The regulatory taking doctrine

Lorenzo Cotula, International Institute for Environment and Development

This is the third of a series of briefings which discuss the sustainable development issues raised by legal arrangements for the protection of foreign investment. The briefings are based on legal research by IIED and its partners. The goal is to provide accessible but accurate information for human rights, development and environmental organisations working on issues raised by foreign investment in low- and middle-income countries.

Briefing 3 introduces one of the most controversial legal doctrines of investment law – “regulatory taking” – and sets out its implications for sustainable development.

The ability of states to regulate activities within their territory is a key attribute of sovereignty. It is also important for the pursuit of sustainable development goals. But host state regulation can negatively affect ongoing investment projects by raising project costs or reducing the value of project assets.

The international “regulatory taking” doctrine requires host states to compensate foreign investors for regulatory measures that negatively affect ongoing investment projects to a significant degree. In these cases, even though the investment has not been formally expropriated (i.e. the investor’s property rights have not been removed), state regulation has nonetheless deprived the investment of its economic value, or of a substantial portion of it. Hence the obligation for the state to compensate the investor.

The regulatory taking doctrine is a valuable safeguard for foreign investors. But at the same time, it can constrain the ability of host states to adopt and implement regulation in pursuit of sustainable development goals.

The taking of property under international law

Under international law, host states have the sovereign right to expropriate assets and to regulate activities within their jurisdiction, as stated for instance in UN General Assembly Resolution 1803 of 1962, which is generally recognised as reflecting law binding on all states (as held in the Liamco v Libya, Amoco v Iran and Kuwait v Aminoil awards).

In addition, international law defines expropriation very broadly. First, the investors’ “property rights” that can form the object of expropriation are defined very broadly to include all rights and interests that have monetary value (as held in the Liamco and Amoco awards). As a result, host state action that breaches investors’ contractual rights has been treated as taking of property (e.g. in the BP, Texaco and Aminoil cases, all concerning concession agreements).

Second, in order to establish whether a taking has occurred, international law considers the impact of government action rather than its intention or form (Tippett). As a result, where regulation affects an investment project in a very significant way, it is treated as a case of

Expropriation (or taking) is the compulsory acquisition of property by the state. The term nationalisation is sometimes used for takings affecting a whole sector or industry rather than a single investment. Regulatory (or “indirect”) taking refers to regulation that negatively affects the implementation, value or costs and benefits of an investment project to such an extent that this must be deemed to have been expropriated. Regulation is broadly defined to include the enactment and/or implementation of treaties, laws, decrees and other legal instruments.
expropriation – even if asset ownership remains vested with the investor ("regulatory taking" or "indirect expropriation").

A regulatory taking may, for example, occur through measures that gravely interfere with the management of a company (e.g., measures placing the investor's local subsidiary under the control of a government-appointed temporary manager, in the case Starrett v Iran); through the imposition of discriminatory taxation or of taxes in breach of agreed commitments (e.g., the imposition of tax rates above maximum ceilings specified in the investment contract, in the case Revere Copper v OPIC); or through the manipulation of environmental regulation in a way that severely affects the interests of the investor (e.g., the enactment of new environmental regulation that prevents the implementation of a project to build and operate a landfill, in Metalclad v Mexico).

This broad interpretation of "expropriation" as including regulatory taking is confirmed by most investment treaties (see Briefing 2). Many such treaties explicitly refer to both "direct" and "indirect" expropriation; and a number of them also refer to measures "tantamount" or having an effect equivalent to expropriation (e.g. article 1110(1) of the North American Free Trade Agreement – NAFTA).

In addition, investment contracts negotiated between investors and host states may shelter the investment from regulatory change well beyond the scope of the regulatory taking doctrine – an issue tackled in Briefing 4.

**Tensions between the regulatory taking doctrine and compliance with evolving international standards**

The broad definition of expropriation and the concept of regulatory taking raise important issues. On the one hand, new regulation may negatively affect the economic benefits that investors expect to derive from their investment. In extreme cases, it may even undermine the viability of the project. For instance, the Metalclad tribunal in the NAFTA case Metalclad v Mexico, where the viability of a project to operate a landfill was jeopardised by the denial of relevant permits and by the establishment of a protected area. The vulnerability of investment to regulatory change would support arguments in favour of entitling investors to compensation for losses incurred.

On the other hand, an obligation for the host state to compensate investors may make it more difficult for host states to enact and implement regulation pursuing sustainable development goals – for instance where new regulation has the effect of raising project costs. Several civil society organisations raised these concerns in the aftermath of the Metalclad ruling, the consequence of which was an obligation for the government of Mexico to compensate Metalclad for losses caused by new environmental regulation.

The Metalclad tribunal took a particularly broad definition of expropriation, as including “not only open, deliberate and acknowledged transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner [...] of reasonably-to-be-expected economic benefit [...]” (para. 103 – emphasis added). This approach may make it more costly – and therefore more difficult – for host states to raise human rights, environmental and other standards applicable to investment projects (a phenomenon referred to by some as “regulatory chill”).

The obligation to pay compensation may constrain regulation in lower-income countries, which may not be able to afford compensation costs. These constraints must be assessed in the light of the duration of many investment projects (which may span several decades), on the one hand, and of the remarkable changes in international human rights and environmental standards over the past few decades, on the other.

In the human rights field, international law has undergone major development since 1948, when the Universal Declaration of Human Rights was adopted. This has happened, among other means, through the adoption and increasing ratification of new human rights treaties, both at global level (particularly the 1966 UN Covenants) and at regional level (e.g., in Africa, the 1981 African Charter on Human and Peoples’ Rights); through international rulings applying international treaties (e.g. the SERAC v Nigeria case, where environmental degradation and economic deprivation caused by oil extraction were found to violate the human rights of the Ogoni people); and through “General Comments” issued by UN bodies responsible for overseeing the implementation of international treaties, which clarify the meaning of treaty provisions.

Similarly, environmental standards have been raised through the increasing number of international environmental treaties; the growing integration of environmental aspects in treaties with a broader remit (e.g. article 32 of the 2000 ACP-EU Cotonou Agreement, and article 19 of the 1994 Energy Charter Treaty); and the greater attention paid to environmental issues by the International Court of Justice (see for instance the Gabčíkovo-Nagymaros case) and by other international dispute settlement bodies (see e.g. the WTO Shrimp/Turtle case).

As a result of these changes, human rights and environmental standards are substantially higher today than they were a few decades ago. Areas that were not previously covered by such standards are now more tightly regulated. It is reasonable to expect that international human rights and environmental standards will continue to be raised over the next decades.

Because of this, host state regulation for sustainable development may originate not only from the political will of those states, but also from the requirement to comply with evolving international obligations. Indeed, to the extent that host states are bound by international standards, for example as a result of their signing up to new environmental treaties, they are required by international law to bring their domestic legal system in line with the new international standards – and to take regulatory measures to that effect. As this may trigger the obligation to pay compensation under the regulatory taking doctrine, host states may be discouraged from adopting and implementing domestic regulations or from accepting new international commitments.

**Expropriation and regulation – Defining the boundaries**

The tensions between the regulatory taking doctrine and the pursuit of sustainable development goals require clarification
of the borderline between direct/indirect expropriation on the one hand (which requires host states to pay compensation), and regulation on the other (which does not require payment of compensation).

After the Metalclad ruling, subsequent NAFTA awards (S.D. Myers, Pope & Talbot and Methanex) have made efforts to clarify that borderline, and have taken a more cautious approach to regulatory taking. At present, Metalclad remains the only NAFTA award in which this type of expropriation claim has succeeded.

In recent years, more specific norms in investment treaties have further clarified the application of the regulatory taking doctrine (see for instance the US-Chile Free Trade Agreement 2003 and the US-Uruguay Bilateral Investment Treaty 2004, which clarify the circumstances under which regulation constitutes a taking). However, these more specific norms only apply to the few recent investment treaties that contain them.

These more recent rulings and treaties suggest that the test for determining whether a regulatory taking has occurred is:

- The character of government interference, particularly with regard to compliance with the public purpose, non-discrimination and due process requirements (see e.g. Methanex), and to the proportionality between the stated purpose and government measures (i.e. effectively that governments should not “take a hammer to crack a nut”; Tecmed);
- The economic impact of government interference, particularly with regard to the test of “substantial” or “radical” deprivation of property rights that is such as to render these rights economically “useless” (Pope & Talbot; Tecmed; Starrett; Tippetts);
- Interference with the investor’s reasonable expectations (Metalclad), particularly those based on host government commitments not to regulate (Methanex).

If regulation falls at these hurdles, the regulatory change constitutes a taking, and the host state must compensate investors negatively affected by it. For instance, while sustainable development considerations are important in establishing whether the taking is legitimate (e.g. whether it pursues a public purpose), they cannot shelter host states from having to pay compensation if the economic impact of new regulation is substantial.

In addition, sustainable development considerations have no bearing on the amount of compensation awarded. Compensation has to be calculated according to the same rules of international law as are applicable to any other expropriatory measure (Compania del Desarrollo de Santa Elena). As a result, host states may have to pay very significant amounts of compensation for enacting regulation in pursuit of sustainable development goals.

This is illustrated by a recent international arbitration (not concerning sustainable development regulation nor regulatory taking); arbitrators awarded the investor a record amount of $867 million in compensation (Ceskoslovenska Obchodni Banka v Slovakia). For small and/or poor countries, such a level of compensation would significantly strain public finances. Governments of these countries would think twice before taking action that would expose them to such a level of liability.

**Conclusion**

Serious concerns were triggered by the NAFTA Metalclad ruling – concerns that in the future states would shy away from raising environmental or other standards for fear of having to pay massive compensation claims. These concerns have been somewhat eased by subsequent rulings and by the more specific provisions of recent investment treaties. Together, this suggests that “a legitimate, proportionate and non-discriminatory measure, which did not render the foreign investor’s property rights economically useless, nor was imposed in clear violation of a prior commitment, will not amount to expropriation” (Waelde and Kolo, 2001:814). The terms “legitimate” and “proportionate” here refer to the public interest behind the measure; and the notion of “economic utility” (or “uselessness”) relates to the commercial viability of the investment project.

This said, the regulatory taking doctrine still requires payment of compensation where regulation results in a substantial deprivation of property rights. This includes cases where environmental or other regulation pursuing sustainable development goals affects the viability of an investment project.

In these cases, the regulatory taking doctrine requires states to compensate investors for losses incurred. As the investment project itself is undermined, investors have a legitimate expectation to be compensated. But in lower income countries, the obligation to pay compensation may also discourage host states from adopting regulation in pursuit of sustainable development goals if doing so would substantially affect foreign investment. This is even more likely given that the sustainable development purpose of regulatory change cannot be taken into account when determining the amount of compensation.

In recent years, much progress has been made to clarify the borderline between expropriation and regulation. But disputes may still arise where aspects of the regulatory taking test are not clear-cut. For instance, what is the threshold beyond which the economic impact of regulation can be deemed as “substantial”? To what extent can clearer regulatory taking criteria embodied in recent investment treaties be applied to disputes regulated by earlier, less specific treaties? The implication is a continued need for vigilance on the part of civil society groups, so as to make sure that the regulatory taking doctrine is not (mis-)used to prevent genuine efforts to pursue sustainable development goals. Vigilance is also needed to ensure that tighter regulatory taking tests are not circumvented by reliance on other standards embodied in investment treaties (e.g. broad interpretations of “fair and equitable treatment” – see Briefing 2) or in investment contracts (particularly stabilisation clauses – see Briefing 4).
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3 On the nature and value of arbitral awards, see Briefing 5.

About IIED

The International Institute for Environment and Development is an independent, non-profit research institute working in the field of sustainable development. IIED seeks to change the world in partnership with others by providing leadership in researching and promoting sustainable development at local, national and global levels. Our goal is to shape a future that ends global poverty and sustains fair and sound management of the world’s resources.

Contact: Lorenzo Cotula
IIED, 3 Endsleigh Street, London WC1H 0DD
Tel: +44 (0)131 624 7042
Fax: +44 (0)131 624 7050
Website: www.iied.org
Email: lorenzo.cotula@iied.org