Research Article

Sovereignty or State Responsibility? Expropriation and the Right to Regulate in International Law on Foreign Investment

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Abstract.

A state is entitled to be bound by investment agreements, including expropriating alien property on its territory. In international law, both represent the state's sovereign principle within the boundaries of territorial integrity. Expropriation and the right to regulate are usually included in investment agreements as part of the substantive rules. This study uses a normative juridical approach. This approach is carried out by examining the library materials, which are secondary data; especially the principles and norms of law. While the aim of this research is to examine the legal aspects of several key concepts within the international investment law regime—the right to regulate and expropriation, both in terms of its regulation and implementation, in order to find best practices. Expropriation and the right to regulate are essentially like two sides of the same coin. This is because lawful expropriation implies state obligations (compensation), whereas unlawful expropriation implies state responsibilities (restitution or reparations). Meanwhile, the right to regulate (police powers), which is based on the concept of state sovereignty, does not. Lawful expropriation is defined as the state measures carried out with the due process of law, in a non-discriminatory manner, for the purpose of the public interest and is accompanied by the payment of compensation. In terms of expropriation, the right to regulate can be regarded as a form of lawful expropriation that does not necessitate compensation.

Keywords: international investment law, expropriation, the right to regulate

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1. Introduction

In general international law, the right to regulate and expropriation are concepts based on the state's sovereignty, a key principle of international law. State sovereignty is the foundation of the contemporary international system. Initially conceptualized in the Treaty of Westphalia in 1648, sovereignty denotes the ultimate political authority within a given territory.[1] As the primary subject of international law, the state is regarded as the sovereign that regulates other legal entities: natural person, legal person, properties, and legal events (circumstances) that occur on its territory. Land is the heart of the idea of sovereignty. A state's territory is the part of land that is under its control.[2] The state's sovereignty is not, however, unlimited. The state has internal and external jurisdiction. States can regulate conduct on their territory, whether on land, at sea, or in the air, through their institutions (legislative, executive, and judicial). This is the domestic jurisdiction of a state. Whereas, externally, the state has the jurisdiction to enter into relations with other international legal subjects. This is usually exercised, in particular, through international agreements concluded by states, whether bilateral, multilateral, or regional. The basis for concluding international agreements is based on state (sovereign) rights which lead to the creation of international obligations[1].Thus, states may agree to be bound by international treaties, but then they are bounded by the principle of *pacta sunt servanda*.

Such propositions denote that in international law, state sovereignty automatically limits itself. Because each state is sovereign under international law, states are considered equal subjects (sovereign equality of states). Interfering in other states' domestic affairs is considered a violation of state sovereignty. Thus, if a state is bound by international agreements (containing international obligations) with another state or (international) legal subject, then violating such agreement is a violation of sovereignty. Within legal frameworks, such violations usually take the form of breaches of international contracts, agreements, or treaties. The implication is that, unless it is based on 'defenses' and 'justifications', state responsibility arises and must be fulfilled if the state's negligence or intentional failure to carry out its obligations can be linked to the state's measures. This responsibility is in the form of reparation, either restitution, compensation, or satisfaction.

A state is entitled to be bound by an investment agreement, including expropriating alien property on its territory. Under international law, both represent the sovereign principle of the state within the framework of territorial integrity[2]. However, the state's right to regulate (*lato sensu*) has limits and consequences. The former has an impact on the state's obligation to comply with the rules of investment agreements, while the latter has implications for the state's obligation to conduct lawful expropriation. It is considered lawful if the expropriation is carried out in accordance with international investment law and or investment agreement provisions. Non-compliance with these conditions, therefore, will be considered unlawful expropriation[3]. Although lawful expropriation has implications for the emerging state's obligation to provide compensation, unlawful expropriation has an impact on the emergence of the State's responsibility for restitution or reparation. However, the state also has the right to regulate (*stricto sensu*), which appears to be expropriation at first but is not categorized as expropriation that requires compensation[4]. This is the distinction between expropriation and the right to regulate, known as police powers, as part of the substantive rules in investment agreements. Thus, how do they differ in the context of international investment law?

This study uses a normative juridical approach. This approach is carried out by examining the library materials, which are secondary data. Especially the principles and norms of law. While the aim of this research is to examine the legal aspects of several key concepts within international investment law regime: the right to regulate and expropriation, both in terms of its regulation and implementation, in order to find best practices.

2. Expropriation and The Right to Regulate

2.1. Expropriation

Expropriation and the right to regulate are part of the substantive rules in investment agreements. The provisions of the investment agreement can be divided into two categories: substantive and procedural rules. While the substantive rules regulate parties' rights and obligations in terms of investment protection, the procedural rules ensure investor remedies through dispute settlement mechanisms if the substantive rules are violated by one of the state parties. The state guarantees protection against expropriation as one of the substantive rules. Expropriation is referred to by a variety of terms, including expropriation, taking, dispossession, and deprivation. Nowadays, expropriation is a term commonly used in the investment treaty regime[5]. Despite differences in terminology, the majority of investment agreements currently regulate expropriation though there is no agreement on a single definition of it. Nevertheless, expropriation can be defined as an act of the state (measure), intentionally or not, in taking part or all of the value of an object (investment), from its owner (foreign investors)[6].

In the context of an investment agreement, the object protected from expropriation is an investment. Expropriation can be considered to occur if it affects various types of objects: tangible or intangible property rights, or property interest within the investment. As a result, the scope of the object in question will be determined by how the definition of investment is formulated. For example, the ASEAN Comprehensive Investment Agreement 2009 (ACIA 2009) contains three (3) aspects that must be fulfilled so that entities become an object that cannot be expropriated: (1) covered investment. Such investment has obtained recognition under the laws of the state concerned or the place where the investment is located. (2) the definition of investment. ACIA uses broad-asset based definition that includes various types of the non-exhaustive list[7] including the values derived thereof[7]. Nevertheless, (3) "... that asset is not an investment regardless of the form it may take" except it has "The characteristics of an investment include the commitment of capital, the expectation of gain or profit, or the assumption of risk"[7]. These are known as characteristics of an investment.

2.1.1. Direct Expropriation

Expropriation has no single definition. This is because, in the context of investment agreements, the concept of expropriation is mostly divided into direct and indirect expropriation. Direct expropriation, also known as formal expropriation, refers to the formal transfer of title (mandatory legal transfer), through the outright physical seizure. Direct expropriation is typically based on state measures for the benefit of the state or a third party designated by it. It is direct because there appears a deliberate intention, as reflected by the law or the state measure, to seize objects directly through taking[8]. An example that is often referred to as a form of direct expropriation is nationalization. According to statistics, ISDS based on nationalization claims performs poorly under investment treaty frameworks. Before September 2016, only 11% of all ISDS claims were motivated by nationalization. However, expropriation in investment agreements typically includes nationalization[9]. This is because the majority of investment agreements regulate the concept of expropriation, both explicitly and indirectly, in a consistent manner. Article 14 of the ACIA regulates: "*A Member State shall not expropriate or nationalise a covered investment either directly or through measures equivalent to expropriation or nationalisation ("expropriation")* ... "[7]. Mengenai ekspropriasi langsung, hal ini terjadi ketika "... *investment is nationalised or otherwise directly expropriated through formal transfer of title or outright seizure*"[7].

2.1.2. Indirect Expropriation

This, however, is different from indirect expropriation because it does not have clear definitions. In general, indirect expropriation refers to any state measure that results in the total or partial loss of an investment, or measures that cause serious losses without an official transfer of ownership or direct confiscation. In other words, these actions are not intended to seize wealth or to transfer the title of investments owned by investors. Others, on the other hand, assert that any measure that has a detrimental or

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a negative impact on foreign investment, regardless of the intention, can be classified as indirect expropriation. In contrast to direct expropriation accompanied by taking, indirect expropriation only examines the state measure through the consequences it causes. Viewed from the subject, the result is a loss of investor power in terms of management, use, or effective control. Meanwhile, seen from the object, there is a significant depreciation of value in investment assets. In the investment regime, indirect expropriation is the second most common lawsuit[10].

By referring to state practice, doctrine, and arbitral awards, *United Nations Conference on Trade and Development* (UNCTAD) identifies the elements contained in the concept of indirect expropriation as follows[8]: a) an action that can be attributed to the state; b) interference with the property rights of investors or other protected legal interests; c) occurs to a certain degree that the right or interest loses all or most of its value, or the investor loses control over his investment; d) occurs despite the fact that the ownership status remains with the owner or the owner still physically owns it. These are the components of indirect expropriation. When evaluating these four things, at least three (3) considerations are taken into account when examining arbitral awards[8]:

1) The impact of a state measure on investment or investors. Concerning the first factor, it can be measured in terms of the object (investment: substantial or effective loss of economic value), subject (investor: loss of control in the form of "*the right to use, enjoy, and dispose of its investment*"), or time (duration of investment: the state measure is long-lasting or permanent). In practice, the three measures are alternative rather than cumulative. In other words, the arbitration tribunal considers the presence or absence of indirect expropriation using at least one of these measures.

2) The impact of the state measure on investor expectations. Expropriation can also be measured by the level of expectation that investors have for their investments as a result of state guarantees that certain actions will not be taken. The presence or absence of interference will be determined by whether investors have "legitimate and reasonable expectations" from their investment.

3) The nature, character, and purpose of state measures. Whether the measure is a legitimate regulation (regulatory act) as part of the right to regulate is taken into consideration[11]. This is determined by considering its purpose, which is that state measures must be carried out solely for the public interest or legitimate public welfare. And this is based on the characteristics attached to it, namely whether the regulatory act is carried out in a non-discriminatory, with due process of law, and proportionate.

2.1.3. (Un)lawful Expropriation

Based on the majority of investment agreements, which have obtained the status of customary international law, expropriation is a sovereign right of the state as long as it is carried out by fulfilling the following conditions[2]:

1. *For a public purpose*. Expropriation must be justified for the public interest at the time of the measure, not later. It makes no difference if the purpose is not met. On the other hand, if the state measure reflects the 'public interest' later rather than at the beginning, this will be considered unlawful. In the practice of arbitration, unless otherwise stated in the investment agreement, the public interest is mostly interpreted from international law viewpoint. International law allows states to determine how a policy is based on the public interest.

2. *Non-discriminatory*. This idea means that the expropriation should not be motivated by prejudice towards foreign investors based on their nationality. The arbitration tribunal has given this interpretation. However, not every investor is subjected to discriminatory treatment by the state. Expropriation is considered discriminatory if the measure is not only directed at foreign investors but is also based on or motivated by the investors' different nationalities.

3. *With the due process of law*. This phrase can be interpreted to mean that the act of expropriation must conform to national legal procedures where there are regulations or laws governing it, or that the policy is based on or follows the applicable legal rules. In addition to complying with national legal mechanisms, aggrieved investors must have the opportunity or access to have their case reviewed before an independent court.

4. *With the payment of compensation*. Expropriation must also be accompanied by compensation in order to meet the last requirement for legality. The method used, for example, based on the *hull formula*, is usually specified in the investment agreement. In this concept, three requirements must be met: prompt, adequate, and effective. Compensation is considered prompt if it is paid promptly; adequate if it bears a reasonable relationship to the market value of the investment in question; and effective if paid for in a freely convertible or usable currency.

As long as expropriation is done lawfully, it is a sovereign right of the state. This is reflected in the fulfillment of the aforementioned obligations, including compensation. Expropriation is considered unlawful if it is carried out without regard for the aforementioned obligations. This implies the emergence of a state obligation to make restitution or reparations. However, in the following section, we will look at state measures that appear to be expropriation but are normatively non-expropriative.

2.2. The Right to Regulate

The right to regulate (*lato sensu*) can be viewed as the state's jurisdiction or sovereignty. This includes the right of the state to enforce the law in its territory through legislative, executive, and judicial instruments[12]. This includes the state's right to be bound by an investment agreement, which implies international obligations that must be met, as well as the state's responsibility if those obligations are not met.

The right to regulate is better understood in the context of investment agreements in a narrower sense (*stricto sensu*). In other words, the right to regulate does not imply that the state has the authority to regulate (which according to customary international law is indisputable) but do the state's measures imply obligations that must be compensated as part of the right to regulate (state jurisdiction or sovereignty) considering that investment agreements protect investors' rights[13]. That is a narrow interpretation of the right to regulate, which refers to specific technical terms as an exception to indirect acts of expropriation.

The right to regulate can be defined as the state's right to take measures contrary to its obligations under investment agreements (or detrimental to the rights of investors), without the obligation to compensate the party (private) who has suffered a loss in order to further the public interest. The right to regulate contains at least two elements in this context: first, it is a legal right. These rights are usually regulated in investment agreements, either as preambles, special exceptions, or general exceptions, in the context of international investment law. The second element is the elimination of the state's obligation to provide compensation as a form of state responsibility resulting from its measures that have negative impacts on investors. This is known as the police powers doctrine. This doctrine is frequently linked to public welfare objectives. There is no single definition, but it is always associated with the protection of public order, vital security interests, public health and safety, the environment, etc. The following is an example of the right to regulate in investment agreements[13]:

2.2.1. Preambule

According to the Vienna Convention on the Law of Treaties (VCLT), the preamble of the treaty contains the purposes and objectives that served as the basis for the agreement's context[14]. The preamble must be taken into account when interpreting the treaty provision, even though it cannot generate rights or responsibilities separate from the rules of its articles. Therefore, the preamble is an interpretive tool that, as demonstrated in several arbitration tribunal decisions in investment disputes. The following formulation is an example from Indonesia-Singapore BIT 2018[15]:

“REAFFIRMING the right of the Parties to regulate and to introduce new measures relating to investments in their territories to meet legitimate policy objectives”.

Regarding the phrase *“reaffirming ... to regulate ...”*, this is a sort of repetition that can turn into redundancy because such a right is already recognized by international law though it can also be seen as a way to emphasize provision (*abudandi cautela*). Nevertheless, the recognition of the right to regulate *lato sensu* does not necessarily remove the state’s obligation to compensate if any investment agreement obligations are breached. In other words, the above formulation risks conflating the distinction between the state’s right to regulate *lato sensu* and the state’s right to regulate *stricto sensu*, which should be made explicit to protect the state’s interests. However, this formulation must be interpreted systematically by understanding the norms of other provisions. And this is the role of special exceptions and general exceptions.

2.2.2. Specific Exceptions

Norms that specify a circumstance that can preclude the use of the guidelines for a certain standard of treatment in an investment agreement are known as specific exceptions. In general, it is either a provision on its own or an explanatory clause in an annex. The formula is usually explained in the appendix as follows[7]:

Non-discriminatory measures of a Member State that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute an expropriation...

Several additional formulations have been discovered, particularly those that explain the conditions around these concepts. For example, the Columbia-United Kingdom BIT 2010 provides exceptions to the concept of indirect expropriation as follows[16]:

Non-discriminatory measures that the Contracting Parties take for reasons of public purpose or social interest (which shall have a meaning compatible with that of ‘public purpose’) including for reasons of public health, safety, and environmental protection, which are taken in good faith, which are not arbitrary and which are not disproportionate in light of their purpose, shall not constitute indirect expropriation

In addition to providing exceptions for conditions that are not classified as indirect expropriation, the above formulation includes an explanatory clause that must be used as guidance, namely the concept of good faith, proportionality, and the purpose of state measure, to determine whether it is classified as the right to regulate or, conversely, indirect expropriation.

2.2.3. General Exceptions

The general exception is another model. Various situations or state measures (generally related to various efforts to protect the public interest) will be excluded from the scope of the investment agreement as a result of this formulation. This formulation appears to be similar to that found in GATT Article XX. Article 17 ACIA 2009, for example, regulates[16]:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between the Member States or their investors where like conditions prevail, or a disguised restriction on investors of any other Member State and their investments, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member State of measures:

1. *necessary to protect public morals or to maintain public order;*
2. *necessary to protect human, animal, or plant life or health;*
3. *necessary to secure compliance with laws or regulations which are not inconsistent with this Agreement, including those relating to:*
    (a) *the prevention of deceptive and fraudulent practices to deal with the effects of a default on a contract;*
    (b) *the protection of the privacy of individuals in relation to the processing and dissemination of personal data and the protection of confidentiality of individual records and accounts;*
    (c) *safety;*
4. *aimed at ensuring the equitable or effective13 imposition or collection of direct taxes in respect of investments or investors of any Member State;*
5. *imposed for the protection of national treasures of artistic, historic, or archaeological value;*

6. *relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.*

On the one hand, the above formulation allows for the exclusion of public policies (letters a-f) from the scope of investment agreements. However, this does not imply that this limitation is without restrictions. According to the first sentence of the formulation above, the right to regulate may be applied to the scope in question as long as it is not conducted arbitrarily, discriminatorily, or covertly. Essentially, while this model is widely used and serves to broaden the scope of state policy, its weakness is that the public interest in question (a-f) must be explicitly described. Meanwhile, the public interest of the state may be dynamic, so there may be areas that are not covered by the general exception.

2.2.4. Security Exceptions

In investment agreements, there is a notion known as security exceptions in addition to general exceptions. These security-based general exceptions tend to be subjective, whereas general exceptions are more objective. For instance, Article 19 of ACIA 2009, regulates[7]:

Nothing in this Agreement shall be construed:

i. *to require any Member State to furnish any information, the disclosure of which it considers contrary to its essential security interests; or*
ii. *to prevent any Member State from taking any action which it considers necessary for the protection of its essential security interests, including but not limited to:*

(a) *action relating to fissionable and fusionable materials or the materials from which they derived;*

(b) *action relating to the traffic in arms, ammunition, and implements of war and such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment;*

(c) *action taken in time of war or other emergency in domestic or international relations;*

(d) *action taken so as to protect critical public infrastructure, including communication, power and water infrastructures, from deliberate attempts intended to disable or degrade such infrastructure; or*

1. *to prevent any Member State from taking any action pursuant to its obligations under the United Nations Charter for the maintenance of international peace and security.*

Although it mentions several objective measures for what the state must protect (security and peace), the above norms are subjective because they include the phrase *"... that it considers necessary..."*. In other words, the host state will be the only one to consider all of the aforementioned factors. However, in practice, an arbitration tribunal's interpretation of such a formulation may differ from one another because some tribunals believe that the exception is not subjective. However, there is an objective measure, such as linking the above norms to concepts in customary international law, such as the necessity of self-defense. Experts, however, generally regard this decision as contentious.

3. Conclusion

Expropriation and the right to regulate clauses are a part of the investment agreement's substantive rules in the regime of investment treaties. The state, as an expression of the right to regulate (*lato sensu*), guarantees protection against expropriation, while also providing space for the state's right to regulate through investment agreements. Expropriation is defined as the state's measurement right to seize or harm objects (investments) in its territory without the consent of the property's owners (foreign investors). Meanwhile, the right to regulate (*stricto sensu*) is the state's right to take measures contrary to its obligations under the investment agreement without the obligation to compensate the party (private) who has been harmed, to further the public interest. Using juridical normative approach, this research concludes that expropriation and the right to regulate are like two sides of the same coin. This is because the limits of lawful expropriation rules imply the state's obligations (compensation), while unlawful expropriation implies state responsibility (restitution or reparations), whereas the right to regulate (which is based on state sovereignty: police powers) does not. State measures are considered lawful expropriation if they are carried out by due process of law, in a non-discriminatory manner, for the public good, and to compensate investors. Meanwhile, the right to regulate might be seen as an expropriation that does not necessitate (minus) compensation. The two concepts are formulated differently and have different impacts.

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