THE USE OF THE PROPORTIONALITY PRINCIPLE TO DISTINGUISH COMPENSATORY INDIRECT EXPROPRIATION FROM REGULATORY MEASURES

Anca T Muir, Georgetown University Law Center

Available at: https://works.bepress.com/anca_muir/1/
THE USE OF THE PROPORTIONALITY PRINCIPLE TO DISTINGUISH COMPENSATORY INDIRECT EXPROPRIATION FROM REGULATORY MEASURES

BY

ANCA TEODORA MUIR
I. Introduction .................................................................................................................................3

II. The applicable standard: from Metalclad to Methanex ..............................................5

1. The sole effect doctrine. Metalclad v. Mexico case ..............................................................10
2. The police power doctrine. Methanex v. United States case ...........................................12
3. Conclusion on the deficiency of the application of the sole effect and police power doctrines .............................................................................................................................................15

III. Proportionality and its applications in international investment law ........16

1. What is proportionality and how do national and international courts use it? .........17
2. The use of the proportionality principle by the European Convention of Human Rights ........................................................................................................................................19
3. The use of proportionality by the arbitral tribunal in the Tecmed case ....................23

IV. Conclusion ........................................................................................................................................27
The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

I. Introduction

The Investor State Dispute Settlement (ISDS) system has been criticized recently as a way for foreign corporations to counter a national government’s right to regulate.\(^1\) A subject of much of this scrutiny is the compensation requested by foreign investors when the host state needs to regulate for the public interest. A recent debate over the Trans-Pacific Partnership (TPP) was questioned because of its ISDS provisions that are seen as an easy way for investors to undermine the ability of the states to regulate in the public interest.\(^2\)

The issue of compensation for actions of indirect expropriation is a controversial issue, especially when the host state uses its police power\(^3\) to regulate in the public interest. When this occurs, it can create a conflict in which an investor claims that his investment was reduced to nothing by the state’s regulations, while the state argues that the regulation was necessary to protect the public interest. Because no Bilateral Investment Treaty (BIT) or Multilateral Investment protection treaty mentions specific criteria to help delineate between regulatory measures and indirect expropriation, the arbitral tribunals are left to decide whether the investor is entitled to

---

\(^1\) See The Economist, The Arbitration Game October 11\(^{th}\) 2014, where it is argued that the investor-state dispute settlement is a way for multinational companies to get compensation when they are not happy with the regulating practices of the host state: “Multinationals have exploited woolly definitions of expropriation to claim compensation for changes in government policy that happen to have harmed their business. For more details see "http://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration.


\(^3\) Black’s Law Dictionary, 10\(^{th}\) Edition 2014, defines “Police power” of the state as the fundamental right of a government to make all necessary laws to preserve the public security, order, health, morality and justice.
compensation. The decision of the tribunal is based on the particular facts of the case.  

Whenever the arbitral tribunals have to answer the threshold question of indirect taking, the applicable standard is the effect doctrine, which looks at the impact of the government measure on the property of the foreign investor. Some tribunals use a substantial or permanent deprivation standard, also known as the police power doctrine, that analyses the purpose of the government measure and not just its effect. In only a couple of cases, the arbitral tribunal used the proportionality test to determine the boundaries between non-compensable state actions and compensable indirect expropriation.

The proportionality principle involves more than simply balancing the interests of the individual and the state. It is used by international and national courts to define the line between the legitimate governmental regulation and excessive interference with rights and obligations of individuals. For this principle to be applied correctly, the court or tribunal needs to follow three steps: the measure taken by the state will be analyzed to determine if it was appropriate to its objectives (suitability), the least burdensome on the affected person (necessity), and balanced between the community and individual interests involved (proportionality analysis). It has been argued that the proportionality test can be used by arbitral tribunals not only to help determine if an expropriation occurred, but also to establish a compensation to the investor that is less than the fair market value, if there is a special interest of the government to interfere and that causes no excessive burden for the investor. But

---

this partial compensation solution will not be addressed here, since most of the investment treaties provide for a prompt and adequate compensation, and a partial compensation will need to be provided as a possibility in the treaties.

In this paper, I will contend that arbitral tribunals can use the proportionality test with more success than the effect and police power doctrine when deciding the existence of an indirect expropriation measure. In doing so, I will first address the problems raised by the applicable standards used to solve the threshold question of indirect expropriation, and show how the two doctrines cannot provide an acceptable answer to the question when a state measure is compensatory as an indirect expropriation. Then, I will examine how the European Court for Human Rights uses the principle of proportionality to resolve conflicts between the rights of individuals and the interest of states, and how the arbitral tribunal built its argument using the principle of proportionality in the Tecmed case. In the conclusion, I will argue that the principle of proportionality is the best solution for deciding whether an indirect expropriation has occurred, because it allows a more nuanced resolution than the sole effect and police power doctrines.

II. The applicable standard: from Metalclad to Methanex

It is undisputed that international law allows that property of foreign investors may be expropriated if certain conditions are met: non-discrimination against the investor; public purpose of the State; due process of law; and the accompaniment of
Anca Muir
The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

prompt, adequate, and effective compensation\(^6\). The requirement for compensation is recognized in both state practice and jurisprudence of international tribunals.\(^7\)

There are also a few exceptions to the compensation rule, and as Ian Brownlie explains, confiscations as a result of crimes being committed and seizure by way of taxation or other fiscal measures are the most used examples.\(^8\) Several arbitral tribunals have highlighted the idea than not all state regulations that are harmful to investors constitute an indirect expropriation and, as a result, not all actions of this nature give the injured party the right to receive compensation.\(^9\) On the other hand, arbitral tribunals seem to be hesitant in assessing whether the public purpose of the state is acceptable or not.\(^10\)

Customary international law recognizes that states have a right to regulate or take other measures that have an impact on the property of the foreign investor without being forced to pay compensation for expropriation, specifically when the regulations or measures are aimed at the general welfare, are non-discriminatory, are made in good faith, and have a legitimate purpose.\(^11\)

\(^6\) Article 6 of the 2012 U.S. Model Bilateral Investment Treaty, called Expropriation and Compensation states that “Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization except:
   a. for public purpose
   b. in a non-discriminatory manner,
   c. on payment of prompt, adequate and effective compensation and
   d. in accordance with due process of law and Article 5”. The same requirements are mentioned in Article 1110 (Expropriation and Compensation) of the North American Free Trade Agreement.


\(^8\) Id. p. 511.


The U.S. Constitution provides in the Fifth Amendment that no person shall be deprived of property without due process of law, “nor shall private property be taken for public use, without just compensation”.\(^{12}\) It was not until the beginning of the twentieth century that the U.S. Supreme Court recognized the concept of regulatory takings in *Pennsylvania Coal Co. v. Mahon* case, where it decided that regulation could amount to expropriation if there is a diminution in the property value.\(^{13}\) In some following cases, the Supreme Court decided that a private property is considered expropriated and requires compensation if it is under the permanent occupation by the government\(^{14}\), but also if the governmental measure “deprives land of all economically beneficial use”.\(^{15}\)

In *Penn Central transportation Co. v. City of New York*, the Supreme Court pointed out three factors that are to be considered when determining whether a regulation constitutes a taking: “the economic impact of the regulation on the claimant, and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectation” and “the character of the governmental action”.\(^{16}\)

This brief look at the U.S. taking jurisprudence cannot be done without mentioning, as many scholars have noted, that it is very difficult to prove a regulatory taking in the U.S. courts, mainly because the claimant has to show that the measure

\(^{12}\) U.S. Const. Amendment V.
\(^{13}\) See *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 414, 43 S. Ct. 158, 159, 67 L. Ed. 322 (1922).
\(^{14}\) See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426, 441 (1982).
had destroyed one hundred percent of the value of the property.\textsuperscript{17} As a result, the U.S. courts have the same hard time in trying to distinguish between compensable takings and non-compensable regulations.\textsuperscript{18}

The investment arbitral tribunals also struggle when trying to determine the regulations that permit the state to evade paying compensation. As an example, the Arbitral Tribunal in the Saluka case mentions that it is hard to delineate between the regulations that are considered permissible and commonly accepted as falling under the police or regulatory power of States and the ones that do not.\textsuperscript{19} What the tribunal found in this case was that international law has to “draw a bright and easily distinguishable line between non-compensable regulations on the one hand and, on the other, measures that have the effect of depriving foreign investors of their “investment and are thus unlawful and compensable in international law.”\textsuperscript{20}

A State uses its police power in order to protect the essential public interest from harm such as limiting exposure to pollution, pesticides, or other toxic substances. However, as the tribunal in the Santa Elena case mentions, the fact that a measure protects society is not enough to excuse the state from paying compensation.\textsuperscript{21} This is

\textsuperscript{18} Id.
\textsuperscript{19} Saluka Investment B.V. (The Netherlands) v. Czech Republic, UNCITRAL Arbitration, Partial Award, 17 March 2006. In this case the Czech Republic was found responsible for the breach if international treaty regarding the protection of investment, where it choose to introduce a discriminatory state aid program in favor of Saluka’s competitor.
\textsuperscript{20} Id. para. 25.
\textsuperscript{21} Compania del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica (2000) ICSID case no, ARB/96/1 (Final Award, Feb. 17, 2000). In this case the claimant was formed with the intention to develop a tourist resort on a terrain in Costa Rica. In 1987, Costa Rica issued an expropriation decree for Santa Elena in order to declare it a preservation site. One important citation from this case is that “Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes.
not to suggest that any measure taken by the government to protect the public interest
needs to be accompanied by compensation to the foreign investor who is deprived of
his property right; however, it is very hard to find arguments for why some complete
deprivations of property rights deserve compensation while others do not. As the
arbitral tribunal mentions in the Pope and Talbot case, it is not enough for the state’s
regulation to be non-discriminatory in order for the arbitral tribunal to reject the
request for compensation by the investor.\(^\text{22}\)

Historically, arbitral tribunals have used the effect rule when looking at the
issue of whether a government regulation could be considered an indirect
expropriation. It has been argued that the effect rule was used exclusively when
developed countries were investing in countries in Latin America, Asia and Africa,
because it was a good way of protecting the investors from unpredictable regulations.
It was not until NAFTA was implemented and expropriations claims started to come
against United States and Canada that the arbitral tribunals started looking at the
police power rule when indirect expropriation claims were brought in front of them.\(^\text{23}\)

Both the sole effect and police power doctrines provide us some guidelines
when addressing the matter of identifying measures that can be considered indirect
expropriation, but neither of them seem to answer the question of how certain state
actions that result in substantial deprivations to the investor give rise to a right of
compensation, while others, with a similar effect from the investor’s perspective, do

\(^{22}\) Pope&Talbot Inc.v. The government of Canada, NAFTA UNICTRAL Arbitration, Award 10 April
2001 para 99. In this case a U.S. investor with a Canadian subsidiary that operated softwood mills,
claimed that Canada’s allocation of the fee-free quota, under the Softwood Lumber Agreement, was
unfair and inequitable. The arbitral tribunal found the government of Canada liable for breaching the
minimum standard of treatment provision of Article 1105 of NAFTA. The tribunal rejected the
expropriation claim made by the investor, after looking at the degree of control the investor had on the
investment and deciding that he could still operate the business.

\(^{23}\) Sebastian Lopez Escarceca, *Indirect expropriation in International law*, Leuven Center for Global
not. Moreover, the awards that have dealt with the threshold issue of indirect expropriation offer contradictory guidelines on how to separate non-compensable state regulations from compensable state measures.25

1. The sole effect doctrine. Metalclad v. Mexico case.

In the majority of the cases, when asked to determine whether an indirect expropriation had occurred, arbitral tribunals use an effects rule, also known as the sole effects doctrine. The sole effect looks at the impact and the duration of the government measure on the rights of the investor. Under this rule, the purpose of the measure or the fact that the title of the property remains with the owner is not important.26

One of the most important cases where the arbitral tribunal applied the sole effect doctrine in order to decide whether the investor had been expropriated is the Metalclad case.27 In this case, Metalclad, a U.S. corporation, with a Mexican subsidiary, received permits by the Federal Government of Mexico and the state of San Luis Potosi to operate and develop a hazardous waste landfill in an area of unique biological diversity of Guadalacazae.28 After the company started building, the municipal authorities imposed a new requirement for an additional municipal permit. When the investor applied for the additional permit, being encouraged to do so by the federal government, the municipality denied the application without giving the

25 Sebastian Lopez Escarcena, see supra note 24, p. 186.
27 Metalclad Corp. v. United Mexican States ICSID Case No. ARB (AF)/97/1 (Award of Aug. 30, 2000).
28 Id. para. 28.
company a chance to present its case.\textsuperscript{29} As a final measure, the governor of San Luis Potosi declared the landfill zone a protected natural area.\textsuperscript{30}

Metalclad filed a complaint against Mexico before the International Center for Settlement of Investment Disputes (ICSID) for violation by the Mexican Government of several NAFTA provisions including Article 1110 (Expropriation).\textsuperscript{31} The arbitral tribunal held that the actions of the local authorities were to be considered as an indirect expropriation and awarded the investor compensation in the amount of $16.7 million.\textsuperscript{32} Mexico petitioned the Supreme Court of British Columbia, the seat of the arbitration, to set aside the award on the grounds that the arbitral tribunal exceeded its jurisdiction, which the court did in part.\textsuperscript{33}

In deciding that the investor had been expropriated, the arbitral tribunal applied the sole effect doctrine and looked only at the way the measures of the host state deprived the investor of the use of his investment:

“Thus, expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favor of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use of reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.”\textsuperscript{34}

It is easy to conclude that the investor in the Metalclad case, who engaged in extensive due diligence by consulting with federal authorities case, had reasonable

\textsuperscript{29} Id. para. 41
\textsuperscript{30} Id. para. 59
\textsuperscript{31} Id.
\textsuperscript{32} Id.
\textsuperscript{33} Mexico v Metalclad Corp [2001] BCSC 664 at [77]–[80]
\textsuperscript{34} Id. para. 103
Anca Muir

*The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures*

expectation when the federal government of the host state gave assurances and supported the investment. On the other hand, the local authorities not only didn't encourage the investment, but their activities were disrupted by local protests. The award has been described as an open door for investors to challenge regulations that deal with a wide area of issues “from pesticide regulation to cigarette packaging requirements” and claim million of dollars for the alleged takings.\(^{35}\)

**2. The police power doctrine. Methanex v. United States case.**

In a few NAFTA awards, like Methanex and Chemtura, and BIT arbitrations like Saluka and El Paso, the tribunals adopted a police power standard. When using the purpose of the state action, the arbitral tribunal looks at the resolution and context of the state’s measure to determine if the regulatory action of the state amounts to an indirect expropriation.\(^{36}\) This doctrine maintains that if the state adopted a measure that is non-discriminatory and has a legitimate public purpose, international law holds the measure lawful and no compensation is necessary.\(^{37}\)

In a major case, Methanex v. United States of America, the arbitral tribunal found that the state acted in the public interest and therefore could not be held liable for any consequences their measures had on the foreign investor’s property. In this case, a Canadian corporation filed an arbitration claim against the United States challenging a health ban imposed by California environmental and public health

\(^{35}\) V. Been & Joel Beauvais, *see supra* 18, p. 33-34. In an almost similar note with the today’s opponents of the ISDS provisions in the TPP the authors declare: “The possibility that NAFTA’s Article 1110 may be used to force governments in the United States and elsewhere to pay compensation for environmental and land use regulations is causing considerable consternation in the domestic and global environmental and land use communities.”

\(^{36}\) Sebastian Lopez Escarcena, *see supra* note 24, p 9.

Anca Muir
The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

authorities on the use of methyl tertiary-butyl ether (MTBE). The ban was based primarily on a research report from the University of California (the UC Report) indicating that MBET was contaminating groundwater and drinking water supplies and was therefore a threat to human health, safety and environment. The Canadian corporation claimed that California’s regulatory ban was a discriminatory act of indirect expropriation that would end Methanex’s business of selling methanol for use in MBTE in California, and asked for $970 million in damages. The U.S. government responded with the police power argument stating that the State of California needed to take action to protect the public health or environment, and that asking the state to be responsible for damages in situations like the one in this case would affect the state’s right to “carry out its most fundamental governmental functions.”

In deciding the case, the arbitral tribunal had to assess the scientific evidence based on the UC Report. The tribunal held that the Report reflected a “serious, objective and scientific approach” even though the investor proved that the scientists could not agree to whether MBTE was a danger to the public health or that the UC Report itself was scientifically accurate. Methanex also had argued that MTBE was present in groundwater because of leaking underground fuel tanks and the appropriate risk management technique would be to address the leaky fuel tank problem. The Methanex tribunal held that the UC Report was not “scientifically incorrect” but did

---

39 Id. para. 15.
40 Id. para. 32.
41 Id. para. 27.
42 Id. para. 50.
43 Id. para. 101. The tribunal also noted that the report was subject to public hearings, testimony and peer-review and that its “emergence as a serious scientific work from such an open and informed debate is the best evidence that it was not the product of a political sham.”
not clarify whether “scientifically correct” is the standard for assessing legitimacy of an environmental measure. As a result, the tribunal concluded that the California ban was “motivated by the honest belief, held in good faith and on reasonable scientific grounds, the MBTE contaminated groundwater and was difficult to clean up.”

The arbitral tribunal also stated that “a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process, and which affects, inter alia, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government.”

Described as a case that can help in justifying the conclusion that arbitral tribunals are not putting the right of the state to regulate at risk, the Methanex case is also a case that can be described as a pure application of the police power doctrine, where the tribunal gave no consideration to the effect of the state’s measure on the investor.

Later, in the Saluka case, the arbitral tribunal was even more categorical in saying that the State was not liable to pay compensation when it adopts non-discriminatory and bona fide regulations. There is a difference between declaring some regulations non-compensatory, and stating that all good faith and non-discriminatory regulations allow states to avoid the duty of paying compensation, as the tribunal seemed to imply in the Saluka case. The conclusion in the Saluka case could have a potentially dangerous effect on the protective scope of investment treaties.

44 Id. para 102.
45 Id. para. 7.
47 Saluka Investment B.V. (The Netherlands) v. Czech Republic, see supra note 20.
3. Conclusion on the deficiency of the application of the sole effect and police power doctrines

States can only rely on the police power argument for non-compensation when the exercise of the police power is in accordance with the international minimum standard. The current international minimum standard does provide that state measures can protect public morals and order, the environment, and health and safety, as long as the exercise of these powers is not unfair, unjust, idiosyncratic or discriminatory. When enacting a police power measure, the state must act with the utmost impartiality and objectivity in achieving the stated public interest objective.

Given the uncertain definition of non-compensable regulations, some arbitral tribunals see it as a “blanket exception for regulatory measures that would create a gaping loophole in international protection against expropriation.” The state should not make a practice of invoking its police power to radically overburden the investors. On the other hand, by using a sole effect standard in deciding indirect

---

49 *Waste Management, Inc. v. United Mexican States (Number II), ICSID Case No. ARB(AF)/00/3*, where the tribunal refers to a minimum standard being breached where there is a complete lack of transparency and candor in an administrative process.
50 G. C. Christie, *What Constitutes A Taking Under International Law?* 33 BYIL 307 (1962) p 338: “A State declaration that a particular interference with an alien’s enjoyment of his property is justified by the so-called police power does not preclude an international tribunal from making its own independent determination of this issue. But, if the reasons given are valid and bear some plausible relationship to the action taken, no attempt may be made to search deeper to see whether the State was activated by some illicit motive.”
51 Pope & Talbot Inc. v. Canada see supra note 23, para 99.
52 J. Paulsson and Z. Douglas, *Indirect Expropriation in Investment Treaty Arbitration*, in N. Horn & S. Kroll, eds. *Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects*, Kluwer Law International, 204, p. 128. Here the authors mention that “Where the value of an investment has been totally destroyed by bona fides regulations in the public interest, it may well be that the international law does not allow the Host State to place such a high individual burden on an investor for the pursuit of a regulatory objective for the benefit of the community at large without the payment of compensation.”
expropriation claims, the arbitral tribunals are criticized for ignoring the State’s motives when regulating.

When looking at the cases that have used the police powers standard\(^{53}\), it is clear that none of these decisions can provide a comprehensive account of the types of public interests that can justify a measure that would otherwise be considered an indirect expropriation. Further, by broadening the category of public interest measures to all non-discriminatory regulations, tribunals diminish the protective scope of investment treaties.\(^{54}\)

It is important to distinguish between the concept that some public interests are pre- eminent and the idea that all good faith non-discriminatory regulation permits states to evade the duty of paying compensation. If tribunals do not wish to analyze whether a measure is indeed justified as being a regulatory measure, this will leave the States to be the judges of their own cause: they can always justify their behavior by invoking some public interest.

III. Proportionality and its applications in international investment law\(^{55}\)

The proportionality principle is a method of legal interpretation that was first developed in German constitutional law and then used extensively in the jurisprudence of European Court of Human Rights, and more recently in

---

53 Methanex Corporation v. United States, see supra note 39.
55 As an example of how the proportionality test is being perceived differently over the years. I would like to mention how in one of his articles from 2005, Andrew Newcombe declared “the role of international expropriation law is to provide a minimum standard of protection to foreign investors against expropriatory measures. It need not, and should not, attempt to find the optimal balance between state interests and property protections.” After only four years, the same scholar sees proportionality as “a significant consideration in assessing police power regulations, absent a breach of specific commitments which arguably may give rise to a duty to compensate.”
The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

jurisprudence of the Inter-American of Court Human Rights.\textsuperscript{56} It is perceived as a “convincing and methodologically clear approach when attempting to balance the interests of both the State and the investor fairly”.\textsuperscript{57}

The German constitution protects individuals against uncompensated destruction of their property right, and the Federal Constitutional Court has ruled in many occasions that the “violation of rights that came into existence under previous law must be justified by public interest considerations, taking into account the principle of proportionality.”\textsuperscript{58} Even the U.K. courts apply the proportionality doctrine in a full range of governmental actions, from administrative law to primary legislation.\textsuperscript{59}

In international investment law, the proportionality test has been proposed as a way for the arbitral tribunals to improve their “adjudicative legitimacy” because it provides a structural analysis that can be understand and accepted more easily by both parties and also can withstand critical scrutiny.\textsuperscript{60}

1. What is proportionality and how do national and international courts use it?

Proportionality helps resolve conflicts between the rights of individuals and the interests of the State, or between conflicting rights of individuals. In international investment law, proportionality means that the tribunal will distribute the burden of the measure between the foreign investor and the host government, and that when the

\textsuperscript{56} See Jose Maria Cantos c. Argentina, I/A Court HR, Series C. No. 97, Judgment, 28 November 2002.
\textsuperscript{58} See Sabine Michalowski and Lorna Woods, German Constitutional Law. The protection of civil liberties, Brookfiled Ashgate, Darmouth, 1999, p. 328.
\textsuperscript{60} See Caroline Henckels, Revising Proportionality Analysis in Investor State Arbitration, JIEL 15(1) 2008, p. 228.
The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

property owner carries a large burden compared with what the state wants to achieve, the measure at issue is deemed to be disproportionate.\(^{61}\)

The principle of proportionality is defined as finding a balance between two contradictory interests. Its aim is to ensure that, when pursuing a public interest, the sacrifice imposed on private interests is “proportionate.” While it is a relatively unfamiliar concept in international investment law, focused as it is on protecting investments, the principle of proportionality has already been significantly developed in other dispute resolution forums.\(^{62}\)

When confronted with a proportionality demand, the national and international courts will look at three elements: suitability, necessity and strict proportionality.\(^{63}\) Each one of these three elements is important for a correct application of the proportionality test. Suitability represents the requirement that the measure should have some benefit in connection with its objective, and will look to see whether the expropriation to the public purpose invoked.\(^{64}\) The second element to be analyzed is the necessity of the measure, which is equally important, as it requires the court or tribunal to look at the objective of the measure or regulation and conclude whether that objective could have been achieved with measures interfering less with the right or interest.\(^{65}\) Finally, on strict proportionality analysis, the court or tribunal must look at the two competing interests and decide whether the measure’s impact on the investor is proportionate to the gain that the public policy wants to achieve.\(^{66}\)

---

\(^{61}\) August Reinisch Standards of Investment Protection, Oxford Scholarship Online, p. 163

\(^{62}\) Thomas Walde and Abba Kolo supra note 64, p. 827.

\(^{63}\) See supra p. 2

\(^{64}\) See James and others v. The United Kingdom, European Court for Humana Rights, 21 February 1986, series A, no. 98, para. 51.

\(^{65}\) If the ECtHR founds the measure was the less invasive one, that conclusion doesn’t lead automatically to the conclusion that Article 1 of the Additional Protocol had been violated.

\(^{66}\) James and others v. The United Kingdom, see supra note 64, para. 51.
From an arbitral tribunal perspective, when confronted with a case where the investor claims his property right was expropriated by the State, and the State uses the police power exception to justify the non-compensatory measure, the tribunal must determine if a range of alternative measures exist, and should then choose the option that is least intrusive upon the rights or interests of the investor.

2. The use of the proportionality principle by the European Convention of Human Rights

The provisions on protection of property were first included in the European Convention for Human Rights in Article 1 of the First Optional Protocol and contained a minimum standard of treatment and a general commitment to the rule of law, without including any reference to direct or indirect expropriation or the right to be compensated. ⁶⁷ Although criticized in the literature as a weak provision that gives people economic and social entitlements rather than actual rights, ⁶⁸ the European Court of Human Rights interpreted very broadly the term “possession” by saying that the peaceful enjoyment of possession includes a guarantee of the right of property for both tangible and intangible assets. ⁶⁹

In relation to the ways a state can interfere with the peaceful enjoyment of possession, the European Court of Human Rights has a broader view as well, stating that “the genuine, effective exercise of the right protected by Article 1 Protocol 1 does

---

⁶⁷ According to Article 1 First Optional Protocol of the European Convention for Human Rights: “Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law. The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”


not depend on the State’s duty to interfere” but it can give rise to a positive obligation for the states to act “in an appropriate manner and with utmost consistency so that their measures are implemented with reasonable clarity and coherence, in order to avoid, in so far as possible, legal uncertainty and ambiguity for the persons concerned by them.”

Even if the public interest of the state is used as a justification for the interference with the right of property, the European Court requires the achievement of a fair balance between the interests of the state or community and those of the affected person. In addition, the Court looks at whether the State used a reasonable and foreseeable legal basis for the expropriatory measure. This is one of the most important aspects of the interpretation given to the Article 1 of Protocol No. 1 by the European Court: even if the state’s measure constitutes a deprivation or control of use that is lawful and for public interest, the Court will still scrutinize whether the measure finds the right balance between the demands of the public interest and the requirement to protect the right of an individual or an organization. In order to achieve this purpose, the objectives of the corresponding measures must be proportional to the means used for their fulfillment.

In the case of Sporrong & Lonnroth v. Sweden, the European Court of Human Rights decided that the court has to look at the “substance of the measure and not its form” when deciding if an indirect expropriation has occurred, because a state may hide its intention to harm an investment behind a measure that is, apparently,
legitimate. Even though the Court found no expropriation occurred in this case, it required the State to pay compensation to the claimant because it had placed “an individual and excessive burden” on plaintiffs and therefore violated Article 1. 73

The European Court for Human Rights looks to the payment of compensation as playing a significant role in the determination of the proportionality of an interference with property; as stated in the James v. The United Kingdom case: “…compensation terms are material to the assessment [of] whether the contested legislation respects [a] fair balance between the various interests at stake, notably, whether is does not impose a disproportionate burden on the applicants.”74

Another important aspect of the European Court interpretation is that when applying the principle of proportionality, the European Court of Human Rights attempts to protect non-nationals. The Court has clearly stated in James and others v. The United Kingdom that nationals played a role in adopting the legislation that was under scrutiny, and concludes that “there may well be a legitimate reason for requiring nationals to bear a greater burden in the public interest than non-nationals.”75 This interpretation can be of great importance in international investment law, as it can create a point of support for the rights of the foreign investors. The difference that is highlighted by the Court between the nationals and non-nationals when enacting a regulatory measure could have an important impact on all investment

73 Sporrong & Lonrho v. Sweden, European Court of Human Rights, Judgment 23 September 1982, where the Court states that “in the absence of a formal expropriation, that is to say a transfer of ownership, the court must look behind the appearances and investigate the realities of the situation complained of …Since the convention is intended to guarantee rights that are practical and effective it has to be ascertained other that situation amounted to the de facto expropriation.” In this case, a long-term expropriation permit had been granted by the state to the applicant’s properties. Although it did not de facto expropriate their properties, the plaintiffs complained that it was impossible for them to sell the properties and that this was an interference with their right to peaceful enjoyment of possession. The government, on the other hand, emphasized the public purpose of the permits system.

74 James and others v. The United Kingdom, see supra note 65, para. 54.

75 Id. para 64.
Anca Muir

The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures

treaty obligations, as all foreign investors are non-nationals and should not be required to bear a greater burden than the nationals of the host state.

Even when recognizing the right of the state to issue regulations in the public interest without the obligation to compensate, the Court will also look at the lawfulness of the measures and will decide if they have to be repaired by putting the applicant in the position he was in before the violation occurred. Whenever a deprivation of property has taken place, the European Court looks at a reasonable and foreseeable national legal basis for the taking, based on the requirement for the respect of rule of law, for stability and transparency. The court will conduct a factual analysis for the assessment of the proportionate relationship between the interest of the state and the individual and will insist that the factors that have to be taken into account vary from case to case.

It is important to note that only in rare occasions will the European Court for Human Rights decide that the total lack of compensation is justifiable. However, the European Court has also developed a jurisprudence whereby the compensation will amount to less than the market value, as the Court is interested in protecting the State’s ability to carry out social and economic reforms not only the ability of the claimant to obtain full compensation. The application of the second element of the proportionality test, the choice of a least invasive measure, will help the Court in deciding if less than full compensation is to be considered sufficient.

76 Caroline Henckels, see supra note 59, p. 227.
77 In the same way the United States Supreme Court decided in the case of Penn Central Transportation Co. v. New York City, this case should be largely based on the facts and circumstances.
3. The use of proportionality by the arbitral tribunal in the Tecmed case.

Several arbitral tribunals have recognized the relevance of proportionality in expropriation disputes, but only the Tecmed case elaborated on proportionality analysis as a means of determining whether a police power measure reflects an appropriate balance between host state and investor interest. The Tecmed case is also criticized for applying only the third step of the proportionality test, without going through the suitability and necessity of the measure. In this case, the arbitral tribunal ruled that the measures taken by the host state constituted indirect expropriation, and to arrive at this conclusion it considered whether the action of the government was proportional to the public interest presumably protected. It shifted the burden to the respondent, Mexico, in order to evaluate whether the expropriation was justified as falling within the State’s police power.

In 1996 Tecmed, through its subsidiary Cytrar, acquired through public action a hazardous waste disposal facility in a rapidly expanding urban area of Mexico. The original permit to operate the landfill had an indefinite duration, but as a result of a regulatory change by the Mexican authorities, the original permit was replaced with a one-year renewable permit. Following community opposition of the facility’s

---

79 See S.D. Myers v. Government of Canada, UNCITRAL Partial Award, Nov. 12, 2000), 40 I.L.M. 1408 (2001), where the tribunal focused on the effect of the state’s measure, and, although it didn’t find enough elements to sustain an expropriation claim, it stated that the purpose of the host state when enacting regulation is relevant in the matter of expropriation. The tribunal highlighted that when a state is enacting a measure impacting on foreign investment is required to select a measure that has the least restrictive effect on investment.


81 Id. p. 238.


83 Id. para. 43.

84 Id. para. 45.
location, authorities entered into an agreement with the investor to relocate the facility, but in 1998, the Mexican authorities refused to renew the facility’s operating permit for Tecmed’s subsidiary.\textsuperscript{85} Moreover, the authorities ordered the investor to cease its operations despite the fact that they didn't offer an alternative location for the new facility, which meant that the investor could not continue operating or use its site for other purposes due to the accumulation of hazardous material.\textsuperscript{86} The Mexican authorities relied on the police powers argument to justify their actions, and argued that the government acted with the objective of protecting the environment and public health.

When asked to decide whether the refusal to renew the permit was an indirect expropriation of the investor, the arbitral tribunal held that it was, as the grounds for the refusal were not convincing and the primary motivation for the non-renewal of the permit was local community opposition to the operation of the site. The tribunal also found that there was no evidence that the site posed any danger to human health or the environment.\textsuperscript{87} When looking at whether the refusal to renew the permit could be considered an act of indirect expropriation, the tribunal looked at the motivations for the non-renewal and the effects of the non-renewal in terms of whether it was “proportional to the deprivation of rights sustained by Cytrar and with the negative economic impact on the claimant arising from such deprivation.”\textsuperscript{88}

The tribunal explained how it came to this conclusion:

After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition

\textsuperscript{85} Ibidem
\textsuperscript{86} Id. para. 108.
\textsuperscript{87} Id. para 142.
\textsuperscript{88} Tecmed see supra note 14, para 132
to the negative financial impact of such actions or measures, the
Arbitral Tribunal will consider, in order to determine if they are to be
categorize as expropriatory, whether such actions or measures are
proportional to the public interest presumably protected thereby and to
the protection legally granted to investments, taking into account that
the significance of such impact has a key role upon deciding the
proportionality.\textsuperscript{89}

When using the principle of proportionality to decide between the right of the
investor to compensation and the public interest of the state, the tribunal quoted from
passage of the European Court for Human Rights case, James v. United Kingdom\textsuperscript{90}
and three more decisions of the same court:

There must be a reasonable relationship of proportionality between the
charge or weight imposed on the foreign investor and the aim sought to
be realized by any expropriatory measure. To value such charge or
weight, it is very important to measure the size of the ownership
deprivation caused by the actions of the state and whether such
deprivation was compensated or not. On the basis of a number of legal
and practical factors, it should be also considered that the foreign
investor has a reduced or nil participation in the taking of the decisions
that affect it, partly because the investors are not entitle [sic] to exercise
political rights reserved to the nationals of the State, such as voting for
the authorities that will issue the decisions that affect such investors.\textsuperscript{91}

\textsuperscript{89} Id. para 122
\textsuperscript{90} James and others v. United Kingdom see supra note 65, para. 4.
\textsuperscript{91} Id.
According to the arbitral tribunal, in order to determine whether the State’s measure was expropriatory, they had to look at whether it was “proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality.” The tribunal asked if the measures taken by the Mexican government were “reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation.” The proportionality principle is not respected if the investor is found to have suffered an excessive burden.

The Tecmed decision is often criticized for using the proportionality analysis without evaluating the elements of sustainability and necessity, which could have helped the authorities to design measures, that do not disproportionately affect investors’ interest. By focusing only on the fact that the environmental and health issues relating to the operation of the site could be addressed through financial penalties, the tribunal ignored the question of whether the measure was lawful and failed to assess relevant considerations.

Another question that the Tecmed case addresses has to do with discrimination, specifically the issue of the foreign investor having more protections than nationals. The tribunal addresses this issue by highlighting that foreign investors have no formal role in public policy making, and they might be particularly vulnerable to abusive state conduct because investors lack formal political representation and because they

---

92 Id para. 117.
93 It is important to mention that the same factors are adopted in US for regulatory takings jurisprudence: the goals and reasonableness of the government measures, the deprivation of economic rights and the legitimate expectations of the investor.
94 Caroline Henckels, see supra note 55, p 232.
95 Id. p. 233.
often cannot leave the jurisdiction without losing the benefit of their investment.\textsuperscript{96} This argument sounds much like the argument used by the European Court of Human Rights in the James and others v. The United Kingdom.\textsuperscript{97}

The approach taken by the arbitral tribunal in the Tecmed case was also endorsed in the decision of the Azurix Corporation v The Argentine Republic case,\textsuperscript{98} where the tribunal cited passages from both Tecmed and the ECtHR decision of James v. U.K. when holding that factors referred to would provide useful guidance on the question of expropriation. It was also used in the Suez, Sociedad General de Aguas de Barcelona S.A., and InterAgua Servicios Integrales del Agua S.A. v Argentina case where state had been found to “have a reasonable right to regulate foreign investment in their territories even if such regulation affects investor property rights. In effect, the police power doctrine seeks to strike a balance between the State’s right to regulate and the property rights of foreign investors in its territory.”\textsuperscript{99}

IV. Conclusion

When deciding whether the investor has been expropriated by the regulatory measure of the host state, arbitral tribunals apply different standards on a case-by-case basis. In most of the cases, the sole effect doctrine is used and the tribunal looks at the effect the regulation had on the investor’s rights. A few cases took a police power approach and decided the threshold issue by looking at the intent of the legislator. Even fewer cases were decided by the application of a proportionality test. Every

\textsuperscript{96} See C. Henckels, supra note 95, p. 233.
\textsuperscript{97} See James and others v. United Kingdom, supra note 65.
\textsuperscript{98} Azurix Corporation v. the Argentine Republic, ICSID Case No. ARB/01/12, Award 14 July 2006, para 310.
\textsuperscript{99} Suez Sociedad general de Aguas de Barcelona SA and InterAgua Servicios Integrales del Agua S.A. v. Argentina (InterAgua v. Argentina) ICSID case No. ARB/03/17, para 147.
Anca Muir

*The use of the proportionality principle to distinguish compensatory indirect expropriation from regulatory measures*

applicable standard can be subject to criticism, but unlike sole effect doctrine which ignores the interest of the state to legislate, and police power doctrine that can leave the investor with no compensation for actions that may be imputable to the state, the proportionality test will help the tribunals determine the right balance between the interests of both parties. By employing proportionality analysis, the arbitral tribunals will provide a clearer and more transparent analysis, in keeping with the three elements of the test: suitability, necessity, and strict proportionality. The arbitral tribunal, when confronted with the question of whether an investor had been expropriated by a regulatory measure of the host state, should first look at the suitability of the measure, then ask whether it was the least invasive way to achieve the public purpose, and as a last step, should try to balance the interest of both state and investor. The Investment State Dispute Settlement system would benefit from a more structural analysis and balanced approach in determining whether a state measure is compensable as an indirect expropriation.