

## Protection against Indirect Expropriation under National and International Legal Systems<sup>1</sup>

Max Gutbrod, Steffen Hindelang & Yun-I Kim\*

### Table of Contents

Introduction .....	293
A. Identifying a Compensable Taking – A Brief Summary of the Present Discussion .....	297
B. Scenarios of State Measures .....	305
I. State Measures Which Are Lawful by National Standards .....	305
1. First Scenario: A State Measure Which Is Lawful by National Standards But Discriminatory .....	305
a) Russian Law .....	306

<sup>1</sup> This is an updated version of an article, originally written by Max Gutbrod and Steffen Hindelang, first published in the *Journal of World Investment and Trade*, Volume 7, No. 1 (February 2006); the publisher's permission is gratefully acknowledged.

\* Max Gutbrod, Dr. iur. (Munich), Rechtsanwalt (German lawyer); Partner at Baker & McKenzie, Moscow. The author has advised on many investments in particular into emerging markets as well as some international arbitration proceedings. He may be contacted at max.gutbrod@bakernet.com.

Steffen Hindelang, Dr. iur. (Tübingen), LL.M. (Sheffield); Research Associate and Lecturer, Eberhard-Karls-University of Tübingen, School of Law, Germany. His research mainly focuses on International and European Economic Law, Comparative Administrative Law, and the EC Legal Framework on Foreign Investment. He may be contacted at st.hi@gmx.de.

Yun-I Kim, Dipl. iur. (Cologne); Ph.D. Candidate, Faculty of Law, University of Potsdam, Germany. Case Assistant to Professor Dr. Karl-Heinz Böckstiegel; Research Assistant to Dr. Richard Happ, Luther law firm, Hamburg. Her research concentrates on International Investment Protection Law and International Investment Arbitration. The views expressed herein are strictly those of the authors.

b) International Investment Agreements .....	309
2. Second Scenario: A State Measure Which Is Lawful by National Standards But Discriminatory and Accompanied With <i>Mala Fide</i> .....	314
a) Russian Law .....	314
b) International Investment Agreements .....	314
3. Third Scenario: Investor Contributing to Bankruptcy .....	317
a) Russian Law .....	317
b) International Investment Agreements .....	318
4. Fourth Scenario: <i>Mala Fide</i> , Investor Acting Unlawfully .....	319
a) Russian Law .....	319
b) International Investment Agreements .....	319
II. State Action Which Is Unlawful by National Standards .....	320
1. Fifth Scenario: Unlawful State Action Against the Management, Management Personally Involved in Crimes .....	320
a) Russian Law .....	320
b) International Investment Agreements .....	321
2. Sixth Scenario: Illegality “All Around” .....	322
a) Russian Law .....	322
b) International Investment Agreements .....	323
C. Conclusions and Outlook .....	325

## Introduction

In recent years, direct expropriation<sup>2</sup> has rarely been seen.<sup>3</sup> States which wish to import capital do not like to be associated with posing a permanent, non-calculable threat to foreign-owned property but prefer to present themselves as jurisdictions with very stable, reliable and orderly regulatory environments.<sup>4</sup> Expropriation, however, has by no means vanished; its execution has just become more subtle.<sup>5</sup> Ambiguously or generously

<sup>2</sup> In a nutshell, direct expropriation is the compulsory transfer of legal title or the outright seizure of property by the State. In contrast, indirect expropriation refers to the situation in which the investor formally remains legal owner. See, instead of all, M. Sornarajah, *The International Law on Foreign Investment*, 2nd ed. (2004), 344, with further references. See generally, C. N. Brower & J. D. Brueschke, *The Iran-United States Claims Tribunal* (1998), 379; G. C. Christie, 'What Constitutes a Taking of Property under International Law?', 38 *British Yearbook of International Law* (1962), 309; P. Comeaux & S. Kinsella, *Protecting Foreign Investment under International Law: Legal Aspects of Political Risk* (1997), 8; A. Mouri, *The International Law of Expropriation as Reflected in the Work of the Iran-U.S. Claims Tribunal* (1994), 70-99; C. Schreuer, 'The Concept of Expropriation under the ECT and other Investment Protection Treaties', 2 *Transnational Dispute Management*, (2005) 3, available at [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) (last visited 9 April 2009); B. H. Weston, 'International Law and the Deprivation of Foreign Wealth: A Framework for Future Inquiry', in R. A. Falk & C. Black (eds), *The Future of the International Legal Order, Vol. 2: Wealth and Resources* (1970), 106; M. M. Whiteman, 8 *Digest of International Law* (1976), 1006-1020.

<sup>3</sup> For one of the few cases where direct expropriation occurred in recent years, Cf. *Mr. Franz Sedelmayer v. Russian Federation*, Award, 7 July 1998. See also Bolivia's Supreme Decree No. 28701, Nationalization of Hydrocarbon Sector, 1 May 2006, 45 ILM 1020 (2006).

<sup>4</sup> M. W. Reisman & R. D. Sloane, 'Indirect Expropriation and its Valuation in the BIT Generation', 74 *British Yearbook of International Law* (2003), 118; L. Reed & D. Bray, 'Fair and Equitable Treatment: Fairly and Equitably Applied in Lieu of Unlawful Indirect Expropriation?', in: A. W. Rovine (ed.), *Contemporary Issues in International Arbitration and Mediation*, 2008, 13; A. K. Hoffmann, 'Indirect Expropriation', in: A. Reinisch, (ed.), *Standards of Investment Protection*, 2008, 151; on the subject of indirect expropriation in general refer to U. Kriebaum, 'Partial Expropriation', 8 *Journal of World Investment and Trade* (2007), 69; U. Kriebaum, 'Regulatory Takings: Balancing the Interests of the Investor and the State', *Journal of World Investment and Trade* (2007), 717; A. Reinisch, 'Expropriation', in: P. Muchlinski *et al.* (eds), *The Oxford Handbook of International Investment Law* (2008), 420-451; J. Griebel, *Internationales Investitionsrecht* (2008), 76-79; R. Dolzer & C. Schreuer, *Principles of International Investment Law* (2008), 89-92.

<sup>5</sup> Reinisch, *supra* note 3, 432.

worded laws are ‘interpreted’ in a way that suits certain groups in the government or are only enforced when it suits a particular interest; administrative discretion is influenced by factors unrelated to the matter at issue, or administrations fail to conduct their processes in a transparent and comprehensible way. All these measures, turned against a foreign investor, can easily drive him out of business. Virtually all bilateral investment treaties (BITs) and multilateral investment agreements (MITs), therefore, reflect this development and also cover acts of State which may expropriate “indirectly through measures tantamount to expropriation or nationalisation”<sup>6</sup> (indirect expropriation<sup>7</sup>). Moreover, many international investment agreements (IIAs)

<sup>6</sup> Article III (1) of the Treaty between the United States of America and the Russian Federation concerning the Encouragement and Reciprocal Protection of Investment, signed 17 June 1992, not yet in force; available at: [www.unctad.org/sections/dite/iiia/docs/bits/usa\\_russia.pdf](http://www.unctad.org/sections/dite/iiia/docs/bits/usa_russia.pdf) (last visited 9 April 2009). See also Article III of the Abs-Shawcross Draft Convention on Investment Abroad of 1959, United Nations Conference on Trade and Development (UNCTAD), *International Investment Instruments: A Compendium*, Vol. V, 2000, 396; Article 0(3)(a) of the Harvard Draft Convention of 1961, in L. B. Sohn & R. R. Baxter, ‘Responsibility of States for Injuries to the Economic Interests of Aliens’, 55 *American Journal of International Law* (1961), 553; Protocol No. 1 of the European Convention for the Protection of Human Rights and Fundamental Freedoms of 1952, available at [www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf](http://www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf) (last visited 11 August 2005); Article 3 of the Draft Convention of the Organisation for Economic Co-operation and Development (OECD) on the Protection of Foreign Property of 1967, in UNCTAD, *International Investment Instruments: A Compendium*, Vol. II, 1996, 114; Article 21 of the American Convention on Human Rights of 1969, available at [www.oas.org/juridico/english/Treaties/b-32.htm](http://www.oas.org/juridico/english/Treaties/b-32.htm) (last visited 1 September 2005); American Law Institute, *Restatement (Third) of the Foreign Relations Law of the United States*, Vol. 2, 1986, §712(1); OECD Negotiating Group on the Multilateral Agreement on Investment (MAI), *The Multilateral Agreement on Investment Draft Consolidated Text*, OECD Doc. DAFFE/MAI(98)7/REV1, 22 April 1998, available at [www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf](http://www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf) (last visited 1 September 2005); Article 13(1) of the Energy Charter Treaty (ECT), available at [www.encharter.org](http://www.encharter.org) (last visited 9 April 2009); Article 1110 of the North American Free Trade Agreement (NAFTA) of 1992, available at [www.nafta-sec-alena.org/DefaultSite/index\\_e.aspx?DetailID=78](http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx?DetailID=78) (last visited 9 April 2009); Article 6 of the 2004 US Model BIT; Article 13 of the 2003 Canadian Model Foreign Investment Protection Agreement; most recently, however, solely referring to ‘expropriation or nationalisation’ without differentiating between direct or indirect expropriation, Article 6 of the 2007 Norway Model BIT.

<sup>7</sup> From an analytical point of view, one can distinguish between “creeping” and “consequential expropriation”. “‘Creeping’ expropriation is comprised out of a number of elements, none of which can – separately – constitute the international wrong.” Reisman & Sloane, *supra* note 3, 123, 125–127. Intention to harm the investment or the investor or an intention to expropriate is not necessary but helps to prove a creeping

not only provide rules on (indirect) expropriation but also establish so-called treatment standards “which refer to the legal regime that applies to investments once they have been admitted by the host State.”<sup>8</sup> Administrative malfeasance, misfeasance and nonfeasance may also affect the investment adversely without amounting to “indirect expropriation”, constituting a less intense interference with the property. Indeed, there are arbitral awards which, while not accepting a claim based on “indirect expropriation”, established a compensable violation of “treatment standards”, i.e. in particular the “fair and equitable treatment” embodied in BITs or MITs.<sup>9</sup>

expropriation; Reisman & Sloane, *supra* note 3, 124, 128. Cf. also *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. Argentina*, ICSID Case No. ARB/97/3, Award, 20 August 2007, at para. 7.5.20 (hereafter referred to as *Compañía de Aguas del Aconquija S.A. and Vivendi Universal*); *Siemens AG v. Argentina*, ICSID Case No. ARB/02/8, Award, 6 February 2007, at para. 270 (hereafter referred to as *Siemens AG*). See also C. Schachter, The Concept of Expropriation under the ECT and other Investment Protection Treaties, in 2 *Transnational Dispute Management* (2005) 3, available at: [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) (last visited 9 April 2009); A. Newcombe & L. Paradell, *Law and Practice of Investment Treaties – Standards of Treatment* (2009), 343-344; Reinisch, *supra* note 3, 426-431. “Consequential expropriation” refers to the situation in which the host State fails to properly create, maintain and manage “the legal, administrative, and regulatory normative framework contemplated by the relevant BIT, an indispensable feature of the ‘favourable conditions’ for investment.” Reisman & Sloane, *supra* note 3, 129, 130. Here, also, an intention on the part of the host State is not required. Reisman & Sloane, *supra* note 3, 129.

<sup>8</sup> R. Dolzer & M. Stevens, *Bilateral Investment Treaties* (1995), 58.

<sup>9</sup> Cf. *CMS Gas Transmission Company v. Argentina*, ICSID Case No. ARB/01/8, Award, 12 May 2005 (hereafter referred to as *CMS*); *Saluka Investments B.V. (The Netherlands) v. Czech Republic*, Partial Award, 17 March 2006; *Azurix v. Argentina*, ICSID Case No. ARB/01/12, Award, 14 July 2006; *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006 (hereafter referred to as *LG&E Energy Corp.*); *PSEG Global, Inc. and Konya Ilgin Elektrik Üretim ve Ticaret Limited Şirketi v. Turkey*, ICSID Case No. ARB/02/5, Award, 19 January 2007; *Enron Corporation and Ponderosa Assets L.P. v. Argentina*, ICSID Case No. ARB/01/3, Award, 22 May 2007 (hereafter referred to as *Enron Corp.*); *Sempra Energy v. Argentina*, ICSID Case No. ARB/02/16, Award, 28 September 2007 (hereafter referred to as *Sempra Energy*); for cases where State action amounted to both indirect expropriation as well as to a breach of the “fair and equitable treatment” standard, cf. *Siemens AG*, *supra* note 6; *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. Argentina*, *supra* note 6. Many BITs provide in rather repetitive wording not only for “fair and equitable treatment” but also for “full protection and security” and prohibit “unreasonable or discriminatory measures in the course of management, maintenance, use, enjoyment or disposal of investments”; Article 2(2) of the Agreement between The Government of the United Kingdom of Great Britain and Northern Ireland and The Union of Soviet

This article will look at six typically posed challenges to foreign investment posed by administrative acts, focusing on the issues of discrimination, *mala fide* and lack of transparency, and will discuss the response of national and international rules applicable to the situation of indirect expropriation.<sup>10</sup> These scenarios are based on Russian legal regulations<sup>11</sup> and are inspired by the events in the Commonwealth of Independent States reality but by no means intend to be a reflection of facts.

We will show that the internal legal order cannot respond to any of these challenges through striking a just balance between legitimate business interests of the foreign investor and the State's sovereign right to regulate. Rather, it is the international (contractual) law on foreign investment which offers the clearly more sophisticated framework for a balanced settlement of a foreign investment dispute. Our prediction is that if economies in transition, like Russia, do not start living up to the standards required by international investment agreements quickly, they might face the risk of the marginalization of their national legal orders in the settlement of foreign investment disputes. Such conflicts, which earlier clearly had an "internal component", would increasingly become international only and would, in this sense, be externalized.

Socialist Republics concerning the promotion and reciprocal protection of investments, signed 6 April 1989, entered into force 3 July 1991. In academic writing, much effort has been spent on the question of whether and how the concepts of "fair and equitable treatment", "full protection and security" and "non-discrimination" are to be delimited from each other.

<sup>10</sup> Occasionally, if it is helpful in making an argument more explicit, we might also make reference to the concept of "fair and equitable treatment", part of the treatment standards attributable to a foreign investment by virtue of IIAs.

<sup>11</sup> Russia, like many countries around the world, has become party to a variety of bilateral and multilateral international agreements (at least partly) concerned with or related to the protection of foreign investment, i.e. numerous bilateral investment treaties (BITs) with all major capital exporting countries (Russia had signed 56 BITs as of 1 June 2005, of which 30 had entered into force; for a detailed list, see the UNCTAD Website at [www.unctad.org/sections/dite\\_pcbp/docs/bits\\_russian\\_federation\\_en.pdf](http://www.unctad.org/sections/dite_pcbp/docs/bits_russian_federation_en.pdf) (last visited 29 August 2005); the full text can be accessed via [www.unctadxi.org/templates/DocSearch\\_\\_\\_779.aspx](http://www.unctadxi.org/templates/DocSearch___779.aspx) (last visited 29 August 2005)); The European Convention for the Protection of Human Rights and Fundamental Freedoms and its First Protocol, available at [www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf](http://www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf) (last visited 11 August 2005); and the Agreement on Partnership and Cooperation, available at [europa.eu.int/comm/external\\_relations/ceeca/pca/pca\\_russia.pdf](http://europa.eu.int/comm/external_relations/ceeca/pca/pca_russia.pdf) (last visited 11 August 2005) with the European Union. Russia is also a signatory to the European Energy Charter Treaty, available at [www.encharter.org](http://www.encharter.org) (last visited 28 August 2005) and is provisionally applying it while the ratification process is pending before the Duma.

This article will start off by providing a brief survey of the present discussion in the literature based on the awards rendered on the subject, on what constitutes a compensable taking in international law (Section A.). It will then turn to certain hypothetical situations (Section B.). These are split into two parts: the first four scenarios deal with State measures which are lawful by national standards (Section B.I.) and the last two scenarios focus on State measures which are unlawful even by national standards (Section B.II.). Finally, it summarizes and evaluates our findings.

## A. Identifying a Compensable Taking – A Brief Summary of the Present Discussion

Above, we referred to the ‘subtle’ governmental interference with foreign property. However, what are those ‘subtle’ measures ‘tantamount to expropriation’ which will eventually give rise to compensation?

It has been suggested that the phrase ‘tantamount to expropriation’ does not only refer to intentional or obvious indirect expropriation but that “[i]t also captures the multiplicity of inappropriate regulatory acts, omissions, and other deleterious conduct that undermines the vital normative framework created and maintained by BITs”.<sup>12</sup> Recalling the objectives pursued by entering into BITs and similar agreements – the establishment and maintenance of a “healthy investment climate”<sup>13</sup> – the concept of ‘indirect

<sup>12</sup> Reisman & Sloane, *supra* note 3, 118–119; differing C. McLachlan *et al.* (eds), *International Investment Arbitration: Substantive Principles* (2007), 291, at para. 8.72–8.74; *cf.* also *Mr. Eudoro Armando Olguín v. Paraguay*, ICSID Case No. ARB/98/5, Award, 26 July 2001, at para. 84; *Sea-Land Services, Inc. v. Iran*, 6 Iran-U.S. C.T.R. (1984), 149 (hereafter referred to as *Sea-Land Services*).

<sup>13</sup> Article 31 of the Vienna Convention on the Law of Treaties of 1969, available at [www.un.org/law/ilc/texts/treaties.htm](http://www.un.org/law/ilc/texts/treaties.htm) (last visited 11 August 2005), asks to have due regard to the object and purpose in the construction of a treaty. Most, if not all, BITs, as well as multinational agreements on investment protection such as the European Energy Treaty or the NAFTA, intend, as provided for in their preambles, to establish favourable conditions for investment by nationals and companies of one State in the territory of the other State. For a review of typical preambles, see Dolzer & Stevens, *supra* note 8, 20–21. In short, they envisage a “healthy investment climate” which is *conditio sine qua non* for the attraction of foreign direct investment. Those treaties “contemplate [...] an effective normative framework: impartial courts, an efficient and legally restrained bureaucracy, and the measure of transparency in decision”; Reisman & Sloane, *supra* note 3, 117. If a State signs up to such a treaty, it must be aware that it not only opens its doors to foreign investment but also commits itself to establish and/or maintain an appropriate legal, administrative, and regulatory framework;

expropriation' is extended to "an egregious failure to create or maintain the normative 'favourable conditions' in the host state".<sup>14</sup>

However, not every governmental adjustment of the normative framework or change in the application of this framework, or even mistake in application – *errare humanum est* – that adversely affects the economies where a foreign investment is made constitutes an expropriatory act (or a violation of treatment standards):<sup>15</sup>

“[S]tate measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.”<sup>16</sup>

Reisman & Sloane, *supra* note 3, 117; undecided, Dolzer, *supra* note 12, 73–74. See, for such an approach, *Kuwait v. American Independent Oil Co. (Aminoil)*, Final Award, 24 May 1982 (hereafter referred to as *Aminoil*), 21 *ILM* (1982), 976, at para. 147; *Mondev Int'l Ltd v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002, 42 *ILM* (2003), 110, para. 127. Some may argue now that an investment treaty is intended to benefit both investor and host State and that, thus, the rights and obligations of both sides need to be recognized; see Dolzer, who stipulates this question at Dolzer, *supra*, 74. As much as this is true, this argument does not speak against the aforementioned. It must be stressed again that BITs and MITs are not intended to prohibit legitimate regulatory measures by the host State. On the contrary, they encourage the host State to exercise its regulatory powers in a transparent, non-discriminating, non-abusive way guided by reason and the rule of law, at least towards the foreign investor. In doing so, the host State is maintaining a “healthy investment climate” which, as already said, is essential for the attraction of foreign capital. The establishment of such an administrative framework will, ultimately, lead to an improvement of the overall governance standards in the host State.

<sup>14</sup> Reisman & Sloane, *supra* note 3, 119.

<sup>15</sup> Reisman & Sloane, *supra* note 3, 117. See also Y. L. Fortier & S. L. Drymer, ‘Indirect Expropriation in the Law of International Investment: I Know it When I See it or Caveat Investor’, 19 *ICSID Review* (2004), 298.

<sup>16</sup> I. Brownlie, *Principles of Public International Law*, 6th ed. (2003), 509; Sornarajah, *supra* note 1, 357; for tax measures in international investment arbitration also *cf. Archer Daniels Midland Company and Tate & Lyle Ingredients Americas, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/04/05, Award, 21 November 2007, available at <http://ita.law.uvic.ca/documents/ADMTateRedactedAward.pdf>, para. 238; *Pan American Energy LLC, and BP Argentina Exploration Company v. Argentina*, ICSID Case No. ARB/03/13, Decision on Preliminary Objections, 27 July 2006, paras 117-139; *El Paso Energy International Company v. Argentina*, ICSID Case No. ARB/03/15, Decision on Jurisdiction, 27 April 2006, paras 101-116; *EnCana Corpo-*



In other words, doing business means taking advantage of opportunities while accepting certain risks. Opportunities, or in other words, “favourable business conditions and goodwill, are transient circumstances, subject to inevitable change.”<sup>17</sup> Thus, the materialization of a risk ordinarily related to a business venture does not amount to an expropriation.<sup>18</sup> It is necessary to distinguish between the legitimate interest in adjusting and executing national policies and the abuse of sovereign powers through illegitimate interferences in foreign investment activities which are tantamount to expropriation.<sup>19</sup>

International tribunals, arbitration courts, jurists and scholars “have increasingly accepted that expropriation must be analysed in consequential rather than formal terms,”<sup>20</sup> and no single, clear-cut test has emerged so far

*ration v. Ecuador*, LCIA Case No. UN3481, Award, 3 February 2006, paras 141, 145, 177; *Enron Corporation and Ponderosa Assets, L.P. v. Argentina*, Decision on Jurisdiction, 14 January 2004, paras 25-32; *Marvin Roy Feldman Karpa (Cemsa) (USA) v. United Mexican States*, ICSID (Additional Facility) Case No. ARB(AF)/99/1, Award, 16 December 2002, 42 I.L.M. 626 (2003) (hereafter referred to as *Feldman*); *United Parcel Service of America Inc. v. Canada*, UNCITRAL Arbitration, Award on Jurisdiction, 22 November 2002, paras 116-117; *Link-Trading Joint Stock Company v. Moldova*, UNCITRAL Arbitration, Award, 18 April 2002, paras 63-92.

<sup>17</sup> H. Sedigh, ‘What Level of Host State Interference Amounts to a Taking under Contemporary International Law?’, 2 *Journal of World Investment* (2001) 4, 646.

<sup>18</sup> *The Oscar Chinn Case, U.K. v. Belgium*, Award, 12 December 1934 (hereafter referred to as *Oscar Chinn*), *PCIJ Rep. Series A/B*, No. 63, 88: “No enterprise [...] can escape from the chances and hazards resulting from general economic conditions. Some industries may be able to make large profits during a period of general prosperity, or else by taking advantage of a treaty of commerce or of an alteration in customs duties; but they are also exposed to the danger of ruin or extinction if circumstances change. Where this is the case, no vested rights are violated by the State.”; *Starrett Housing Corp. v. Iran*, 4 Iran-U.S. Claims Tribunal Rep. (1983), 156: (hereafter referred to as *Starrett Housing*) “Investors in Iran, like investors in all other countries, have to assume a risk that the country might experience strikes, lock-outs, disturbances, changes of economic and political system and even revolution. That any of these risks materialised does not necessarily mean that property rights affected by such events can be deemed to have been taken.” *Feldman, supra* note 15, para. 112: “Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue [...]”.

<sup>19</sup> Reisman & Sloane, *supra* note 3, 17.

<sup>20</sup> *Revere Copper and Brass, Inc. v. Overseas Private Inv. Corp.*, OPIC Award, 24 August 1978, 58 *ILM* (1980), 271-272; lately, T. Wälde & A. Kolo, ‘Environmental Regulation, Investment Protection and “Regulatory Taking” in International Law’, 50 *International and Comparative Law Quarterly* (2001), 813; Reisman & Sloane,

to determine whether an indirect expropriation has taken place.<sup>21</sup> Indeed, it seems that the organic and slow “common law method of case-by-case development is pre-eminently the best method, in fact probably the only method, of legal development”<sup>22</sup> in this field. The discussion surrounding three important factors which have emerged from this process deserve to be mentioned here.

The severity of the impact on the owner’s legal status, namely the ability to use, enjoy, control and freely dispose of his investment, has been accepted as a central factor in drawing the dividing line between expropriation and legitimate administrative regulation.<sup>23</sup> Importantly, however, it is controversial whether this severity is the sole/predominant factor<sup>24</sup> or merely one of several important factors.<sup>25</sup> There is case law supporting both

*supra* note 3, 121. A wide range of State measures may be interpreted as expropriatory if those measures significantly reduce the value of the property rights of an investor or render them useless; see Reisman & Sloane, *supra* note 3, 123.

<sup>21</sup> Sornarajah, *supra* note 1, 351.

<sup>22</sup> Christie, *supra* note 1, 338; *cf.* also Reed & Bray, *supra* note 3, 13; Reinisch, *supra* note 3, 438; Newcombe & Paradell, *supra* note 6, 344, 366-368.

<sup>23</sup> Dolzer, *supra* note 12, 79; Z. A. AlQurashi, ‘Indirect Expropriation in the Field of Petroleum’, 5 *Journal of World Investment and Trade* 6 (2004), 911.

<sup>24</sup> One strand of case law supports this doctrine: *Tippetts, Abbett, McCarthy, Stratton v. Tams-Affa Consulting Engineers of Iran* (hereafter referred to as *Tippetts*), 6 Iran-U.S. C.T.R. (1984), 225–226; *Starrett Housing*, *supra* note 17, 154; *Phelps Dodge Corp. v. Iran*, 10 Iran-U.S. C.T.R. (1986), 130; *Metalclad Corp. v. United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000 (hereafter referred to as *Metalclad*), para. 103; *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre and the Government of Ghana* (hereafter referred to as *Biloune*), 95 *ILR* (1989), 183 *et seq.*; *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6, Award, 12 April 2002, para. 107; *Compañía del Desarrollo de Santa Elena, S.A. v. Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, para. 76. For a more detailed analysis of the presented case law, refer to AlQurashi, *supra* note 22, 907–909 and Dolzer, *supra* note 12, 86–90.

<sup>25</sup> Another strand of case law suggests that there are more factors to be taken into consideration: Oscar Chinn, *supra* note 17, 88. See also T. Weiler, ‘Saving Oscar Chinn: Non-Discrimination in International Investment Law’, in N. Horn, (ed.), *Arbitrating Foreign Investment Disputes* (2004), 159-192; *Barcelona Traction, Light & Power Co., Belgium v. Spain*, (hereafter referred to as *Barcelona Traction*), *ICJ Rep.* (1970), 1, see separate opinions of Judge Fitzmaurice, 106, Judge Gros, 273, and Judge Tanaka, 159; *Sea-Land Services*, *supra* note 11, 149; *S. D. Myers, Inc. v. Canada*, First Partial Award, 13 November 2000 (hereafter referred to as *S. D. Myers*); *Técnicas Medioambientales Tecmed S.A. (Spain) v. The United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, 29 May 2003, at para. 116 (hereafter referred to as *Tecmed*); see also the *Feldman* case, *supra* note 15. For a more detailed analysis of the

views.<sup>26</sup> In this article, we follow the school of thought that determining indirect expropriation only by diminution in property value might reduce national policy space to zero as governments would then be confronted with claims for compensation any time they change policy;<sup>27</sup> and this would limit international law on foreign investment to an insurance policy against bad business decisions.<sup>28</sup> We will proceed, therefore, from the assumption that the impact of the State measure is a central but not the sole factor.

The degree of interference with property rights which is necessary in order to hold a State liable for indirect expropriation is also controversial.<sup>29</sup> Again, two strands of case law have emerged. One line of case law, basically as evidenced by decisions of the European Court of Human Rights (ECHR),<sup>30</sup> requires that property rights have been rendered totally valueless, i.e. the investor has been definitely and fully deprived of the ownership of his property,<sup>31</sup> while more moderate authorities demand a significant or sub-

presented case law, refer to AlQurashi, *supra* note 22, 909–911, Dolzer, *supra* note 12, 81–86.

<sup>26</sup> Dolzer points at the weakness of the “sole effect doctrine”, stating that “the proponents of the ‘sole effect doctrine’ would have to explain why international law protecting aliens should require a higher standard of protection than the major domestic legal orders”; Dolzer, *supra* note 12, 91.

<sup>27</sup> Wälde & Kolo, *supra* note 19, 839; F. O. Vicuña, ‘Carlos Calvo, Honorary NAFTA Citizen, Keynote Address’, 11 *New York University Environmental Law Journal* (2002), 27; J. Paulsson & Z. Douglas, ‘Indirect Expropriation in Investment Treaty Arbitrations’, in N. Horn, (ed.), *Arbitrating Foreign Investment Disputes* (2004), 145–158, at 146; Feldman, *supra* note 15, para. 112.

<sup>28</sup> American Law Institute, *Restatement (Third) of the Foreign Relations Law of the U.S.A.*, Vol. 2, 1987, §712, comment g. Cf. also Reinisch, *supra* note 3, 433.

<sup>29</sup> Summarizing Wälde & Kolo, *supra* note 19, 837 *et seq.*

<sup>30</sup> See, for example, the following cases: *Handyside v. United Kingdom*, ECHR (1976) Series A, No. 24, 29; *Poiss v. Austria*, ECHR (1987), Series A, No. 117, 108; *Sporrong and Lönnroth v. Sweden*, ECHR (1982) Series A, No. 52, 1 *et seq.* (hereafter referred to as *Sporrong and Lönnroth*); *Matos e Silva, Lda. and Others v. Portugal*, ECHR (1996-IV), No. 14, 1092, para. 79; all cases also available at: <http://cmiskp.echr.coe.int/tkp197/search.asp?skin=hudoc-en> (last visited 9 April 2009). See, for a more detailed discussion, H. R. 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”’, 11 *New York University Environmental Law Journal* (2002), 148–173; See also E. M. Freeman, ‘Regulatory Expropriation under NAFTA Chapter 11: Some Lessons from the European Court of Human Rights’, 42 *Columbia Journal of Transnational Law* (2003), 184–204.

<sup>31</sup> *Sporrong and Lönnroth*, *supra* note 29, para. 63; *Fredin v. Sweden*, ECHR (1991) Series A No. 192; *Starrett Housing*, *supra* note 17, 154; *Tippetts*, *supra* note 23, 225 *et seq.*; *Kozacioğlu v. Turkey*, judgment of 19 February 2009, para. 70; also refer to *Lauder v. Czech Republic*, UNCITRAL Arbitration, Award, 3 September 2001, para.

stantial interference with the property rights.<sup>32</sup> The ECHR leaves the State a rather wide “margin of appreciation” in the implementation of their domestic laws and regulations referring to expropriation.<sup>33</sup> However, this strand of case law should not be over-emphasized; nor should it have “authoritative” impact on the determination of indirect expropriation outside the European Convention for the Protection of Human Rights and Fundamental Freedoms,<sup>34</sup> as the Convention and its First Protocol<sup>35</sup> aim to set minimum standards for the protection of fundamental rights<sup>36</sup> and are not an investment protection agreement and, therefore, do not intend to establish “a healthy investment climate” – in other words, an elevated standard for the protection of property – as BITs and MITs do. In the context of the latter, there is a stronger emphasis on the protection of the legitimate interests of a foreign investor. Therefore, this article proceeds from the assumption that a significant or substantial interference with property rights, i.e. a significant reduction of value, is sufficient for the establishment of an indirect expropriation

198, which stated that a detrimental effect on the economic value of property is not sufficient to constitute an expropriation.

<sup>32</sup> *Pope & Talbot Inc. v. Canada*, Interim Award, 26 June 2000, paras 96–98, 102; *S. D. Myers*, *supra* note 24, para. 283; *Feldman*, *supra* note 15, para. 110; *Revere*, *supra* note 19, 258–330; *Metalclad*, *supra* note 23, para. 103; *CME Czech Republic B.V.(The Netherlands) v. Czech Republic*, UNCITRAL Arbitration, Partial Award, 13 September 2001, para. 604 (hereafter referred to as *CME*); *Tecmed*, *supra* note 24, para. 115; *GAMI Investment, Inc. v. Mexico*, UNCITRAL Arbitration, Final Award, 15 November 2004, para. 126; *Telenor Mobile Communications A.S. v. Hungary*, ICSID Case No. ARB/04/15, Award, 13 September 2006, para. 65; *LG&E Energy Corp.*, *supra* note 8, paras 188-191; *Enron Corp.*, *supra* note 8, para. 245; *Eastern Sugar B.V. v. Czech Republic*, SCC Case No. 088/2004, Partial Award, 27 March 2007; *M.C.I. Power Group L.C. and New Turbine, Inc. v. Ecuador*, ICSID Case No. ARB/03/6, Award, 31 July 2007, para. 300; *Parkerings-Compagniet A.S. v. Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007; *Sempra Energy*, *supra* note 8, para. 284. See, for a brief discussion, OECD, “*Indirect Expropriation*” and the “*Right to Regulate*” in *International Investment Law*, Working Papers on International Investment No. 2004/4; available at: [www.oecd.org/dataoecd/22/54/33776546.pdf](http://www.oecd.org/dataoecd/22/54/33776546.pdf) (last visited 11 August 2005), 10–14.

<sup>33</sup> *Freeman*, *supra* note 29, 189–191; ECHR, *Mellacher and Others v. Austria*, judgment of December 19, 1989, Series A No. 169, para. 45.

<sup>34</sup> Posing the same question, see R. Dolzer, ‘Indirect Expropriation: New Developments?’, 11 *New York University Environmental Law Journal* (2002), 74.

<sup>35</sup> Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950 and its first Protocol; available at: [www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf](http://www.echr.coe.int/NR/rdonlyres/D5CC24A7-DC13-4318-B457-5C9014916D7A/0/EnglishAnglais.pdf) (last visited 1 September 2005).

<sup>36</sup> Compare Article 53 ECHR; see also C. Grabenwarter, *Europäische Menschenrechtskonvention*, 2nd ed. (2005), §2, mn. 14.

if the other criteria are met: first and foremost, the effect of the State measure on the legitimate expectations of the investor; and the nature of the governmental action.

Finally, as just mentioned, an important factor to be taken into consideration is the nature, i.e. the purpose and context, of the governmental action. This issue directs our attention towards the question of whether the State measure affecting the property rights of the foreign investor promotes a recognized social purpose or the general welfare, e.g. public health, safety, the rule of law, morals or welfare, etc., and whether it is carried out taking due account of the legitimate expectations of the investor<sup>37</sup> with a non-

<sup>37</sup> “Investors are ready, and can be expected to be ready, to accept the regulatory regime in situations in which they invest [because they are in the position to make a risk/reward assessment of their investment]. Investment protection rather turns around the issues of unexpected changes with an excessive detrimental impact on the foreign investor’s prior calculation.” Wälde & Kolo, *supra* note 19, 819. Courts, tribunals [*cf. Aminoil, supra* note 12, 1034; *Phillips Petroleum Co. Iran v. Iran*, 21 Iran-U.S. C.T.R. (1989), 79 *et seq.*; *Amoco International Finance Corporation v. Iran*, 15 Iran-U.S. C.T.R. (1987), 189 *et seq.*; *Starrett Housing, supra* note 17; *Metalclad, supra* note 23, paras 89, 99; *Feldman, supra* note 15, paras 145 *et seq.*; *Tecmed, supra* note, paras 91, 149 *et seq.*, 154; *International Thunderbird Gaming Corporation v. Mexico*, UNCITRAL Arbitration, Arbitral Award, 26 January 2006, para. 147; *LG&E Capital Corp. and LG&E International Inc. v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, para. 195 (hereafter referred to as *LG&E Capital*). Also, the ECHR has relied on this concept; see the ECHR cases quoted by Dolzer, *supra* note 33, 78–79, and commentators *cf.* e.g. AlQurashi, *supra* note 22, 913; see also Wälde & Kolo, *supra* note 19, 821 *et seq.*, who want to rely heavily on jurisprudence of the U.S. Supreme Court] have frequently referred to the interpretative factor of the “disappointment of legitimate expectations”. In order to distinguish regulation from indirect expropriation, one has to ask whether the State has frustrated the legitimate expectations of the investor based on representations and actions of the host State. In order to do so, one must base one’s evaluation on the facts, taking into account all aspects of the specific case at hand. Not only contractual commitments formalize legitimate expectations but also formal governmental promises in treaties, laws and even investment brochures do so. See A. A. Fatouros, *Government Guarantees to Foreign Investors* (1962), 69 *et seq.*; more critical: Sornarajah, *supra* note 1, 100 *et seq.*; just recently, M. W. Reisman & M. H. Arsanjani, ‘The Question of Unilateral Governmental Statements as Applicable Law in Investment Disputes’, 19 *ICSID Review* (2004), 328–343, which lacks, however, a dogmatic explanation of how a State can bind itself by unilateral statement - despite its value as evidence for the creation of legitimate expectations within the concept of indirect expropriation or fair and equitable treatment - in international law towards an investor which is very often not a subject of international law; see also *Southern Pacific Properties (Middle East) Ltd. and Southern Pacific Properties Ltd (Hong Kong) v. Arab Republic of Egypt*, ICSID Case No. ARB/84/3, Decision on Jurisdiction and Dissenting Opinion, 14 April 1988 (hereafter

discriminatory,<sup>38</sup> non-protectionist,<sup>39</sup> transparent, *bona fide* attitude advancing legitimate State interests. A State measure advances “the common good” if it pursues a legitimate purpose, is necessary and proportionate.<sup>40</sup> However, even a legitimate, non-discriminatory regulation might require compensation if an individual investor is required to make a special sacrifice, i.e. giving up legitimate expectations for enjoying his investment-backed property, for the benefit of the society at large.<sup>41</sup>

referred to as *Southern Pacific Properties*), excerpts of the Decision published in 16 *Yearbook Commercial Arbitration* (1991), 28, para. 46. This concept allows, firstly, to focus on the legal situation in the host State at the time when the investment is placed in that country. Secondly, it contains the idea that an expectation deserves more protection as it is increasingly backed by investment and, thirdly, it harbours an element of flexibility, i.e. legitimate expectations may fade in time and there may be a change of priorities in the host society; Dolzer, *supra* note 33, 78–79.

<sup>38</sup> “[A]ny taking that is pursuant to discriminatory or arbitrary action, or any action that is without legitimate justification, is considered to be contrary to the non-discrimination requirement, even absent any singling-out on the basis of nationality. This includes prohibition of discrimination with regard to due process and payment of compensation requirements. Moreover, the non-discrimination requirement demands that governmental measures, procedures and practices be non-discriminatory even in the treatment of members of the same group of aliens.” UNCTAD, *International Investment Agreements: Key Issues*, Vol. 1, 2004, 239. That also means that in order to fall foul of the non-discrimination rule it is not required that the host State discriminates explicitly and formally against the foreign investor; it is sufficient that the State measure is discriminatory in its effect. For the application of this notion in recent NAFTA awards, refer to *S. D. Myers*, *supra* note 24, para. 308. See also Wälde & Kolo, *supra* note 19, 835–837. For an older notion of discrimination and the general problem of its application, consult W. McKean, *Equality and Discrimination under International Law* (1983); E. W. Vierdag, *The Concept of Discrimination in International Law* (1973).

<sup>39</sup> It is no easy task to establish the “intention” of a government. However, “formal statements of the responsible Minister or a series of circumstances pointing to the protectionist intent being the main motivator for a policy can be taken to indicate the ‘intention’”; Wälde & Kolo, *supra* note 19, 826, footnote 66. See especially the First Partial Award, paras 171-195 and the separate Concurring Opinion of B. Schwartz, paras 62-63, in *S. D. Myers*.

<sup>40</sup> Wälde & Kolo, *supra* note 19, 827.

<sup>41</sup> S. Rose-Ackermann & J. Rossi, ‘Disentangling Deregulatory Takings’, 86 *Virginia Law Review* (2000), 1441-1496. See also Bundesgerichtshof (German Federal Supreme Court), BGHZ 6, 280; Bundesverwaltungsgericht (German Federal Administrative Court), BVerwGE 5, 145; BVerwGE 19, 98. The “special sacrifice” (*Sonderopfer*) concept is of primary importance in German constitutional expropriation law but is also known to the U.S. legal order; refer to *Monogahela Navigation Corp. v. U.S.*, 148 US (1893), 312. Its underlying principle is discrimination, but it goes beyond this concept. It is intended to protect the minority against the majority, prevent-

## B. Scenarios of State Measures

### I. State Measures Which Are Lawful by National Standards

#### 1. First Scenario: A State Measure Which Is Lawful by National Standards But Discriminatory

As mentioned before, as long as a government exercises its administrative powers in a transparent, non-discriminatory and lawful way with beneficial intentions, negative effects on a foreign investment, legal or illegal, are unlikely to be remediable. Rather, they are the result of the changing business conditions inevitably linked to any business venture. Departing from this unlikely ideal world, we turn our attention to the first of our six scenarios.

Under Russian law, raw materials and subsoil resources are the property of the State.<sup>42</sup> However, Russian law provides for the right of a third party to acquire such assets.<sup>43</sup> A mining licence is the legal instrument which is used to acquire title to a good that is being extracted from underground. Due to its importance and special nature, a mining licence is typically acquired through a tender. One of the major criteria for decision under the tender regime is the minimal amount to be extracted (“Minimal Amount”) for the purpose of ensuring the efficient use of subsoil resources.<sup>44</sup> However, in many cases, the Minimal Amounts are not matched in practice. Also, formal violations of law reportedly take place frequently;

ing the latter from shifting the costs of regulation to the former; see, Wälde & Kolo, *supra* note 19, 845. The authors of this article are aware of the fact that it is critical to derive principles on indirect expropriation from cases decided in national fora, at least if one draws heavily only on the case law developed in one single nation (Wälde and Kolo indeed do so, arguing that U.S. law, as the law of the last hegemonic power, enjoys extra authority; Wälde & Kolo, *supra* note 19, 821–822, even if it might be the most powerful nation at present. One must consider these national principles, but as part of a comparative study of the rules developed in other major jurisdictions. This approach would be in conformity with the teaching on the sources of international law in regard to the “general principles of law” embodied in Article 38 of the Statute of the ICJ; Dolzer, *supra* note 12, 69,76–78.

<sup>42</sup> Article 1.2 of the Russian Law “On the Subsoil” – “O nedrakh” No. 2395-I dated 21 February 1992.

<sup>43</sup> Articles 1.2 and 12 of the Russian Law “On the Subsoil” – “O nedrakh” No. 2395-I dated 21 February 1992.

<sup>44</sup> Article 13.1 of the Russian Law “On the Subsoil” – “O nedrakh” No. 2395-I dated 21 February 1992.

that is, there are minor procedural deviations from the way the licence is to be issued, for instance the signatures on the licence are not being made on the document as anticipated by legislation.<sup>45</sup>

In our first scenario, a number of investors receive a mining licence. The mining licence of one of these investors is withdrawn because of non-compliance with the terms of the licence (Minimum Amounts) and due to formal violations of the rules on licence issuance at the time of the granting of the licence. As a consequence of the withdrawal, he goes bankrupt. Under similar conditions, other investors' licences remain intact.

#### a) Russian Law

Under the Subsoil Law, the licensing authority is entitled to withdraw the licence provided that the conditions for doing so are set out in law.<sup>46</sup> However, in accordance with Articles 20 and 50 of the Subsoil Law, a licensee has the right to challenge the licence withdrawal in court. A licence is seen as an act undertaken by the administration.<sup>47</sup> Thus, the rules established by the Arbitration Procedure Code of the Russian Federation for challenging administrative acts (including appealing rules)<sup>48</sup> have been applied. Currently, there is no body of legislation or theory in Russia which would give guidance to public authorities when deciding upon cases dealt with by administrative bodies;<sup>49</sup> in particular, there is no theory of due process.<sup>50</sup> As a

<sup>45</sup> As an example, see M. Pustilnik, Russian authorities show new interest in oil companies, *Moscow News*, 28 July 2005; available at: [www.gasandoil.com/goc/news/ntr43548.htm](http://www.gasandoil.com/goc/news/ntr43548.htm) (last visited 29 April 2009).

<sup>46</sup> Article 20 of the Russian Law No. 2395-I dated 21 February 1992 "On the Subsoil" – "O nedrakh".

<sup>47</sup> It should be noted that Russian practice or law does not know of the term "administrative act" as such (*Verwaltungsakt*).

<sup>48</sup> Chapter 24 of the Arbitration Procedure Code of the Russian Federation of 2002.

<sup>49</sup> M. Gutbrod, 'Aktualnye problemy regulirovaniya Rossiskogo bankovskogo sektora i finansovykh rynkov', *Financial Risks Management*, No. 3/2005, 2 *et seq.*

<sup>50</sup> For example, the term is only mentioned in Article 4(11) of Federal Law No. 164 – FZ, 8 December 2003 "On the Fundamental Principles of the State Regulation of Foreign Trade Activity": "[...] the basic principles of the state regulation of foreign trade activity shall be: [...] ensuring the right to appeal, either *in due process* of law or in accordance with any other procedure prescribed under the law, against any illegal actions (inaction) of governmental agencies and their officials and also the right to challenge regulatory legal acts of the Russian Federation, derogating from the right of a participant in foreign trade activity to conduct such foreign trade activity." (emphasis added).



consequence, from the perspective of the holder of a licence, there is no body of doctrine he could rely upon when his licence is revoked.<sup>51</sup> In particular, there is no basis in theory to support the argument that purely formal violations of the conditions of licensing that have no material consequences cannot lead to the withdrawal of a licence, and the general view is that the revocation for such formal reasons is lawful.

The argument that other investors in similar situations would not have their licences withdrawn would also not be heard in any of the proceedings. Whilst there is a general prohibition of discrimination under the Russian Constitution, this has not been implemented in procedural law up to now.

Turning to the possibility of proceedings before the Constitutional Court, due to the very complicated procedures, rules, and reasons for initiation of proceedings by the Russian Constitutional Court, it is unlikely to hear the case, although sometimes decisions of the Russian Constitutional Court are unexpected and do not clearly follow established rules.

Furthermore, a licence is not deemed to be a property right.<sup>52</sup> The fact that investors are willing to pay a higher price for a company when it has a licence would suggest that, if the licence is looked at from an economic perspective, it has a value and therefore is a property right or at least is to be treated as a property right. Nevertheless, in the commentaries<sup>53</sup> to the Russian Constitution, licences in general and mining licences in particular are not mentioned as potentially being property rights, and in the few deci-

<sup>51</sup> See, for instance, the Decision of the Federal Russian Arbitrazh Court of the District of Moscow, No. KA-A40/4680-05, 2 June 2005.

<sup>52</sup> For instance, the relevant statutes in Article 2 of the Law “About licensing of different kinds of activity”, No. 128-FZ, dated 8 August 2001, give no indications in regard to the existence of characteristics resembling property rights: possession, use and disposal. In addition, the term “property right” itself is not mentioned.

<sup>53</sup> O. E. Kutafin, *Commentary to the Russian Constitution* (2003), Articles 24(1), 36(2), 55(3), 57, 75(3), and 132(1); L. L. Lasarev, *Commentary to the Russian Constitution*, 2003, Articles 14(6), 9(1), 24(4), 34(4), 37(1), 57(1), 58(4), 75(3), and 114(2) and (4); W. D. Karpovich, *Commentary to the Russian Constitution* (2002), Articles 24(1), 37(1), 43(2), 45(2), 57, 71, 72(1), 74(1), 103(1), and 132(1); L. A. Okunkova, *Commentary to the Russian Constitution* (1994), Articles 41, 45, and 114.

sions<sup>54</sup> concerning the withdrawals of mining licences, the argument that a licence could be a property right has not played any role.<sup>55</sup>

Moreover, whilst under the Constitution<sup>56</sup> international contracts and maybe even custom would have precedence over national law,<sup>57</sup> this has never, to the best of our knowledge, led to issues of due process (according to international standards) or discrimination being discussed in Russian courts.<sup>58</sup>

In summary, the investor is unlikely to succeed with his claim in Russian courts.

<sup>54</sup> Reportedly, there have been only a few instances in which mining licences have actually been withdrawn. Even in the context of what has often been described in the press as a crusade against Yukos, Yukos has not actually lost any of the mining licences which reportedly violated mining legislation.

<sup>55</sup> *Northgas v. Gazprom*, Decision of the Federal Arbitrazh Court of the District of Moscow, No. KA-A40/12425-04, dated 11 January 2005.

<sup>56</sup> Virtually all Russian authors dealing with issues of the application of international treaties in the Russian Federation ground their positions on Article 15(4) of the Constitution of the Russian Federation, which states that “[t]he universally-recognized norms of international law and international treaties and agreements of the Russian Federation shall be a component part of its legal system. If an international treaty or agreement of the Russian Federation fixes rules other than those envisaged by law, the rules of the international agreement shall be applied.” See [www.constitution.ru/en/10003000-02.htm](http://www.constitution.ru/en/10003000-02.htm) (last visited 8 April 2009).

<sup>57</sup> See, for instance, T. N. Neshatayeva, *International Civil Procedure* (2001), 46: “A question on the norms of jus cogens character, which mostly exist in the form of custom has already been touched upon. Considering these norms as principal ones apparently witnesses that the widest application of them is possible in the practice of the RF Constitutional Court [...]. It is possible to assume that the priority of the interpretation of jus cogens norms (norms-principles) by the RF Constitutional Court is a feasible approach to this question for Russian judicial practice in general [...] The issue becomes more complicated when it concerns other international legal norms of customary origin. Article 15 of the RF Constitution, and later Article 7 of the RF Civil Code included the norms of this type (the universally-recognized norms of international law) into the Russian legal system. But their place in the system is less clear in comparison to treaties [...]. While hearing economical disputes in Arbitrazh Courts one can already meet participants’ references to well-known international norms of customary character. First of all, this is true for the substantive norms contained in widely known international conventions which are not mandatory for the Russian Federation [...]. At this time courts are extremely cautious in appraisal of the procedural norms of those conventions that are not in force for Russia yet.”

<sup>58</sup> *Northgas v. Gazprom*, *supra* note, 54; *Yukos*, Decision of the Constitutional Court, No. 36-O, dated 18 January 2005.

## b) International Investment Agreements

The foreign investor's licence,<sup>59</sup> but not those of his competitors, irrespective of whether they are nationals of the host country or other foreign investors, is revoked (i) due to his non-compliance with the terms of issuance and (ii) due to formal deficiencies with the licence. This scenario clearly raises the issue of discrimination, which we will focus on here.

As aforementioned, the non-discrimination requirement in the event of indirect expropriation "demands that governmental measures, procedures and practices be non-discriminatory even in the treatment of members of the same group of aliens."<sup>60</sup> It is apparent that this is not the case here. In spite of this, one may argue in favour of the State that the government is "merely" enforcing the law, in other words serving the rule of law when revoking a defective licence whose issuance terms were not followed by the investor.

Regarding the "non-compliance with the terms of the licence," under international law the investor certainly has no legal right to have his licence be held valid if he does not act in conformity with its terms. He was aware of the terms at the moment of receipt and could not have had any legitimate expectations that an illegal situation would be tolerated. A single investor or a group of investors within a larger grouping of investors in a similar situation may have conducted their business not in compliance with the licence conditions and, therefore, also not in compliance with the law; but even if this is tolerated by the administration for some time, the investors cannot rely on continued toleration of the illegal situation. The same applies to an investor whose illegal conduct of business was not tolerated right from the beginning. He cannot claim to be discriminated against simply because he was being treated in compliance with the law. Any other finding would be clearly against the rule of law and the principle of legality (*Legalitätsprinzip*). Likewise, if the administration changes its internal practice in general in regard to the application of administrative discretion after it learns about the illegality and begins to apply the law properly, then of course there is no

<sup>59</sup> Licences are now clearly protected by IIAs; see for example *Amco Asia Corporation, Pan American Development Limited and P.T. Amco Indonesia v. Republic of Indonesia*, ICSID Case No. ARB/81/1, Decision Annuling the Award, 16 May 1986 (hereafter referred to as *Amco* (Annulment)), 25 I.L.M. (1986), 1439 *et seq.*; *cf.* also for example *Metalclad*, *supra* note 23; *Tecmed*, *supra* note 24; see also Sornarajah, *supra* note 1, 389 *et seq.*

<sup>60</sup> UNCTAD, *International Investment Agreements: Key Issues*, Vol. 1 (2004), 239.

expectation which deserves to be protected. A government must have the right to return to a state of legality.<sup>61</sup>

This principle was correctly applied in the *Estonian Bank Licence* case (*Genin (U.S.A.) v. Estonia*)<sup>62</sup> The Central Bank of Estonia cancelled the bank licence of the claimant in conformity with the Estonian Banking Code<sup>63</sup> due to the Claimant's severe violations. The Tribunal rejected the claim for compensation due to the fact that the Central Bank of Estonia had carried out its supervision duty in full compliance with the law, non-arbitrarily, and without discrimination; and in doing so, the Tribunal balanced the procedural conduct of the government and the (illegal) conduct of the investor.

However, one must ask whether the same reasoning can be applied if the government fails generally to enforce a certain law – which it was obliged to do without any discretion and was able to enforce – when it just picks one out of a group of investors in a similar (illegal) situation and suddenly enforces the given law only against this one particular investor, while claiming to serve the rule of law? We do not think so.<sup>64</sup> If a statute fails to create its intended “equal treatment” generally by systematic illegal execution<sup>65</sup> of the law, then the proper application in one or a few instances would constitute a violation of the non-discrimination requirement. Equality under the law means first and foremost equal application of it.<sup>66</sup> Even if the investor is not entitled to demand treatment which is against the law, he has the right to demand that the State not apply the law in his case differently from

<sup>61</sup> Of the same opinion but not differentiating: AlQurashi, *supra* note 22, 914.

<sup>62</sup> *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia*, ICSID Case No. ARB/99/2, Award, 25 June 2001.

<sup>63</sup> Even if a revocation of a licence is well justified, the State must act with procedural regularity; otherwise, it would be held liable to pay compensation. In *Middle Eastern Cement Shipping* and *Metalclad*, the host State was not held liable for the cancellation of the licence but for a lack of due process, especially for a lack of transparency.

<sup>64</sup> For a more detailed and principled account of this issue *cf.* S. Hindelang, ‘No Equals in Wrong? The Issue of Equality in a State of Illegality’, 7 *Journal of World Investment and Trade* 6 (2006), 883-897.

<sup>65</sup> This means that the investor should be able to demonstrate that the State, in respect to the other instances, was not acting due to ignorance of these instances or legal obstacles which would bar it from enforcing the law in question but due to reasons unrelated to the aforementioned.

<sup>66</sup> V. Götz, ‘Über die “Gleichheit im Unrecht”’, in O. Bachof *et al.* (eds), *Verwaltungsrecht zwischen Freiheit, Teilhabe und Bindung: Festgabe aus Anlass des 25jährigen Bestehens des Bundesverwaltungsgerichts* (1978), 254.

how it applies it in other cases.<sup>67</sup> Thus, the investor has the right to be protected from the burden of an application of a previously unenforced law as long as the State does not return to a state of legality in all similar cases.<sup>68</sup> In order to avoid abusing the argument regarding intentions to return to a state of legality, which is in principle the obligation of the host State, the host State must demonstrate that it enforces the given law now in all situations similar to that of the investor. If a host State lacks the capabilities to handle all cases at once, it must demonstrate that the enforcement of a given law against the investor is the first instance in a uniform conceptual approach towards the state of legality.<sup>69</sup>

With regard to our scenario, this would mean that the State should be barred from pleading that it serves the principle of legality as long as it fails to demonstrate that it is truly returning to a state of legality.<sup>70</sup> Thus, the treatment of the investor must be characterized as arbitrary, discriminatory and exposing him to sectional prejudice. The investor “expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments.”<sup>71</sup>

The answer to the question of whether a revocation of the licence on the grounds of a “formal violation” of the law on licence issuance is subject to the provisions of the IIAs on indirect expropriation depends, firstly, on whether the investor was able to remedy this revocation immediately at the moment of announcement. If he, however, did not do so due to the fact that the rules on licence issuance lacked clarity or were contradictory, then those formal defects should not destroy the investor’s legitimate expectations for

<sup>67</sup> It is important to note that this observation applies only to the situation in which the State is obliged by law to interfere with a right of an investor in a certain way without any discretion but does so only on a selective basis. This is not to be confused with the notion of “no equality in wrong” (*keine Gleichheit im Unrecht*), in German constitutional doctrine. For the distinction - a detailed outline would go beyond the scope of this article - refer to C. Kölbl, *Gleichheit “im Unrecht”* (1998).

<sup>68</sup> *Id.*, 80, especially p. 141 (English summary); an argument stating that the principle of legality demands the immediate proper execution of the law in question against the investor implies that the principle of legality takes precedence of the principle of equality. This is doubtful. The principle of legality carries inherently the demand of due application of the principle of equality; *Id.*, 43, 83.

<sup>69</sup> *Id.*, 82, 90.

<sup>70</sup> An exception might be necessary in situations in which immediate action is necessary in order to avert damage to life and limb.

<sup>71</sup> *Tecmed*, *supra* note 24, para. 154.

the continuing validity of the licence.<sup>72</sup> In the words of one commentator, governments “should not be able to rely on legal and formal technicalities if they consistently (in particular with respect to nationals) disregard such technicalities or if such technicalities were not discernible to the investor and its domestic legal advisers for reasons of lack of transparency.”<sup>73</sup> This

<sup>72</sup> See, in general, on the issue of transparency in IIAs, UNCTAD, *Transparency*, UNCTAD Series on Issues in International Investment Agreements, 2004, especially 63; available at: [www.unctad.org/en/docs/iteiit20034\\_en.pdf](http://www.unctad.org/en/docs/iteiit20034_en.pdf) (last visited 30 August 2005).

<sup>73</sup> T. Wälde, ‘Investment Arbitration under the Energy Charter Treaty: An Overview of Key Issues’, 1 *Transnational Dispute Management* (2004) 2; available at: [www.transnational-dispute-management.com](http://www.transnational-dispute-management.com) (last visited 11 August 2005). The concept of transparency arrived late in international investment law. In regard to the standard of treatment, two cases deserve to be mentioned. In *Metalclad*, *supra* note, 23, para. 76, the NAFTA Tribunal defined the concept of transparency (stated in Article 1802 NAFTA) as requiring the following: “[...] all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another Party.” If a State becomes aware of “confusion or misunderstanding” among investors concerning the legal requirements to be fulfilled, the Party would have “the duty to ensure that the correct position [would be] promptly determined and clearly stated so that the investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws” (summary taken from OECD, *Fair and Equitable Treatment Standard in International Law*, Working Papers on International Investment, No. 2004/3, 37). Since Mexico had failed to provide such a framework, it was held liable for breach of the fair and equitable treatment standard. However, this reading was rejected in a review by the Supreme Court of British Columbia on the grounds that the treaty obligation of transparency was outside Chapter Eleven and, thus, outside the fair and equitable treatment standard. Moreover, the NAFTA Tribunal was charged to have failed to have put forward any evidence that the obligation of transparency has become customary international law. Also, in *Maffezini*, a lack of transparency in administrative conduct was established, which led the Tribunal, in connection with other factors, to the conclusion that Spain had violated the fair and equitable treatment standard contained in the Spain–Argentina BIT. No explanation was given on the precise meaning of the lack of transparency. See *Maffezini (Argentina) v. Kingdom of Spain*, ICSID Case No. ARB/97/7, Award, 13 November 2000. See also UNCTAD, *Transparency*, UNCTAD Series on Issues in International Investment Agreements, 2004, especially 63, available at [www.unctad.org/en/docs/iteiit20034\\_en.pdf](http://www.unctad.org/en/docs/iteiit20034_en.pdf) (last visited 9 April 2009); J. Jr. Hanna, ‘Is Transparency of Governmental Administration Customary International Law in Investor-Sovereign Arbitrations? - Courts and Arbitrators May Differ’, 21 *Arbitration International* (2005), 187.

reasoning is supported by the Decision in the *SwemBalt* case (*Sweden v. Latvia*)<sup>74</sup> and the *Metalclad* case.<sup>75</sup>

Moreover, even if the investor learns about a violation of national laws and the government continues for some time to tolerate this situation, the investor must be protected. If the government later suddenly started enforcing the law in a discriminatory fashion, the same reasoning as that advanced above would apply. But even if the government acts in a non-discriminatory way, it should be liable for compensation if it fails to enforce the law non-proportionately, for example without a transitional period for the old, by national standards “unlawful”, investments. Keeping in mind that IIAs, among other functions, intend to promote rules of good governance, the requirements for the host State, though depending on the individual circumstances, should not be too low.<sup>76</sup> One might therefore conclude that a State, by consistently disregarding legal formalities at the time it issues licences, loses its right to withdraw such licences for those formal violations if it does not conduct the withdrawal with procedural regularity and in a non-discriminatory manner.

<sup>74</sup> Reported by K. Hobér, ‘Investment Arbitration in Eastern Europe: Recent Cases on Expropriation’, 14 *American Review of International Arbitration* (2003), 407. This case was concerned with the removal and subsequent public auctioning of a ship by Latvian governmental officials due to an alleged breach of a lease contract on an anchorage. The Tribunal based its finding of indirect expropriation on the failure of the government to inform the investor about the (alleged) invalidity (retroactive change of laws) of the lease contract in due time (four months inactivity) and cacophonous statements of a governmental official, the participation of governmental officers in the (alleged) illegal activity of concluding the lease contract and the missing proportionality between the (alleged) wrongful act of the investor and State measures; *id.*, 414.

<sup>75</sup> The NAFTA Tribunal in *Metalclad* dealt with a case in which the investor did not obey the local building and environmental rules and thus acted unlawfully in regard to national rules. However, representations were made by governmental officials who were not aware of their own legal order. It was held that the investor’s legitimate expectations in the lawfulness of his undertaking cannot be destroyed if he learns about the illegality of the investment after it was made. Refer also to J. Paulsson & Z. Douglas, ‘Indirect Expropriation in Investment Treaty Arbitrations’, in N. Horn, (ed.), *Arbitrating Foreign Investment Disputes* (2004), 154-157.

<sup>76</sup> Wälde, *supra* note 72.

## 2. Second Scenario: A State Measure Which Is Lawful by National Standards But Discriminatory and Accompanied With *Mala Fide*

In our second scenario, the mining licence is defective as in [scenario 1. The government does not want to withdraw the mining licence because it fears negative consequences for the country's reputation as a location for investment. It therefore suddenly, without giving any prior notice, starts enforcing a certain tax rule or changes the interpretation of a certain tax rule in general, knowing, however, that this change in administrative practice hits only a certain investor or even intending to hit a certain investor. As a consequence, one foreign company goes bankrupt.

### a) Russian Law

Russian law does not sanction a State organ changing the interpretation of tax legislation. The fact that the intention of the taxation was not to obtain money but rather to harm (*mala fide*) would not change this analysis. Also, as already mentioned above, outside the Constitution there is no prohibition of discrimination under Russian law. Whilst Russian law, in particular constitutional law, recognizes the principle of non-discrimination, the literature<sup>77</sup> has apparently only dealt with the implications of this principle for investors at the beginning of their investment activity, and court practice has up to now not taken up these principles.<sup>78</sup>

### b) International Investment Agreements

Changing and adapting national taxation regimes is in general not considered to be an illegitimate regulation but something necessary to maintain and further the overall development and prosperity of a society.<sup>79</sup> As already mentioned, in principle a foreign investor cannot have any legiti-

<sup>77</sup> S. Krupko, 'Investition agreements and disputes between countries and private foreign investors', in *Business and Law* (Attachment No. 5, 5/2001), 6, 14-15, 17-18; S. Krupko, 'Investment activity in the constituent entities of the Russian Federation', in *Business and Law* (No. 10/2000), 42.

<sup>78</sup> *Id.*

<sup>79</sup> Paulsson & Douglas, *supra* note 74, 155-156; R. Dolzer, *Eigentum, Enteignung und Entschädigung im geltenden Völkerrecht* (1985), 252; Newcombe & Paradell, *supra* note 6, 358, para. 7.24.



mate expectation that a given tax regime is not subject to any alterations. This was confirmed, for example, in the awards in *Feldman*<sup>80</sup> and *Goetz*.<sup>81</sup>

In the scenario at hand, however, the situation might be different. If the administration suddenly starts enforcing a certain tax rule in general, knowing, however, that it hits only a certain investor or even intending this, then several conflicting interests need to be balanced. On the one hand, a State must have the right to adapt its tax policy to new situations, maybe even implementing the recommendations of international expert panels. If the tax rules are applied in law and in fact non-discriminatorily, and if this change can be seen as proportionate in regard to the ends pursued with the change, then it is the ordinary risk of doing business when a certain company might not be able to pay its taxes due to its financial situation, i.e. insufficient profits, and this could happen even if the host State was aware of this effect.<sup>82</sup> On the other hand, a discriminating effect, not in law but in fact, but originating from sudden and unexpected changes accompanied by *mala fide* intentions should be remedied by IIAs if the damage suffered by a foreign investor is “substantial”.<sup>83</sup> The investor can reasonably expect that tax laws are not used for protective aims or political purposes totally unrelated to taxation but for the functions usually assigned to them. It was also sudden, unreasonable and unpredictable changes in the application of law, though not a tax law, which led to the finding in favour of the investor in the *CME* case.<sup>84</sup>

From a host State point of view, one could argue in defence of measures taken that the same result (bankruptcy) would have also been inflicted

<sup>80</sup> *Feldman*, *supra* note 15, para. 109-111.

<sup>81</sup> *Goetz and others v. Burundi*, ICSID Case No. ARB/95/3, Award, 10 February 1999, para. 124. Refer also to Paulsson & Douglas, *supra* note 74, 155. See, for the taxation of windfall profits of the oil industry, the *Aminoil* case, *supra* note 12; for the situation in the United States, *U.S. v. Ptasynki*, 462 US (1983), 74 *et seq.*

<sup>82</sup> *Kügele v. Polish State*, Upper Silesian Arbitral Tribunal Case, 5 February 1932, *Amtliche Sammlung von Entscheidungen des Schiedsgerichts für Oberschlesien*, Vol. 3 (1931), 20. See also H. Lauterpacht, *Annual Digest of Public International Law Cases*, Vol. 6 (1931/32), 69.

<sup>83</sup> “Substantial damage” is understood in the sense that a profitable usage of the investment is impossible; R. Dolzer, *Eigentum, Enteignung und Entschädigung im geltenden Völkerrecht* (1985), 252 *et seq.* Refer also to Dolzer, *supra* note 12, 78.

<sup>84</sup> *CME*, *supra* note 31. The actions and non-actions of the Czech Media Council were not part of proper administrative process (no justification for the sudden change in the interpretation of the legal situation or other regulatory measures and its enforcement (1996) and the illegal collusion (1999) with a Czech national with a protectionist intent).

upon the investor by a mining licence withdrawal. Such an argument, however, does not seem very convincing. Even if a licence withdrawal could have been conducted in a non-discriminatory, transparent manner with a *bona fide* intention, as referred to in the first scenario, the plea of a “hypothetical alternative lawful conduct” would not rule out the finding of indirect expropriation<sup>85</sup>, but might, and this is certainly a very cautious ‘might’, only have an effect on the determination of the damages.<sup>86</sup> Thus, to sum up, the conduct of the tax authorities must undoubtedly be attributed to the host State.<sup>87</sup> The discriminatory application of tax laws coupled with *mala fide* in

<sup>85</sup> A first, rather simple argument relates to the rules of causality. An infringement of a given right cannot be imputed to someone if it can be demonstrated that the infringement would also have been caused if this person had acted correctly. For the example here, this would mean that the infringement (indirect expropriation) would also have occurred if the host State had lawfully revoked the licence. This apparently is not the case. Thus, the host State must have inflicted the infringement. A second argument may be drawn from the second *Amco v. Indonesia* Award on the Merits, *Amco Asia Corporation and Others v. The Republic of Indonesia*, ICSID Case No. ARB/81/1, Resubmitted, Award on the Merits, 31 May 1990 (hereafter referred to as *Amco II* (Merits)), in para. 143, the Tribunal states: “[E]ven were a decision on grounds other than those stated in the Degree in principle sustainable, they could no more be lawful than the decision made on grounds of shortfall of investment, because of the general background that pervaded the decision-making.” It does not matter that the same result could have been reached in another way, i.e. that the foreign investment could have also been adversely affected by measures which are in principle sustainable; it is only the process of how this result is reached (and that this process was ultimately malconducted) which matters. Of the same opinion: Sornarajah, *supra* note 1, 390.

<sup>86</sup> It is open to question whether all of the loss inflicted upon the foreign investor by the discriminatory application of certain tax laws can be attributed to the host State due to the fact that substantial damages would have occurred also in the case of a lawful (in terms of public international law) revocation of the licence. The *Amco II* (Merits) Award casts doubts on this; in para. 174, it reads: “To argue, as did Indonesia, that although there had been procedural irregularities, a ‘fair BKPM’ [the governmental body acting on behalf of Indonesia] would still have revoked the licence, because of Amco’s own shortcomings, is to misaddress causality. The Tribunal cannot pronounce upon what a ‘fair BKPM’ would have done. This is both speculative, and not the issue before it. Rather, it is required to characterise the acts that BKPM did engage in and to see if those acts, if unlawful, caused damage to Amco. It is not required to see if, had it acted fairly, harm might then rather have been attributed to Amco’s own fault.”

<sup>87</sup> See the Draft Articles on Responsibility of States for Internationally Wrongful Acts adopted by the International Law Commission at its fifty-third session (2001), available at [http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9\\_6\\_2001.pdf](http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_6_2001.pdf) (last visited 22.April.2009) See also Commentaries to the Draft Articles on Responsibility of States for Internationally Wrongful Acts adopted by the International Law Commission at its fifty-third session (2001), available at: <http://untreaty.un.org/>

the way described above that has a severe impact on the foreign investment constitutes an indirect expropriation.

As for the standards of proof it will be no easy task for any investor to establish the “intention” of a government.<sup>88</sup> However, the “formal statements of the responsible Minister or a series of circumstances pointing to the protectionist intent being the main motivator for a policy can be taken to indicate the ‘intention’.”<sup>89</sup> Therefore, since the internal governmental papers which reveal the true intention of a government are often – understandably – not accessible in their entirety to international tribunals, in order to prevent cacophonous statements, governments are well advised to keep their high ranking officials, to whose statements international tribunals would have to turn, under close check until a final position has emerged within the government;<sup>90</sup> they are best off developing a public communications strategy handled by experts.

### 3. Third Scenario: Investor Contributing to Bankruptcy

An investor holds a legally valid mining licence. The government starts enforcing a certain tax rule or changes the interpretation of a certain tax rule in general, with the stated aim to test the ability of companies to pay taxes. As the investor is afraid that his company will not survive, he withdraws money from the company. As a consequence, the company goes bankrupt.

#### a) Russian Law

When considering a law, a Russian court would typically look at the letter of the law and not at the intention of the lawmaker. As a consequence, if the pure letter of the law does not violate the Constitution, the intention of the lawmaker would not play any role and, to the best of our knowledge, the intention of the lawmaker has not played any role in decisions of courts,

[ilc/texts/instruments/english/commentaries/9\\_6\\_2001.pdf](http://ilc/texts/instruments/english/commentaries/9_6_2001.pdf) (last visited 22.April.2009)  
For academic writing, see, instead of others, Brownlie, *supra* note 15, 420-456 with further references.

<sup>88</sup> Newcombe & Paradell, *supra* note 6, 342.

<sup>89</sup> Wälde & Kolo, *supra* note 19, 826. See especially the First Partial Award, para. 171-195 and the Separate Opinion of B. Schwartz, para. 62-64 in *S.D.Myers*, *supra* note 24.

<sup>90</sup> Difficulties in finding officials with adequate training should not serve a host State as a valid defence, since it signed the IIA fully aware of its duties and the quality of its officials.

even in cases where laws have been considered illegal.<sup>91</sup> *A fortiori*, it is not likely to be of importance if the implementation of a law is the means by which an illegal decision is to be implemented. The action of a government would therefore clearly be legal. The same would apply if no new tax provision is enacted but an already existing provision is interpreted in a different way.<sup>92</sup> In both cases, the outlook for an investor is not promising.

## b) International Investment Agreements

In this scenario, much depends on the representations the government made to the foreign investor in regard to the tax regime. Did the government, for example, include a stabilization clause in the licence agreement, ensuring that taxes and other financial liabilities would remain as agreed for the duration of the concession? Then, the investor can reasonably expect that the tax regime will remain unchanged and raise this in the BIT context. If the government changes the law despite these representations and, as a result, the company finds it difficult to continue operations and closes operations, then the government appears to be liable under international law irrespective of the company's decision to close down, as the decision in *Revere* suggests.<sup>93</sup> Otherwise, the host State's measures are lawful if executed without any discrimination.

<sup>91</sup> Decision of the Russian Constitutional Court, No. 15, dated 16 July 2005.

<sup>92</sup> For example, Article 113 of the Tax Code, No. 146-FZ, dated 31 July 1998 (as effective on the date when the *Yukos* Decision of the Constitutional Court was passed), stated that "a person cannot be held liable for a tax offense if three years (the statute of limitations) have expired since the day when the offense was committed or since the first day after the end of the tax period during which the offense committed." (this Article of the Tax Code was amended on 27 July 2006). In the *Yukos* Decision of the Constitutional Court, No. 36-O, dated 18 January 2005, the Court re-interpreted this provision to apply only for "conscientious" taxpayers. It was deemed not to apply to "un-conscientious" taxpayers, which *Yukos* was found to be. However, the wording of the statute does not actually provide a basis for this interpretation.

<sup>93</sup> *Revere*, *supra* note 19, 291 "In our view, the effects of the Jamaican Government's actions in repudiating its long term commitments to RJA (the subsidiary of RC), have substantially the same impact on effective control over use and operation as if the properties were themselves conceded by a concession contract that was repudiated [...]" For a discussion, refer to R. Dolzer, 'Indirect Expropriation of Alien Property', 1 *ICSID Review* (1986), 41-65, Sornarajah, *supra* note 1, 378-380. In contrast, in the *Elsi* case, the foreign company, in the view of the Court, went bankrupt because of its own financial situation and not because of the action of the host State; *Elettronica S.p.A. (U.S. v. Italy)*, Award, ICJ Reports 1989, 15, para 119.

#### 4. Fourth Scenario: *Mala Fide*, Investor Acting Unlawfully

An investor holds a legally valid mining licence. He has used money in an unlawful manner, including by bribing officials, to ensure that taxation of revenues derived from the mining licence is not fully enforced against his business. Nevertheless, certain taxation rules are suddenly generally enforced, leading to the bankruptcy of the investor, which had been the ultimate intention of the State.

##### a) Russian Law

As discussed above, under Russian law the intention of any State action is not relevant. Accordingly, it cannot possibly be relevant to balance various interests against each other.

##### b) International Investment Agreements

Legitimate expectations can only be vested in a legitimate business venture. In the given case, the entrepreneur uses illegal means to acquire a competitive advantage. If the host State were to enforce its criminal laws to prevent the foreign investor from doing so and bring him to justice, this would be a legitimate exercise of administrative powers. However, the situation at hand poses another question. Is it justifiable that the State intentionally bankrupts an investor using taxation law as means of punishment, thus attributing functions to that law which an investor cannot reasonably foresee, in order to prosecute and remedy the criminal offences committed by the foreign investor?

If the bankruptcy is the consequence of an unbiased, non-discriminatory and proportionate prosecution carried out in good faith, especially if the bankruptcy relates to the payment of taxes owed, penalties due and the conviction of the investor in criminal proceedings, a State should not be held liable for the bankruptcy. However, a host State should by no means be able to plead the *tu quoque* argument, since it is generally bound to the notion of legality, in contrast to a private actor. It should, therefore, not be allowed to (ab)use the violation of the law by the foreign investor as a reason to disregard any due process requirements, one of which is to apply the laws in conformity with the functions assigned to them.<sup>94</sup> By using

<sup>94</sup> *Tecmed*, *supra* note 24, para. 154.

taxation law, which does not have a function of acting as penalization for criminal charges (e.g. bribery), those due process requirements are infringed, since no investor can reasonably foresee such an application. Moreover, the host State is also required to conduct the prosecution of allegedly criminal behaviour committed by the foreign investor itself using due process. The investment only “loses” protection in so far as it is erected on illegal groundings. Any deprivation or diminishment of property rights beyond this point cannot be justified. The principle that the taking of property “as means of the exaction of a criminal penalty is lawful”<sup>95</sup> and that it does not need to be compensated has been overridden by the groundbreaking changes brought by IIAs.<sup>96</sup>

## II. State Action Which Is Unlawful by National Standards

### 1. Fifth Scenario: Unlawful State Action Against the Management, Management Personally Involved in Crimes

In our fifth scenario, a foreign investor runs his business venture in a legal manner. However, the management is personally involved in crimes. The investor is imprisoned, however not for the personal crime that he has allegedly committed, but for a completely unrelated tax matter. The ultimate intention of the government is to hit the business. As a consequence of the management being imprisoned, banks withdraw their loans and, as a consequence of that, the business goes bankrupt.

#### a) Russian Law

As frequently reported in the press, Mr Khodorkovsky was imprisoned in 2004 for committing violations of tax legislation and subsequently condemned to serve many years for those tax violations. The arguments reportedly made by people close to Mr Khodorkovsky and by himself included that, in reality, the reason for the imprisonment was not the violation of tax legislation but the intention of Mr Khodorkovsky to get involved in politics and the desire of the Russian State to acquire his wealth, namely the Yukos

<sup>95</sup> Sornarajah, *supra* note 1, 390.

<sup>96</sup> *Id.*, 390. See, for the old state of the law, A.V. Freeman, *The International Responsibility of States for Denial of Justice* (1938), 518, footnote 2.

Group. However, in the decisions publicly available,<sup>97</sup> this argument has never been considered, and there is no evidence that it has been used by representatives of Yukos and/or Mr Khodorkovsky as a legal defence. Ignoring the intentions of the State in the results of legal proceedings in this manner does coincide with what most Russian lawyers would confirm as their view, namely that measures taken by the State against an individual would not have any impact when considering the legal merits of an action against a group of companies in the context of assessing an action that could potentially constitute an indirect expropriation.

## b) International Investment Agreements

Prosecution of crimes is the duty and prerogative of any State and, thus, is viewed as legitimate State action. As already stated, if the bankruptcy is the consequence of an “orderly” prosecution, then the State is not liable for the bankruptcy. However, it is also generally accepted that an unjustified “attack” on the management is regarded as an “attack” on the investment because the foreign investor is entitled to organize and control his business venture as a part of the bunch of property rights protected by an IIA.<sup>98</sup> Here again, the intention and the nature of the governmental actions would be the decisive criteria. If charges are only brought up “artificially” with an intention to bankrupt the investor, the State conduct will come within the reach of an IIA. This is necessary in order to protect foreign investment comprehensively as envisaged in the IIAs. Thus, indirectly, IIAs

<sup>97</sup> *Yukos* Decision of the Russian Constitutional Court, No. 36-O, dated 18 January 2005, the only decision on the *Yukos* case available in a public database, as explained above, deals with technical issues of the interpretation of tax legislation rather than with the overall economical effect of government action.

<sup>98</sup> See *Tokios Tokelés v. Ukraine*, ICSID Case No. ARB/02/18, Decision on Jurisdiction, 24 April 2004, paras 91–93. In the case at hand: “Tokelés claimed that, following its publication of a book favourable to a leading Ukrainian government opposition leader, Ukrainian government authorities: (1) conducted numerous invasive investigations falsely disguised as tax investigations; (2) initiated frivolous actions in Ukrainian domestic courts, including actions to invalidate contracts entered into by Tokelés's subsidiary; (3) placed the subsidiary's assets under administrative arrest; (4) unreasonably seized financial and other documents and (5) falsely accused its subsidiary of engaging in illegal activities.” The American Society of International Law, *International Law in Brief*, 25 June 2004; available at: [www.asil.org/ilib/ilib0711.htm#j3](http://www.asil.org/ilib/ilib0711.htm#j3) (last visited 22 April 2009). See also *Sedco, Inc. v. National Iranian Oil Company*, 9 Iran-U.S.C.T.R. (1985), 248 (appointment of directors by the State; not concerned with any criminal prosecution); *Biloune* case, *supra* note 23.

seem to have also a moderating, good governance effect on the prosecution of crimes, at least in regard to a foreign investor. However, a criminal investigation which raises issues of human rights violations would not be remediable in international investment law; it would be a case for an international human rights convention like the ECHR.<sup>99</sup>

## 2. Sixth Scenario: Illegality “All Around”

The foreign investor uses its company for financing a political campaign against taxation of oil proceeds in order to create a favourable business environment, including gaining significant influence on the State’s legislature and administration for its company. The campaign, however, is partially illegal under the laws of the host country. Also, the investor is involved in murder and in bribing officials responsible for the prosecution of the murders in order to secure its favourable business environment. As a consequence, the foreign investor gains significant influence on the process of forming the host State’s will. The State takes action illegal under the State’s law against the company and the investor with a view to stop these activities. These activities comprise the engineering of arbitrary and unfounded tax claims, the arbitrary and non-proportionate seizure of production facilities, the arbitrary freezing of funds, the harassment of the management, non-transparent investigations and a public auction which from the beginning is anything but open to bidders other than the pre-chosen winner. All these activities are conducted with the view to drive the company out of the business (total loss), at which the State ultimately succeeded.

### a) Russian Law

As discussed above, intentions are not relevant under Russian law. This is particularly true for intentions of State action.<sup>100</sup> There is nothing in the literature, practice or in discussions with Russian lawyers suggesting that any interconnection between actions against a shareholder and a company from a legal point of view would be accepted as making a difference under Russian law. In addition, whilst under Russian law there are rather detailed legal provisions about national emergency, no evidence of a theory of extra-

<sup>99</sup> *Biloune, supra* note 23, para.1.

<sup>100</sup> As above, see as an example the Decision of the Russian Constitutional Court, 18 January 2005, No. 36-O.



legal emergency, for instance during a constitutional breakdown, could be found.<sup>101</sup>

## b) International Investment Agreements

By means of a (partially illegal) political campaign<sup>102</sup> and criminal activities,<sup>103</sup> a foreign investor created a favourable business environment for his company. In this process he gained significant influence on all three branches of government of the host State and ultimately to a significant extent controlled the process of forming the political will in the host State. An orderly prosecution became impossible due to the political influence of the foreign investor. The corrupting activities of the investor started to threaten the very democratic order in the country. In order to stop these activities and with a view to return to a state of lawfulness, non-corrupted parts of the government take steps to dismantle the influence of the foreign investor by bankrupting him. In the course of action as prescribed above, the title of property is either transferred by auction to another entity or the investment is completely devaluated. This scenario drives the point even further to the extremes and poses the question of where the boundaries of the protection of a foreign investment by an IIA are to be drawn.

By taking the measures described above, the host State pursues legitimate objectives: securing State order, democracy and pluralism and re-erecting the rule of law. However, does this give the State the right to take recourse to any means at its disposal? We would like to suggest that proportionality has to be retained also in such cases. Even if the intention of the government is to return to a state of lawfulness and to secure the continuing operation of such a noble concept as democracy, and even though the for-

<sup>101</sup> A search in the most commonly used legal database on “extra-legal emergency” as of 8 April 2009 gave no results.

<sup>102</sup> The interference in domestic politics by foreign investors seen as agents of their home State is a well-known instance (as with Allende in Chile) and has been addressed by prohibition in many soft-law instruments (voluntary codes of conduct). However, no hard-law international obligation has arisen so far. In general, there has been little movement in formulating binding obligations of foreign investors (multinational corporations). Refer to Sornarajah, *supra* note 1, 171, 174-182. Moreover, in general, home States do not carry responsibility for the acts of their nationals not acting on behalf of the home State abroad; refer to Article 4-11 of the International Law Commission’s Draft Articles on Responsibility of States for Internationally Wrongful Acts.

<sup>103</sup> It seems that criminal activities of a foreign investor do not automatically render an investment unprotected by IIAs. See Sornarajah, *supra* note 1, 390.

foreign investor could not reasonably expect that his illegal activities would be continually tolerated by the host State, a legitimate expectation of due conduct of the prosecution of investment-related crimes should nevertheless not easily be compromised. Unfortunately, arguments based on the defence of such noble but very broad and vague concepts such as democracy and/or the rule of law are also capable of being (ab)used to cover protectionist activities in a host State and to quieten criticism from abroad.

The situation at hand, however, could come close to a state of necessity<sup>104</sup> within the meaning of Article 25 of the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts, which is seen to reflect customary international law.<sup>105</sup> The wrongfulness of an act not in conformity with an international obligation is precluded when, inter alia, the act is the only way for the State to safeguard an essential interest against a grave and immanent peril (Article 25(1)(a)). If one is prepared to accept the perpetuation of democracy as essential interest<sup>106</sup> and is, moreover, willing to view a single businessman or a small group of such as grave and immanent peril to the core of democratic system, recourse to the defence of "state of necessity" is still, however, put in doubt by the fact that it is confined to situations to which the respondent State has not contributed (Article 25(2)(b)), at least not in a manner "sufficiently substantial and not merely incidental or peripheral."<sup>107</sup> However, by allowing a foreign investor to gain significant influence on essential functions of government and not fighting corruption effectively, the State contributed to such a situation. If one were, nevertheless, to accept such a defence of the

<sup>104</sup> See, on the customary law doctrine of "state of necessity" in general, Brownlie, *supra* note 15, 447-449 with further references. Cf. also S. Schill, 'Auf zu Kalypso? Staatsnotstand und Internationales Investitionsschutzrecht – Anmerkung zur ICSID-Entscheidung LG&E Energy Corp v. Argentina', 5 *German Arbitration Journal* (2007), 178-186. The state of necessity, though in the context of treatment standards due under a BIT regime, was also invoked and lengthily discussed in a recent ICSID arbitration, *CMS*, *supra* note 8, paras 304-394; *Enron Corp.*, *supra* note 8, para. 93, *Sempra Energy*, *supra* note 8, paras 333-355; *LG&E Capital*, *supra* note 36, para. 201-266.

<sup>105</sup> *CMS*, *supra* note 8, para. 315.

<sup>106</sup> Very high standards of proof are required, and it is doubtful whether an international tribunal would accept a state of necessity in the situation at hand. See *CMS*, paras 319-331.

<sup>107</sup> Commentaries to the Draft Articles on Responsibility of States for Internationally Wrongful Acts, adopted by the International Law Commission at its fifty-third session (2001), Article 25, para. 20; available at [http://untreaty.un.org/ilc/texts/instruments/english/commentaries/9\\_6\\_2001.pdf](http://untreaty.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf) (last visited 04 April 2009).

host State, this would mean compromising one of the main objectives of IIAs, i.e. to promote good governance standards. By concluding an IIA, the State committed itself to such standards and should have fought corruption right from the beginning. It should not be rewarded for failing to do so.<sup>108</sup>

## C. Conclusions and Outlook

The task of both the national and international rules governing foreign investment activities is to balance legitimate business interests and the State's sovereign "right to regulate". From a national perspective, our survey reveals that the legal order of a country, in transition like Russia, is hardly prepared to strike an adequate balance between the aforementioned interests. Much more than occasional differences in views of courts,<sup>109</sup> it fails in a systematic manner to dispense any protection against the "common" threats a foreign investor is exposed to in such a business environment. It appears ignorant of notions such as due process, the prohibition of discrimination and transparency. Turning to the international perspective, a comparison of the outcomes produced by the national and international legal orders demonstrates that the former can hardly live up to the standards re-

<sup>108</sup> For case law on the legality of the investment in general see, *Fraport AG Frankfurt Airport Services Worldwide v. Philippines*, ICSID Case No. ARB/03/25, Award, 17 August 2007; see also C. Borris & R. Hennecke, 'Das Kriterium der Einhaltung von Vorschriften nationalen Rechts in ICSID-Schiedsverfahren - Anmerkungen zum Schiedsspruch in der Sache Fraport v. Philippines', 6 *German Arbitration Journal* (2008) 2, 49-58.

<sup>109</sup> As demonstrated, for instance, in the *Media Most Gusinsky* case, in which the partly government-owned Gazprom giant guaranteed two loans to Media Most in 1998 that totalled US\$ 380 million, secured by a 40 per cent piece of the company. After criticizing the politics of the Kremlin, with the Kremlin allegedly being instrumental in bankrupting Media Most by calling in the loans, the owner of Media Most, Mr Gusinsky, was arrested, allegedly without any charges, and he was allegedly compelled to sign an agreement to sell his company. Available at [www.mytimes.com/2000/11/15/world/russian-gas-company-pulls-out-of-deal-with-media-tycoon.html](http://www.mytimes.com/2000/11/15/world/russian-gas-company-pulls-out-of-deal-with-media-tycoon.html) (last visited 29 April 2009). In response to this, the ECHR ruled that the Russian government had violated Articles 5 and 18 of the European Convention on Human Rights in relation to Gusinsky, namely his rights to freedom and security. The Court ruled that the violation in itself was enough for moral damages to be awarded. As a result, it asked the Russian Federation to pay €88.000 in damages. Available at <http://cmiskp.echr.coe.int/tkp197/view.asp?item=1&portal=hbkm&action=html&highlight=russia%20%7C%2070276/01&sessionId=22944796&skin=hudoc-en> (last visited 29 April 2009). No arguments as to illegal expropriation or moral damages because of such violations seem to have been made before Russian courts.

quired and imposed by international investment instruments, even in “everyday situations”, as the discussion of our scenarios has revealed.

Two possible conclusions can be drawn from this observation. Either the development of international investment law has gone too far, *quasi* overstraining the capabilities (or the willingness) of the legal order to imbibe the international standards, or Russia, as just an example of many other economies in transition, has to start urgently—more than ten years after signing its first BIT—living up to the standards of good governance required by the IIAs it has signed if it does not want to face significant externalization of legal disputes concerned with foreign investment.<sup>110</sup> This is no fanciful perspective.

As regards the first possible conclusion, we do not think that the development of international investment law has gone too far. Most IIAs, on the one hand, offer a foreign investor the necessary back-up against sudden protective measures of its host State which is needed to conduct business in a foreign jurisdiction with a certain degree of predictability. On the other hand, IIAs are also capable of accommodating legitimate State interests. Moreover, they encourage and promote “good governance” standards. International commitments are at present the best way to protect foreign investments against internal attacks and differing interests in the political establishment of a State. However, the host State itself will also benefit from an internal legal order which acts transparently and produces reliable, predictable and just outcomes. Thus, with regard to foreign direct investments, the national legal systems of economies in transition should make an effort to live up to the standards set under international investment law. By doing so, these states can create incentives for foreign investors to perceive their domestic legal systems as a genuine alternative to international investment law and arbitration. This bears of course the *caveat* that in view of the amounts usually involved in such a dispute, the potential for protective measures can be minimised, but never be wholly excluded. Of course, sometimes a country subject to international investment arbitration for the first time has to learn the hard way about the obligations it has signed up

<sup>110</sup> One way to force an international investor to resort to national jurisdictions is the “local remedies requirement”. However, the exhaustion of local remedies as a precondition for commencing an international investment arbitration is nowadays rarely required by BITs; C. Schreuer, *The ICSID Convention: A Commentary* (2001), 391-393. For an appraisal of alleged new tendencies in arbitration, see C. Schreuer, ‘Calvo’s Grandchildren: The Return of Local Remedies in Investment Arbitration’, 4 *The Law and Practice of International Courts and Tribunals* (2005) 1, 1-3.

for. But at the end of the day, drawing the right conclusions from the lessons learned, it should begin to improve its administrative procedures in particular and its legal system in general so that foreign investors do not feel the need to resort to international arbitration in the first place.

This brings us to our second possible conclusion which, in our view, appears to be the correct analysis. Countries such as Russia should be aware of the costs which they have to bear if they are not capable or willing to offer the necessary legal tools to respond to the needs and problems of foreign investors. They risk that legal issues are litigated far away from the place where the conflict originated, adjudicated by rules they were able to shape only to a limited extent, and decided by people sometimes not fully aware of the local situation. In a nutshell, they risk marginalizing their own legal order, which, in general, should be able to best accommodate the country's specificities.

Whilst countries may ignore individual cases for some time, in the long run there are only two ways out: either to take leave from the IIA regime, which would completely sideline the country in question, in the view of the investors' as well as the state community,; or while globalization is deepening to stop hesitating and tackle the issue.

