THE POLICE POWER DOCTRINE AS A STATE'S PROTECTION AGAINST THE CLAIM OF INDIRECT EXPROPRIATION UNDER THE INTERNATIONAL INVESTMENT ARBITRATION

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ABSTRACT

Many concerns surrounding the conflict between the state's right to regulate and the protection of foreign investors remain unresolved in the recent years. Among these issues are the efforts of states to deal with investor claims of indirect expropriation. And further, to respond the claims, states will rely on the Police Power Doctrine to reject indirect expropriation claims directed against them. This study aims to determine to what extent the implementation of the Police Power Doctrine can be used to provide protection for states in the claim of indirect expropriation against investors in International Investment Cases. This study indicates the vague limitation of the doctrine raises the need to do a more clarification regarding the doctrine's limitations as there are still many conflicting opinions and differences in the use of the doctrine. This research is legal research with a normative legal approach and comparative legal study where the approach used alongside are International Investment Law and other regulations. This study research shows that, despite the arbitral tribunal's recognition of the Police Power Doctrine, the doctrine's many inconsistencies and the lack of a clear judgment on how it should be applied provides a gap in International Investment Law.

Keywords: International Investment, Police Power Doctrine, Foreign Investor's Protection.

INTRODUCTION

Several states have welcomed foreign investment during the past half centuries. Many states have benefited from foreign investment through Foreign Direct Investment ("**FDI**") in the following ways, including by growing their economies and creating new job opportunities.

FDI or foreign investment is often discussed in international economic trade, where the definition of FDI is an international capital flow through which a company from one state establishes or expands its business in another state (Krugman & Maurice, 1999). As one of the important topics and widely used in recent years, FDI has been shown to help create new jobs, introduce advanced technology, organization, communication and marketing of a states. All states in general are fully aware of the importance of foreign investment and are always trying to attract investors by offering facilities and incentives to foreign companies.

One of the benefits and incentives given to foreign companies is the guarantee of investment security under the protection of international law. Investment protection under this international law provides an important means for investors to secure their investments from the actions of host states.

Bilateral Investment Treaties ("**BIT**") and Multilateral Investment Treaties ("**MIT**") have provisions to protect companies intending to invest. Agreements between the two states ensures that foreign investors will receive fair and equal treatment, protection and security, and prohibits discrimination based on the original nationality of the investor (Vandevelde, 2005). Both the BIT and MIT contain regulations for investors, private companies, and the relationship between foreign investors and the host state. With the BIT and MIT agreement, foreign investors benefit from one of the investment protection clauses or a combination of the protection clauses contained in the agreement.

One of the investor protection instruments contained in the BIT is that the host state cannot arbitrarily take over or expropriate a foreign investment. Expropriation is described as the government's taking of a private property, which must be accompanied by fair compensation.(Sharan, 2001.) The host state cannot take over a foreign investment unless the takeover is carried out for general purposes, following a legal process and accompanied by payment of compensation. (Dugan, 2008.) And if the recipient state takes over a foreign investment without fulfilling the requirements mentioned above, then the takeover will be illegal and constitute as a violation of the BIT.

There are two types of expropriation provides by the Customary International Law: (1) a form of direct expropriation in which a State overtly and intentionally confiscates a property and/or privately transfers ownership of a foreign property by the government or the government-appointed third party, (2) indirect expropriation where government actions affect the transfer of property which results in foreign investors losing the benefits of their investment. (Sornarajah, 2010.) At first expropriation only involved a direct taking of the physical property of the foreign investor. However, recently there have been many cases of international investment where the government has carried out expropriations that are indirectly affecting the economy of the investors and in some cases, investors are so severely affected that they cannot gain benefit from their investments. (UNCITRAL, 1983.)

In international investment law, when foreign investment is negatively impacted as a result of the host state using its regulatory authorities, the Police Power Doctrine is always used by states to avoid paying compensation for the indirect expropriation they have caused. For example, in the case of Feldman v. Mexico, Feldman as a foreign investor were unable to ask for compensation towards Mexico as the new regulations made by the Mexican government are proven to be made as one of the state's regulatory powers and are intended for the public interest through environmental protection. (ICSID, 2002.)

A host state's act for not paying compensation to foreign investors is strengthened in the case of Saluka v. Czech Republic. (UNCITRAL, 2006.) The court concluded that a state is not required by international law to compensate foreign investors when the state has used its regulatory authority in a non-discriminatory manner aimed for general welfare. The question is to what extent the implementation of the police power doctrine can be used to protect a state even if it has harmed foreign investors' investments.

THE HISTORY OF INTERNATIONAL INVESTMENT AGREEMENT

International investment treaties emerged during the colonial era when most countries were threatened by European powers and the newly independent states of America. The Jay Treaty was signed by the United States and Great Britain soon after the American Revolution which established protections for the citizens of investors from the recipient capital states. (Vandevelde, 2005.) In that era, international law only recognized the threat of coercion (Use of Force) as a protection for international investment. Other provisions on investment were included in several agreements in relations between the two states, but the treaties at the time did not provide full and detailed protection for foreign investment.

In the post-colonial era, after the end of colonialism, military forces of former colonial states were abolished to protect international economic interests. (Cameron, 1997.) However, the fear of economic exploitation on the part of developed countries causes many developing countries to refuse to participate in the international economy. At the same time, the gap between developing countries and the Soviet Union over foreign investment encouraged other developed countries to strengthen legal protections for foreign investment through international investment treaties. Foreign Investment Treaties in the post-colonial era, the friendship, commerce, and navigation ("**FCN**") promised equal treatment and permanent protection and security for the property of foreign investors. (*Treaty of Friendship, Commerce and Navigation, U.S.-Greece*, 1951.) Where foreign investment property cannot be expropriated without payment or compensation. Few international investment treaties exist during this period and mostly are focusing on protecting foreign investments from political risks.

In the history of international investment, the global era began in the late 1980s. This era began to change the context and content of foreign investment agreements and how investment agreements were negotiated. In this global era, the number of BITs is also increasing. This increase in BIT agreements is due to two reasons. The first occurred after the economic improvement of several Asian countries which had high levels of investment and encouraged the production of their goods for export. (World Bank, 1993.) Second, bank loans, which at one point made up half of all capital flows to developing countries, became less available due to the debt crisis of the 1980s. (Rapley, 1997.) Therefore, it is expected for developing countries to seek foreign investment as a way to finance their state's development.

FOREIGN INVESTORS PROTECTION

As already mentioned, in order to promote foreign investment in a secure and stable environment for investors on another state's territory, the International Investment Protection Standard includes fair and equitable treatment, full protection and security, national treatment, and equal treatment for all members (national treatment and most-favored nations treatment). These protection standards can be found in almost all foreign investment agreements. The Court of Plasma Ltd. v. Republic of Bulgaria found these protection standards may overlap in certain clauses, but may also be defined separately. From the point of view of the arbitral tribunal, these protection standards, although related, can be applied and defined separately and autonomously. (ICSID, 2005.)

The first standard of protection is the Fair and Equitable Treatment ("**FET**") Standard, commonly referred to as the absolute, unconditional, and independent standard, which provides favourable terms and conditions to protect foreign investors and is considered the most basic standard of treatment. (Yannaca-Small, 2008.)

The FET standard is one of the most important protection standards for foreign investors to protect their investments in foreign countries, this standard requires the host state to give certain treatment to foreign investors regardless of the treatment given to its own citizens. (M.K., 2006.) This FET standard is frequently used in bilateral investment agreements ("**BITs**"), and its primary aim is to eliminate any potential gaps regulation in investor protection. In the BIT, the FET protection standard stipulates that the host state must provide fair and equal treatment in accordance with the FET. (Lowe, 2017.) This FET protection standard is also designed to attract foreign investment to demonstrate that the host state will safeguard their foreign investment fairly and equitably.

The second standard of protection is 'full protection and security' ("**FPS**") in which the host state is committed to protecting foreign investors against unfavourable events and malicious actions. This standard imposes obligations on States under international law to prevent injury or harm caused by third parties to the property of foreigners on their territory. (UNCITRAL, 2012) One could argue that the primary goal of this protection standard has historically been to safeguard investors against various forms of physical aggression, including the theft of investment property. However, the FPS concept has now evolved to include both legal and physical protection.

The third standard of protection is national treatment, which is regarded as one of the key principles in international investment law to guarantee that the host state treats foreign investment equally to domestic investors. (A.K., 2008.) National treatment requires the host state not to treat foreign investment differently or less than its nationals. (Kurtz, 2008.)

The fourth protection standard, Most Favoured Nation provides equal benefits to all foreign investors investing in the host state. Additionally, this clause enables the investor to gain benefit from the higher investor protection criteria that could be included in other investment agreements to which the host state is a party to. (Salacuse, 2015.)

THE CONCEPT OF INDIRECT EXPROPRIATION

Leading arbitrators and legal experts have struggled with the complicated matter of when a state's regulatory actions can be regarded as an expropriation for decades. (Gazzini, 2010.) International investment treaties provide protection for foreign investors, which require states to protect foreign investors against both direct and indirect expropriation. In cases involving international investment, the idea of indirect expropriation itself has a lengthy and complex history. Indirect expropriations are challenging because there are protection criteria that the state has promised foreign investors while also balancing those interests with the need for the state to set regulations that are compliant with its own laws.

To protect foreign investment, various investment treaties have included provisions to protect investments from being expropriated by the host state. Expropriation is widely accepted to be the action of a government's seizure of private property, which involves the payment of compensation. (Sharan, 2006.) In the past, the concept of expropriation was very clear. In other words, it was the taking of physical property belonging to foreign investor by the state. Initially, expropriations involve the immediate confiscation of physical property belonging to foreign investors. Recently, many other characteristics have been found in the form of taking that does not affect the ownership rights of foreign investors' physical objects. (Newcombe & Paradell, 2009.)

The protection of foreign investment property in the host state against direct expropriation has long been in international investment practice. However, since physical expropriation of foreign investment properties is no longer common, nowadays expropriations appear more in the form of "indirect expropriations" where actions taken by the government interfere with property rights or reduce the value of foreign investment properties. In general, an indirect expropriation happens when the state interferes with how a property is used or the benefits it provides, even though the property is not taken and the legal owner rights remain unaffected.

In practice, protection against indirect expropriation entitles foreign investors to make claims against the host state on the grounds that the state in exercising its regulatory powers (laws, decrees, or other interference) has confiscated, in whole or in part, from assets, even if the state does not physically confiscate their assets or investments. Investors can claim economic losses caused by state actions that affect their assets. Under NAFTA, a foreign investor can interfere with a government's ability to regulate in the event of an acquisition by a host state. It can be determined by the Police Power Doctrine.

THE POLICE POWER DOCTRINE

When foreign investment is negatively impacted by the implementation of the host state's regulatory powers, the Police Power Doctrine is always invoked in international investment law as an excuse for not paying compensation against indirect expropriation claims. In many cases of International Investment Arbitration, states are reluctant to agree that regulatory measures taken in the public interest of their states can be considered as an expropriation, and resulting in the state being obliged to compensate foreign investors who are affected. In order to protect the freedom to exercise their regulations, states have appealed on the grounds of the Police Power Doctrine. (Zamir, 2017)

The Police Power Doctrine has a long history of being recognized as a principle of customary international law. (UNCITRAL, 2006) The Police Power Doctrine has been noted and debated in the 1987 Harvard University Convention on the International Liability of States for Injury to Aliens Nationals and the Third Restatement of US Foreign Relations Law. (American Law Institute, 1987.) The doctrine started to take shape on a global scale in the 20th century. The idea of police power was expressly acknowledged in Federico Garcia Amador's Fourth Report on the Law of State to the International Law Commission ("**ILC**") in 1959. Similar results were obtained with the 1961 Harvard Convention Draft on the Responsibility of State and the 1965 Second Restatement of the Law of the American Law Institute. The theory thereafter started to be applied and recognized in cases involving international investment law, such as those in the Iran-US Court, where there are some indications that the doctrine applies as a part of international law.

The case of Philip Morris v. Uruguay observes that, since 2000, various investment decisions have contributed to developing the scope, content and conditions of The Police Power Doctrine under international law. (ICSID, 2016) Under this doctrine, states are protected from paying compensation when adopting bona fide non-discriminatory measures for public policy purposes. (Ranjan & ANAN, 2016.) Various government regulatory interventions, such as taxation, maintenance of public order, health or morality can be considered as a bona fide act. (Brownlie, 2008.) And a large number of foreign investment arbitration courts have applied this doctrine to identify indirect expropriations. (ICSID, 2012.)

However, this doctrine that gives states the freedom to adopt their regulatory measures has created a gap in the protection of international investment. (UNCITRAL, 2002.) As discussed by one expert, Prabhash Ranjan, "it is one thing to state that the host state has the right to adopt non-discriminatory regulatory measures for public purposes, but that right may conflict with the content of the BIT regarding expropriation provisions and protection of foreign investment". (Ranjan, 2019.) In addition, the application of the police power doctrine exacerbates inequality between the host state and foreign investors where foreign investors have to bear the risk of being affected by the host state's regulatory actions without being entitled to any compensation even though the taking has a very detrimental effect on their investment.

POLICE POWER DOCTRINE IN INTERNATIONAL INVESTMENT ARBITRATION.

Investor-state investment arbitrations have long recognized the Police Power Doctrine long before it was expressly incorporated into International Investment Agreement ("**IIA**").

Some arbitral tribunals have addressed the purpose of government action without explicitly discussing the principle of police powers. In the case of Methanex v. United States, the court considers that: non-discriminatory regulations for public purposes that are enforced in accordance with legal process which affecting foreign investors cannot be considered expropriation and the state

is not obligated to provide compensation unless a specific commitment from the state has been given to foreign investors. (UNCITRAL, 2005.) In the case of Myers v. Canada, the doctrine is more explicitly discussed, where the court states that all regulations enforced by the state are not included as an act of expropriation. According to NAFTA's Article 1110, public authorities' regulatory actions are not subject to legal action. (Expropriation and Compensation). (UNCITRAL, 2000.)

In another case Saluka v. The Czech Republic, the court determined that it was well-established in international law that states are not obligated to compensate foreign investors when they exercise their regulatory power by enacting non-discriminatory measures intended to promote the welfare of all citizens. (UNCITRAL, 2006.) Thus, in that case, when the Czech Republic has made the claim for expropriation, the court dismissed the suit and the Czech Republic is not obligated to compensate foreign investors who are affected because the state's acts have been acknowledged as falling within international customary law. The court specifically stated that 'an action of a government exercising its regulatory powers is lawful and permissible even if it has a detrimental effect on investors' investments. Further, in the Quiborax case, the court found that the act of exercising regulatory authority by a government is lawful and permissible even if it has adversely affected an investor's investment. (ICSID, 2015.)

International law generally recognizes regulatory activities carried out under the so-called “police power” of the state cannot be compensated. (ICSID, 2015.) A number of courts have also further used the police power doctrine and firmly consider that the doctrine is embedded in international law. (UNCITRAL, 2001.)

THE POLICE POWER DOCTRINE AS A STATE’S PROTECTION

The subject of conflict between state regulatory law and the protection of foreign investors has left many unresolved issues. The state's attempts to handle investor claims based on indirect expropriation of their investments due to public interest rules such as health and environmental protection are among these issues. One way in which a state can deal with a possible indirect expropriation claim is to include a clause stipulating that government regulation in the public interest will not be considered as an expropriation into an investment agreement (“**BIT**”). And furthermore, respondent will use the Police Power Doctrine to defend against investor claims that state regulatory actions amounted to indirect expropriation. This doctrine's core belief is that a state is not liable for indirect expropriation resulting from certain lawful legislation.

However, further questions arise as to which specific government actions may fall within The Police Power Doctrine. There are several categories under which non-compensable actions may occur, according to the 1961 Harvard Draft Convention on the International Responsibility of States, the actions may occur through a) taxation b) general changes in the value of currency c) maintenance of public order, health or morality d) exercise of the rights to war or e) normal operation of State law is subject to certain conditions in the draft convention. Second, it can be seen from the opinions of experts who have tried to determine the types of state regulatory actions that are under police power. For example, according to George Christie, "actions in the interest of public health and morality, changes in the value of a nation's currency, and the implementation of a state's tax laws would all justify actions that, due to their severity, cannot be justified.". As long as it is not discriminatory. (Christie, 1962.) Then According to Newcombe and Paradell, international authorities accept three general sorts of police powers that could justify non-compensation in cases of expropriation, namely, a) public order and morality b) protection of human health and the environment and c) state taxation.(Newcombe & Paradell, 2009.)

Although there are two options for determining state action as above, the government's actions are still very ambiguous. This is due to a few factors. First, defining the scope of an action that falls under "public policy" is frequently challenging. As Newcombe and Paradell have discussed, the scope of action of state power based on public order and policy is very difficult to define. In other words, for an action that can be considered as an act of the Police Power Doctrine, the question of explaining the definition of 'public policy' remains unanswered.

Second, the opinion that it is permissible to extend actions under the Police Power Doctrine such as actions intended to maintain peace and order can be considered to be included in the protection of health and the environment has been challenged. Appropriation for crime, bona fide general taxation, or measures necessary for the maintenance of public order' are believed to be the sole limitations of the Police Power Doctrine. In particular, with respect to regulatory measures relating to the environment, the court in Santa Elena v Costa Rica found, expropriation in an environmental measure, no matter how laudable and beneficial to society as a whole, respectfully, similar to other expropriation acts that can be taken by a State to carry out its policies: Even if a property is taken for domestic or foreign environmental goals, the State is still obligated to compensate the owner. (Gangl et al., 1978)

This shows that the police power doctrine is still an uncertain doctrine. This opinion is supported by the opinion of the Saluka court where the court stated that international law has not yet comprehensively and definitively identified which regulations are 'permitted' and will be accepted as part of the police or state regulatory powers. Drawing a distinction between regulations that aren't subject to compensation and actions that effectively deprive foreign investors of their investment, breaking the law in the process and warranting compensation under international law, is nevertheless crucial. In the absence of a strong boundary between the two actions, the arbitral tribunal has the discretion to determine what kind of regulatory action falls under the jurisdiction of the state police power and whether the action can exempt the state from compensation or not.

TO WHAT EXTENT CAN THIS DOCTRINE BE USED BY A STATE?

In order to answer the question above, first, it's crucial to evaluate situations in cases in which the actions that come within the Police Power Doctrine are not considered as expropriations even though they significantly deprived foreign investors from their investment.

The first case to be discussed is that of Metanex v. US. Expropriation will only take place in accordance with Methanex rules if regulatory actions (which are a part of the Police Power Doctrine) are discriminatory, are not adopted in accordance with the legal process, do not serve a public purpose, or if they violate particular protections provided by the government to foreign investors.

In the case of Saluka v. Czech Republic, regulatory action falling under the Police Power Doctrine does not constitute as an expropriation despite such action having a negative impact on foreign investment. The definition provided a clearer explanation of the issue relating to the "substantial deprivation" of a foreign investment.

The extent to which host states can rely on the Police Power Doctrine is explained in more detail and clarity in the case of Burlington v. Ecuador. Ecuador invoked the Police Power Doctrine in this instance in response to the investor's expropriation allegation, and the court ruled that in order to establish whether the regulatory action qualifies as an indirect expropriation, it must be demonstrated that the regulatory action (i) resulted in the seizure of a substantial investment; (ii) permanently, and (iii) have no justification in the Police Power Doctrine. Thus, the court must determine whether the actions of the State concerned result in substantial deprivation of investment or not. The Court found that there had been no substantial expropriation, which rendered it unnecessary to determine whether the regulatory act is protected by the Police Power Doctrine. In other words, the court acknowledges that it must determine whether the regulatory action is justified and qualifies as an act under the Police Power Doctrine if it has caused a considerable deprivation and is permanent in nature. Although the court does not argue specifically which acts of Ecuador fell under police power, the court recognizes that if such action by itself falls under the Police Power Doctrine, then the act does not constitute expropriation even if there is substantial deprivation.

In the case of Chemtura v Canada, the court eliminated expropriation claims by applying the Police Power Doctrine. (Viñuales, 2013.) The court found that there was no substantial seizure of the investor's investment. The Court then added that aside from the taking undertaken by Canada, Canada's actions were a part of Canada's national police authority and therefore does not fall under expropriation.

The Police Power Doctrine clearly states an action that is in accordance with its state's police power will not be considered as an expropriation as long as the state's actions are intended for public purposes and in a non-discriminatory manner. Drawing the distinction between legitimate regulatory actions that do not constitute as an expropriation and actions that amounts to expropriation is the fundamental challenge in dealing with indirect expropriation allegation. States have therefore begun to add provisions in new International Investment Agreements that draw the boundary more explicitly by barring particular actions from the scope of possible expropriation claims. For instance, China-Australia Free Trade Agreement (“**ChAFTA**”) expressly disallows legitimate and non-discriminatory regulatory measures from treaty protection, stating that such measures of a Party that are non-discriminatory and for the legitimate public welfare objectives of public health, safety, the environment, public morals, or public order shall not be the subject of a claim under this Section. (ChAFTA, 2015.)

The opposing group, declares that legitimate regulation won't be regarded as expropriatory, but it acknowledges that in "rare circumstances," it might. The EU-Canada Comprehensive Economic and Trade Agreement (“**CETA**”) states that the Parties reaffirm their right to regulate within their territories to achieve legitimate policy objectives, such as the protection of public health, safety, the environment, or public morals, social or consumer protection, or the promotion and protection of cultural diversity. (CETA, 2014.)

The debate will most likely continue, however. Even if one agrees that the police powers doctrine should lead some acts to be categorized as non-compensable and non-expropriatory, the doctrine's boundaries are still up for debate. As furher the Saluka award explains that international law has yet to specify in a thorough and final manner precisely what laws are considered 'permissible' and 'generally recognised' as coming within the police or regulatory power of States

CLOSING

International Law is still changing and expanding including International Investment Law. The emergence of the Police Power Doctrine indicates as the law evolves; many efforts will be made to expand protections afforded by law. In applying the Police Power Doctrine, a tribunal adhere to the specification in which such action of the state has to be non-discriminatory, are adopted in accordance with the law, and serve a public purpose. However, as each tribunals have its own interpretation and regulation of the Police Power Doctrine, the specification of the doctrine previously mentioned is not the only specification used to determined the extent of the doctrine. Further due to the fact that the majority of investment claims are based on older International Investment Agreements, tribunals frequently have to make decisions about where to draw the line between legal regulatory action and expropriatory measure without any explicit examples excluding specific measures or providing a clear guidance to tribunals. Other tribunals have acknowledged that in light of customary law, measures that fall within the scope of The Police Powers Doctrine are not eligible for compensation, whereas some tribunals have chosen to concentrate only on the effect of the given measure, without taking the context and the intentions of the host state. However, there hasn't been any consistency over the extent of the police powers doctrine. Therefore, it showed that the doctrine's current consensus regarding measures that fall within the doctrine only covers a small number of policies related to taxes, health protection, morality, and public order (such as a forfeiture for crime). Even these efforts, though, will be subject to very specific guidelines. Furthermore, it is evident that a government action's formal classification or status will not preclude a tribunal from determining whether it constitutes expropriation or not, and the police powers doctrine does not grant the host state a broad exemption from paying for a state's regulatory actions. While the police power doctrine is acknowledged by international investment law and has frequently been applied in international investment arbitration proceedings as a state's defence against accusations of indirect expropriation, the vague limitation of the doctrine raises the need to do a more clarification regarding the doctrine's limitations. This shows the many differences regarding the extent in the provisions of the Police Power Doctrine and the lack of specific determination regarding its application needs to be addressed. There are still many conflicting opinions and differences in the use of this doctrine, creating a gap in International Investment Law.

The lack of limits and rules for the use of this doctrine is also a drawback which until now has not been clearly explained. Therefore, it is important for the doctrine to get a further explanation for when in used as one of State's safeguards in International Investment Arbitration will become clearer and more certain.

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