Overview

A. Introduction

1. The vast majority of investment treaties prohibit a host state from expropriating the investments of protected foreign investors, except when such action is taken for a public purpose, on a non-discriminatory basis, in accordance with due process of law and on payment of compensation. This advisory provides a general overview of this core protection.

2. Expropriation claims can generally be split into four main issues:
   2.1 Is there a protected investment?
   2.2 Was that investment expropriated?
   2.3 Was the expropriation lawful under the investment treaty?
   2.4 What are the consequences of an unlawful expropriation?

B. Is there a protected investment?

3. The expropriation provisions in investment treaties protect “investments”. This term is generally defined in the treaty. Most treaties define “investment” in very wide terms to cover “every kind of asset” including shares, concessions, debt instruments, land and moveable property. Very wide interpretations have been given to these definitions by arbitral tribunals. It has been noted that “investments” must be capable of ownership under the domestic law of the host state (as public international law does not create property rights); in other words, the argument is that if the alleged investment cannot be owned, then by definition it cannot be taken.

4. In addition, to qualify for protection, that investment must be an investment of a qualifying “investor”. Again, this term is ordinarily defined in the investment treaty. In general, to qualify as a protected “investor”, the investor needs to be a national of one of the contracting states to the treaty on which it seeks to rely. As regards companies, most investment treaties provide that a company will be a national of a contracting state if it is constituted under or organized in accordance with the laws of such state.

5. Tribunals have not taken a consistent approach to the relationship between the investor and the investment. With regard to host states where title can be divided into beneficial and legal title, some tribunals have held that it is enough for the investor to have a bare legal interest as opposed to a beneficial interest in the investment (although lack of beneficial interest may impact the valuation of the investor’s claim to damages).

C. Was that investment expropriated? Direct expropriation

6. A direct expropriation occurs upon the forcible deprivation of title or loss of physical possession of the property constituting the investment by administrative or legal measures.

D. Was that investment expropriated? Indirect expropriation
7. The majority of investment treaties expressly recognize that an expropriation can be also be indirect. With those treaties that do not expressly extend their protection to indirect expropriations, it is possible that the protection is implicitly extended to indirect expropriations as well.

8. With indirect expropriations, the protected foreign investor retains ownership and physical possession of its investment but is nevertheless subjected to a substantial interference with its rights in that investment; there must be a "substantial deprivation" that renders the investor's property rights "useless". Such a deprivation is a defining feature of indirect expropriations.

9. The following paragraphs address particular issues that have emerged in relation to specific types of expropriation.

**Regulatory Expropriation**

10. Arbitral tribunals have had particular difficulty with regulatory actions taken by host states that interfere with an investor's rights but are alleged to have been taken for a public purpose in pursuance of the state's sovereign rights. Here, it is necessary to determine whether or not the measure in question is a compensable indirect expropriation or a valid non-compensable regulation. There are two main approaches to this issue.

11. The first approach is known as the “Sole Effects Doctrine”. With this approach, the regulatory purpose (no matter how legitimate or laudable) is irrelevant. The effect of the measure alone is considered to determine whether or not an indirect expropriation has occurred. Thus, under this approach the question is whether there has been a substantial deprivation (see para 8 above).

12. The second approach is known as the “Police Powers Doctrine”. This approach rejects the Sole Effects Doctrine, holding that international law protections against unlawful expropriation cannot prevent bona fide regulation in the public interest. A review of the main arbitral decisions applying this approach suggests the following three-stage analysis:

12.1 *First*, it is necessary to establish that there has been a substantial deprivation (i.e. the general test as discussed at para 8 above).

12.2 *Second*, if the stage one test is met, it is then necessary to determine whether or not the measure in question falls within the mandate of the relevant state agency and within the normal exercise of the host state’s regulatory powers (i.e. within its recognized police powers). If this test is not met, the measure will amount to an indirect expropriation (since it was found to result in a substantial deprivation at the first stage).

12.3 *Third*, if the stage one and two tests are met, the question of whether or not the measure is expropriatory will be assessed on the basis of several factors. A global assessment of these factors (or their absence) is necessary; no single indicator is in itself decisive. Thus, under the Police Powers Doctrine, it is generally thought that an investor will have to establish one or more of the following indicators to demonstrate that the measure is expropriatory: (i) a lack of genuine (i.e. bona fide) public purpose; (ii) that the measure in question is not designed to achieve the alleged public purpose; (iii) that the measure in question is discriminatory; (iv) a lack of due process; (v) a lack of proportionality between the effect of the measure and the public purpose sought to be realized; (vi) a breach of the investor’s legitimate expectation that a particular action would not be taken by the host state; (vii) a breach of the fair and equitable treatment standard; and/or (viii) a direct benefit to the host state from the measure.

**Creeping expropriations**

13. Sometimes, the deprivation of an investment occurs through a series of state actions, rather than by way of an instantaneous (direct or indirect) taking. This is referred to as a “creeping expropriation”, which is a type of indirect expropriation. Such expropriations take place through an incremental, cumulative series of state actions which in the aggregate destroy the value of the investment, even though each individual action may not itself amount to an expropriation.

**The need for a sovereign act**

14. For a host state’s action to be classified as expropriatory, that action must be taken by the state in its sovereign capacity. The main effect of this requirement is to exclude from the scope of the protection conferred by the applicable investment treaty actions taken by a state solely in its capacity as a party to a contract with an investor (i.e. those actions taken by a state that could have been taken by a non-state entity). For example, a simple non-performance will not generally amount to an expropriation, but a legislative measure or action taken by regulatory authorities which has the effect of invalidating the investor’s contract rights in law would most likely meet this test.

**E. Was the expropriation lawful under the investment treaty?**

15. As was noted at the outset of this advisory, the vast majority of investment treaties provide that an expropriation will only be lawful when the following conditions are met:
15.1 First, the expropriation must be for a **public purpose**. The expropriation must be motivated by a legitimate public purpose, not private gain or some other illicit objective (such as where the expropriation is undertaken for political reasons). A failure to use the expropriated property for a significant period of time after the expropriation may indicate that it was not taken for a public purpose. This requirement essentially prevents abusive expropriations. It is for the arbitral tribunal and not the host state to determine whether or not the expropriation was for a public purpose, though “due deference” is often afforded to the host state in the course of this examination.

15.2 Second, the expropriation must be **non-discriminatory**. The usual approach to this requirement is that for discrimination to exist there must be different treatment between persons or entities in like circumstances based on a particular characteristic (e.g. nationality, race, religion) without a reasonable justification. It is generally thought that there is no requirement to prove an intention to discriminate.

15.3 Third, the expropriation must be taken in accordance with **due process of law**. Most tribunals have held that the host state must comply with international due process standards, which include a requirement to comply with its domestic legal processes for the expropriation. More specifically, tribunals have required: reasonable advance notice of the expropriation; a procedure under domestic law for the investor to raise its claims against the action; compliance with that procedure; a fair hearing within a reasonable time by an impartial adjudicator.

15.4 Fourth, **compensation** must be paid to the investor. Treaties generally set the measure of compensation required for a lawful expropriation. A common formulation is that the investor must be paid “prompt, adequate and effective compensation”. In this context “prompt” means soon after the expropriation; “adequate” refers to the quantity of compensation and is generally regarded as meaning the fair market value of the investment immediately before the date of expropriation (or the date it became publicly known, if earlier); and “effective” means compensation paid in a convertible currency, usually the currency in which the investment was made. As for valuation, “fair market value” is generally determined using one or more of the following valuation techniques: (i) an income approach (e.g., using a discounted cash flow analysis); (ii) a market approach (e.g., comparable transactions); (iii) an asset approach (e.g., based on book value); (iv) a sunk costs approach; or (v) a hybrid approach. Further, investment treaties frequently provide that such compensation shall include interest from the date of expropriation to the date of payment; in any event, interest would usually be ordered.

F. What are the consequences of an unlawful expropriation?

16. A failure to comply with the conditions for legality set out in the relevant investment treaty (e.g. those conditions set out at para 16 above) results in a breach of the expropriation standard; the expropriation will consequently be regarded as unlawful. However, it should be noted that a number of tribunals have held that a mere failure to pay compensation does not make an expropriation unlawful.

17. With unlawful expropriations, the host state is bound to make full reparation to the investor in respect of the injury caused to it by the state. This requires that the investor is so far as possible put in the position it would have been in if the investment had been made but the breach had not occurred. The remedies that are most commonly awarded are compensation for damages and restitution.

18. With **compensation for damages**, it is widely accepted that the investor is entitled to be paid fair market value, valued using the same techniques mentioned above. Thus, despite the volume of commentary on this topic, there is in practice very little difference between compensation for an unlawful expropriation and compensation for a lawful expropriation. In practical terms, the key difference between compensation in these two scenarios is the date of valuation: as noted above, with lawful expropriations, compensation is assessed on the basis of the investment’s fair market value at the **date of expropriation** plus interest; by contrast, with unlawful expropriations, compensation is based on the fair market value that the expropriated investment would have had **at the date that the arbitral award is rendered** but for the host state’s breach of the investment treaty. However, it is arguable that to prevent this rule from penalizing an investor that has succeeded in establishing an unlawful expropriation, such investor is entitled to elect whichever valuation date basis results in a higher overall valuation.

19. **Restitution** is requested and ordered far less frequently. It will not usually be ordered if it is impossible or if it would lead to disproportionate results. In the event that restitution is ordered, the claimant is also entitled to compensation for the losses sustained that would not be covered by restitution so as to ensure full reparation. However, in practice, awards ordering expropriation will often allow the host state to instead pay compensation in lieu of restitution; indeed, some investment treaties expressly require this.

G. Conclusion

20. At present, the main focus on expropriation tends to be on whether or not an expropriation has occurred. This can be particularly complex in the context of regulatory takings, as explained above. Expropriation claims are often coupled with a fair and equitable treatment claim, which are statistically more likely to succeed in the context of an (alleged) indirect expropriation. For our earlier advisory on the fair and equitable treatment standard, click here. These matters continue to develop as further decisions are rendered in a wider array of scenarios. We will keep you apprised of such developments.