CHAPTER FOUR: IMPROVING THE APPLICATION OF THE PROPORTIONALITY TEST

This chapter will present a solution and assess how the application of the proportionality test in indirect expropriation claims can be improved, as the main problem behind the methodologically wrong application of the test is a lack of guidance for investment tribunals. Thus, the parties of BITS should establish clearer provisions about indirect expropriation, including guidance with a reference to the proportionality test in an assessment of a claim. Moreover, these provisions should also set out the situations that will are exempted from indirect expropriation. Consequently, a clear expression of the parties' intention will reduce a tribunal's interference and a risk of the misinterpretation of BITs and the proportionality test. Thus, clarifying the parties' intentions in indirect expropriation provisions within BITs will be discussed as an effective solution.

I. Solution: Establishing clear provisions about indirect expropriation in BITS:

In investment disputes, tribunals decide on indirect expropriation claims by first examining the related provisions in the applicable BIT. However, if the parties' intentions are not clear, or, in other words, if the provisions are not clear enough to guide tribunals, then tribunals intervene to interpret BITs at their discretion. Thus, they start considering different legal instruments or concepts by adopting them from different jurisdictions and interpreting them in the way they see appropriate. Consequently, the lack of clear and explicit terms in BITS will result in giving a tribunal a high degree of discretion to intervene and interpret the parties' intentions.

a. Setting out criteria for the assessment of indirect expropriation claims:

Various Tribunals' decisions on indirect expropriation claims has led some states to take action to renew their BITs as it is evident that provisions about indirect expropriation are not clear

enough to guide tribunals in their assessments. For instance, the US and Canada Model BITs established provisions which clearly indicate how indirect expropriation should be examined by tribunals, setting out clear criteria. As the US Model BIT (2012) states:

> 4. The second situation addressed by Article 6 [Expropriation and Compensation]
>
> (1) is indirect expropriation, where an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure.
>
> (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by case, fact-based inquiry that considers, among other factors:
>
> (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;
>
> (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and
>
> (iii) the character of the government action.[185]

Thus, the provision presents clear guidance for tribunals to follow in the assessment of the measure, stating that they must examine both the purpose and effect of the measure. Praphash Ranjan also claims that contracting states must clearly indicate how the balance should be considered in indirect expropriation. [186] Moreover, Paul Michael Blyschak argues that greater clarity in provisions will improve the transparency and predictability in their interpretation, and this will be beneficial for both foreign investors and host states.[187] Thus,

[185] US Model BIT(2012) ANNEX B, For the text of the Model BIT see https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/2870/download
[186] Ranjan (n 16) 880.
[187] Paul Michael Blyschak, 'State Consent, Investor Interests and the Future of Investment Arbitration: Reanalyzing the Jurisdiction of Investor-State Tribunals in Hard Cases' (2009) 9 Asper Rev. Int'l Bus. & Trade L. 129.

establishing clear provisions about indirect expropriation in BITs will provide parties a chance to provide their own understanding of the balance without letting tribunals intervene and misinterpret their intentions.

Many BITs have followed the approach of the US Model BIT and some of them have customized provisions according to their own priorities and intentions. Furthermore, it could be argued that some have even improved the content of these provisions by adding different criteria. For instance, the China-New Zealand FTA (2008) refers to *"proportionality, discrimination and breach of the State's previous written commitments to the investor"* [188] when assessing the existence of a deprivation:

> 3. In order to constitute indirect expropriation, the State's deprivation of the investor's property must be:
>
> (a) Either severe or for an indefinite period; and (b) Disproportionate to the public purpose.
>
> 4. A deprivation of property shall be particularly likely to constitute indirect expropriation where it is either: (a) Discriminatory in its effect, either as against the particular investor or against a class of which the investor forms part; or (b) In breach of the State's prior binding written commitment to the investor, whether by contract, licence, or other legal document. [189]

Thus, the wording in the above BIT is very similar to the US Model, which clearly determines how an indirect expropriation claim should be examined in relation to both public and private

[188] UNCTAD, 'Expropriation' (n 3) 60.
[189] China-New Zealand FTA (2008) ANNEX 13, For further information see https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-in-force/china-fta/nz-china-fta-resources/ .

interests. Furthermore, this BIT has also added an examination of the measure within the proportionality aspect and this indicates it is a good example to be followed by other states.

b. Indicating situations that will not amount to expropriation:

In addition, BITs should clearly indicate the situations that will be exempted from indirect expropriation. An example for this type of provision can again be found in the Canada Model BIT:

> Except in rare circumstances, such as when a measure or series of measures are so severe in the light of their purpose that they cannot be reasonably viewed as having been adopted and applied in good faith, non-discriminatory measures of a Party that are designed and applied to protect legitimate public welfare objectives, such as health, safety and the environment, do not constitute indirect expropriation.[190]

This provision is an obvious example of approaching a state's right to regulate in deference, considering the public interest explicitly and prioritizing it in certain circumstances. In addition, this type of provision will reduce the interference of tribunals with state sovereignty by preventing them from interpreting the 'right to regulate' as they see appropriate.

To conclude, the main problem is a lack of guidance for tribunals on how to assess indirect expropriation claims and how to apply the proportionality test properly in investment disputes, as it has been adopted from different jurisdictions and this has resulted in the misinterpretation of the test. Thus, the solution is the establishment of a clear guidance for tribunals in BITS, which set out the situations that will not amount to expropriation and offer criteria to be followed by the tribunals in the assessment, preferably referring to the proportionality test. Furthermore, the provisions in the US and Canada Model BITs and the China-New Zealand FTA are good examples for the way in which indirect expropriation should

[190] Canada Model BIT Annex B, see (n 29).

be established in BITSs in relation to considering the parties' intentions in the assessment. Thus, guidance about assessing indirect expropriation claims through the proportionality test should be determined specifically in each BIT with reference to the parties' intentions. Consequently, this clear expression of parties' intentions in the assessment will decrease the intervention of tribunals and achieve a balance in indirect expropriation claims.

CONCLUSION:

This dissertation has aimed to outline how to improve the application of the proportionality test in indirect expropriation claims in order to find a balance between states' right to regulate and investment protection. Thus, this research started its assessment by addressing the lack of explicit provisions about indirect expropriation in BITs, which creates uncertainty about how tribunals should assess whether a government's measure has led to expropriation or not. Moreover, while BITs mainly aim to protect foreign investors from host states' acts by requiring certain state obligations, they mostly fail to provide provisions that explicitly refer to the 'right to regulate'. This is why many tribunals have interpreted BITs in favour of investors and disregarded the public interest, which creates the necessity to achieve a balance between states' right to regulate and foreign investment in indirect expropriation claims. Thus, the dissertation has highlighted that tribunals should consider states' right to regulate in deference by applying some limitations, such as a consideration of legitimate expectations. Consequently, it is argued that a balance can be achieved by examining the purpose and effect of the measure as it is provided for by the proportionality test.

The proportionality test is considered as the best approach to provide a balance between public and private interests in investment disputes. Moreover, it is adopted from the jurisprudence of the ECtHR, first by the *Tecmed t*ribunal in deciding an indirect expropriation claim. The *Continental* tribunal also applied the proportionality test in an indirect expropriation claim, relying on WTO case law and the "necessity" concept in the GATT. Thus, the research looked at the interpretation used by these tribunals in order to address how they applied the proportionality test to assess an indirect expropriation claim and what the results were. It was found that adapting a concept from different jurisdictions for investment disputes

has resulted in its misinterpretation and a lack of clarity and reasoning in decision-making. Moreover, the reason behind this is a lack of guidance for investment tribunals in interpreting the proportionality test in investment disputes. This is therefore the main problem to be solved in order to improve the application of the test in indirect expropriation claims.

As a result of this analysis, this dissertation has claimed that BITs should provide guidance for tribunals about the assessment of indirect expropriation claims. These provisions should provide criteria to be followed by tribunals and set out circumstances that are exempted from expropriation. Moreover, it is argued that it would be better to have a reference to the proportionality test in these provisions. By offering this solution, this research has aimed to highlight the importance of the parties' intentions by reducing the discretion available to tribunals in the assessment of an indirect expropriation claim. Moreover, examples from BITs were given to outline the potential language of the provisions, which may also be followed by other states. However, it might be optimistic to expect all other states to renew their existing BITs or adopt new agreements containing these aspects. Nevertheless, this dissertation is hopeful that states will adopt explicit provisions in BITS to improve the application of the proportionality test in indirect expropriation claims by eliminating the problems with its interpretation by tribunals, arising from a lack of guidance.

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