USING THE PUBLIC LAW CONCEPT OF PROPORTIONALITY TO BALANCE INVESTMENT PROTECTION WITH REGULATION IN INTERNATIONAL INVESTMENT LAW: A CRITICAL APPRAISAL

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Abstract

Due to the adjudication of a large range of regulatory measures under investment treaty arbitration (ITA), the belief that bilateral investment treaties (BITs) fail to balance investment protection with a host country's right to regulate has gained currency as of late. In order to balance investment protection with regulation, many scholars have advocated for the use of public law principle of proportionality to interpret BITs. This paper critically examines the application of the principle of proportionality in BITs under four heads. First, given the fact that many questions related to independence and impartiality of ITA remain unanswered, the use of proportionality in ITA might further dent the credibility of the system by granting significant discretion to arbitrators. Second, proportionality principle has been applied in a flawed manner by many arbitral tribunals, which raises doubts about its application. Third, one should be very careful in relying on jurisprudence of European Court of Human Rights and the WTO to support the application of proportionality in ITA because of the many contextual differences between the two. Fourth, when interpreting BITs, application of principle of proportionality in many instances will completely ignore the clear textual language and thus violate the rules of treaty interpretation.

Keywords

Investment law, proportionality, right to regulate

1 Introduction

At the heart of international investment law are more than 3,000 Bilateral Investment Treaties (*BITs*), which are regarded as the most important sources of

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law.¹ BITs are treaties signed bilaterally by two countries to protect investments made by investors of both countries.² As of the end of 2013, a total of 3,236 BITs have been concluded.³ This mass of BITs has generated a significant volume of cases arising out of disputes between foreign investors and host states (investment treaty arbitration or *ITA*).⁴ In recent years, the *ITA* system⁵ has come under scathing criticism for failing to balance rights of foreign investors (investment protection) with host countries' right to regulate (regulation).⁶

In response to this criticism, some authors argue that conceptualising the *ITA* system as a public law discipline and interpreting BITs using a public law method, namely comparative public law, will help in balancing investment protection with host countries' regulatory power and thus effectively responding to the criticism

¹ R Dolzer & C Schreuer, *Principles of International Investment Law* (2012), 13; J W Salacuse, 'The Treatification of International Investment Law' (2007) 13 *Law and Business Review of the Americas* 155, 157.

² J W Salacuse, 'BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries' (1990) *International Lawyer* 655. For a general discussion on BITs, see Dolzer & Schreuer above n 1; A Newcombe & L Paradell, *Law and Practice of Investment Treaties* (2009) 1–73; J Salacuse, *The Law of Investment Treaties* (2010); K J Vandevelde, *Bilateral Investment Treaties: History, Policy and Interpretation* (2010).

³ This includes 2,902 stand-alone investment treaties and 334 investment chapters in FTAs. See *World Investment Report—Investing in the SDGs: An Action Plan* (2014) 114, <http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf> [accessed 22 September 2014].

⁴ From a negligible number in the early 1990s, the total number of treaty-based cases rose to 568 by the end of 2013. See UNCTAD, *Recent Developments in Investor State Dispute Settlement* (UNCTAD IIA Issue Note 1, 2014) <http://unctad.org/en/PublicationsLibrary/webdiaepcb2014d3_en.pdf> [accessed 22 September 2014].

⁵ In this paper, words like 'ITA system', 'international investment law' are used interchangeably—they refer to the network of 3,000-odd BITs.

⁶ L T Wells, 'Backlash to Investment Arbitration: Three Causes', in M Waibel et al (eds), *The Backlash Against Investment Arbitration* (2010) 341. See also S Schill, 'Enhancing International Investment Law's Legitimacy: Conceptual and Methodological Foundations of a New Public Law Approach' (2011) 52 *Va JIL* 57, 69, who states: 'the extent to which investment treaties limit a state's regulatory powers and subject the exercise of such powers to liability claims by foreign investors may become the litmus test for the future viability of the system'. See also S D Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions' (2005) 73 *Fordham LR* 1521; G Van Harten, *Investment Treaty Arbitration and Public Law* (2007); A Kaushal, 'Revisiting History: How the Past Matters for the Present Backlash Against the Foreign Investment Regime' (2009) 50 *Harvard ILJ* 491; R Howse, 'Sovereignty, Lost and Found', in W Shan et al (eds), *Redefining Sovereignty in International Economic Law* (2008) 72–3; B Choudhary, 'Recapturing Public Power: Is Investment Arbitration's Engagement of the Public Interest Contributing to the Democratic Deficit?' (2008) 41 *Vanderbilt JTL* 775; S Spears, 'The Quest for Policy Space in New Generation of International Investment Agreements' (2010) 13 *JIEL* 1037.

of the ITA system.⁷ On the other hand, some authors question this by asking how ‘to properly structure a methodology of identifying, sorting, and weighting comparative sources’ for applying the comparative public law method.⁸ Also, it is argued that the wisdom of prioritizing domestic public law (in the name of comparative public law method) over public international law to interpret BITs is open to question.⁹ This is because domestic public law methods are rooted in a particular sociopolitical and economic context, and thus, if one is not sensitive enough about these different contexts, it could result in crude transplants of principles and practices of one legal regime to another.¹⁰

The focus of this paper is not the ‘comparative public law method’ of interpreting BITs. Instead, the focus of this paper is much narrower: it deals with the application of the public law principle of proportionality in ITA.¹¹ The principle of proportionality has its origins in German administrative and constitutional law,¹² and is defined by Kingsbury and Schill as ‘a method of legal interpretation and decision making in situations of collisions or conflict of

⁷ See C N Brower & S Schill, ‘Is Arbitration a Threat or a Boon to the Legitimacy of International Investment Law?’ (2009) 9 *Chi JIL* 471; Schill, above n 6; S Schill, ‘International Investment Law and Comparative Public Law – An Introduction’, in S Schill (ed), *International Investment Law and Comparative Public Law* (2010). See also S Montt, *State Liability in Investment Treaty Arbitration* (2009).

⁸ J Kurtz, ‘The Shifting Landscape of International Investment Law and its Commentary’ (2012) 106 *AJIL* 686, 693.

⁹ *Ibid.*

¹⁰ *Ibid.* Vadi has argued that one needs to be careful while adopting the comparative method to the ITA system: V Vadi, ‘Critical Comparisons: The Role of Comparative Law in Investment Treaty Arbitration’ (2010) 39 *Denver JILP* 67. It has also been argued that the public law paradigm of the investment treaty system, because of the focus on investor-state regulatory relationship, ignores the underlying state-state treaty relationship. See A Roberts, ‘Actors and Analogies Shaping the Investment Treaty System’ (2013) 107 *AJIL* 45.

¹¹ B Kingsbury & S Schill, ‘Public Law Concepts to Balance Investors’ Rights with State Regulatory Actions in the Public Interest – The Concept of Proportionality’, in S Schill (ed), *International Investment Law and Comparative Public Law* (2010) 75; A S Sweet, ‘Investor-State Arbitration: Proportionality’s New Frontier’ (2010) 4 *Law and Ethics of Human Rights* 47; U Kriebaum, ‘Regulatory Takings: Balancing the Interests of the Investor and the State’ (2007) 8 *JWIT* 717; A Kulick, *Global Public Interest in International Investment Law* (2012) 168–220; C Henckels, ‘Indirect Expropriation and the Right to Regulate: Revisiting Proportionality Analysis and the Standard of Review in Investor-State Arbitration’ (2012) 15 *JIEL* 223; E M Leonhardsen, ‘Looking for Legitimacy: Exploring Proportionality Analysis in Investment Treaty Arbitration’ (2012) 3 *JIDS* 95.

¹² Kingsbury & Schill, above n 11, 80. See also D Grimm, ‘Proportionality in Canadian and German Constitutional Law’ (2007) 57 *U Toronto LJ* 383, 384–7; M P Singh, *German Administrative Law in Common Law Perspective* (2001) 160.

different principles and legitimate public policy objectives'.¹³ The proportionality test will have three steps¹⁴ which must be assessed cumulatively.¹⁵ First, whether the measure is suitable for the legitimate public purpose; this will require a causal link between the measure and its object.¹⁶ If the measure satisfies the first step, the second step will be to find out whether the measure is necessary i.e. whether there is a less restrictive alternative measure that will achieve the same objective.¹⁷ If indeed the measure is 'necessary', then the third step (also known as proportionality *stricto sensu*) will involve balancing the effects of the measure on the right that has been affected with the public benefit sought to be achieved by the measure.¹⁸ It is argued that the use by an arbitral tribunal of the proportionality analysis mentioned above when interpreting BIT provisions like expropriation will enable tribunals to resolve conflicts between competing rights and interests of foreign investors, on the one hand, and host states on the other.¹⁹ Thus, and following this argument, the use of proportionality analysis by arbitral tribunals will effectively respond to the criticism that BITs do not balance investment protection with regulation.²⁰

This paper critically examines whether the public law principle of proportionality, which is espoused as an important interpretative method to balance investment protection with regulation, can be applied in BITs. In order to set the stage for assessing the application of proportionality in ITA, the paper first provides a background and context of the debate on investment protection and regulation by mapping the backlash against the ITA system (Section 1). The paper then argues that structure of the ITA system does not support the adoption of a proportionality-type analysis in the adjudication of disputes (Section 2). This is followed by discussing the flawed and often truncated application of proportionality principle in ITA. (Section 3). Next, and by taking the example of expropriation provision and provisions on monetary transfers, the paper also argues that the language of substantive provisions in many BITs does not support the use of proportionality analysis (Section 4). In Section 5, the paper argues that ex-

¹³ Kingsbury & Schill, above n 11, 79.

¹⁴ H Xiuli, 'The Application of the Principle of Proportionality in *Tecmed v Mexico*' (2006) 6 *Chinese JIL* 635, 636-37; Kingsbury & Schill, above n 11, 85-88; Kulick, above n 11, 186-9.

¹⁵ Leonhardsen, above n 11; J H Jans, 'Proportionality Revisited' (2000) 27 *Legal Issues of Economic Integration* 239, 240-1.

¹⁶ Jans, above n 15, 240.

¹⁷ Jans, above n 15, 240; Kingsbury & Schill, above n 11, 86-7.

¹⁸ Jans, above n 15, 241; Kingsbury & Schill, above n 11, 87-8.

¹⁹ Kingsbury & Schill, above n 11; Sweet (2010); Kulick, above n 11.

²⁰ Kingsbury & Schill, above n 11.

treme caution should be exercised in relying on jurisprudence of the WTO and European Commission (EC) to support proportionality analysis in the ITA system. Merely critiquing the proportionality analysis is not sufficient and thus in Section 6 the paper proposes what an arbitral tribunal should do when faced with situations involving a clash of investment protection with host countries' right to regulate. Finally, the paper concludes by observing that the debate on use of proportionality analysis in ITA fits well in the larger debate in international investment law as to how to address conflicts between investment protection and host countries' regulatory power. The primary responsibility to address this conflict should be with countries, the makers of international law, and not with party-appointed arbitrators.

2 The Backlash Against International Investment Law

As mentioned above, there has been a significant increase in investor-state disputes in international investment law covering a wide array of regulatory measures such as environmental policy;²¹ sovereign decisions regarding privatisation;²² regulatory issues related to the supply of drinking water;²³ urban policy;²⁴ monetary policy;²⁵ laws and policies related to taxation;²⁶ policy related to the re-organisation of public telephone services;²⁷ industrial policy related to

²¹ *Metalclad Corporation v United Mexican States*, ICSID Case No ARB(AF)/97/1 (Award, 30 August 2000); *Methanex Corporation v United States of America* (2005) 44 ILM 1345.

²² *Eureka BV v Poland*, ICSID Case No ARB/01/11 (Award, 19 August 2005).

²³ *Biwater Gauff Ltd v Tanzania*, ICSID Case No ARB/05/22 (Award, 24 July 2008).

²⁴ *MTD Equity v Chile* (2005) 44 ILM 91.

²⁵ *CMS Gas Transmission Co v Argentina*, ICISD Case No ARB/01/8 (Award, 12 May 2005); *CMS Gas Transmission Company v Argentina*, ICSID Case No ARB/01/8 (Annulment, 25 September 2007); *Enron Corporation v Argentina*, ICSID Case No ARB/01/3 (Award, 22 May 2007); *Enron Creditors Recovery Corp v Argentina* ICSID Case No ARB/01/3 (Annulment, 30 July 2010); *Sempra Energy International v Argentina*, ICSID Case No ARB/02/16 (Award, 28 September 2007); *Sempra Energy International v Argentina*, ICSID Case No ARB/02/16 (Annulment, 29 June 2010); *LG&E Energy Corporation v Argentina*, ICISD Case No ARB/02/1 (Award, 25 July 2007); *Continental Casualty Company v Argentina*, ICSID Case No ARB/03/9 (Award, 5 September 2008).

²⁶ *Occidental Exploration and Production Co v Ecuador*, LCIA Case No UN 3467; *EnCana Corporation v Ecuador*, LCIA Case No UN3481; *Feldman v Mexico*, ICSID Case No ARB(AF)/99/1 (Award, 16 December 2002).

²⁷ *Telenor Mobile Communications v Hungary*, ICSID Case No ARB/04/15 (Award, 13 September 2006).

sectors like media;²⁸ financial services;²⁹ banking;³⁰ energy;³¹ public postal services;³² electricity services;³³ motorway construction;³⁴ and tourism.³⁵ Furthermore, there have been instances where a host country's important public interest measures like health measures³⁶ have been challenged by foreign investors as a potential breach of a BITs. The most sensitive have been the ITA cases against Argentina,³⁷ where foreign investors challenged Argentina's regulatory measures to safeguard its economy from a complete collapse as violation of Argentina's obligations under different BITs. There have also been cases where ITA tribunals have adjudicated on the actions of the judiciary.³⁸

Foreign investors challenging the sovereign actions of host states under BITs should not come as a surprise because that is what BITs are meant to do—to hold states accountable for the exercise of their public power while dealing with foreign investment. However, the adjudication of such a wide gamut of sovereign regulatory measures by ITA tribunals on potential breaches of BITs, and the awarding substantive damages to foreign investors³⁹—resulting in diversion of taxpayer's money to foreign investors—have generated a backlash against international investment law. This backlash has been further fueled by instances arising where a similar set of facts,⁴⁰ or even the same provision of a BIT,⁴¹ are

²⁸ *CME Czech Republic BV v Czech Republic*, UNCITRAL (Partial Award, 13 September 2001); *R S Lauder v Czech Republic* (2001) 9 ICSID Rep 66.

²⁹ *Fireman's Fund Insurance Company v Mexico*, ICSID Case No ARB(AF)/02/01 (Award, 17 July 2006).

³⁰ *Saluka Investments v Czech Republic*, UNCITRAL (Partial Award, 17 March 2006).

³¹ *Duke Energy Electroquil Partners v Ecuador*, ICSID Case No ARB/04/19 (Award, 18 August 2008).

³² *United Parcel Service of America v Canada*, UNCITRAL/NAFTA (Award, 24 May 2007).

³³ *Nykomb Synergetics v Latvia*, SCC (Award, 16 December 2003).

³⁴ *Bayindir Insaat Ticaret Ve Sanayi AS v Pakistan*, ICSID Case No ARB/03/29 (Award, 27 August 2009).

³⁵ *Waguih Elie George v Egypt*, ICSID Case No ARB/05/15 (Award, 1 June 2009).

³⁶ *Philip Morris Asia Ltd v Australia*, UNCITRAL, PCA Case No 2012–12.

³⁷ *CMS v Argentina*, ICSID Case No ARB/01/8; *Enron Corporation v Argentina*, ICSID Case No ARB/01/3; *Sempra Energy International v Argentina*, ICSID Case No ARB/02/16; *LG&E Energy Corporation v Argentina*, ICSID Case No ARB/01/01; *Continental Casualty Company v The Argentine Republic*, ICSID Case No ARB/03/9.

³⁸ *Saipem SpA v Bangladesh*, ICSID Case No ARB/05/7 (Award, 30 June 2009).

³⁹ See 'Former Yukos Shareholders awarded US \$ 50 billion in damages against Russia' (*FT World*, 28 July 2014) <<http://www.ft.com/cms/s/0/f5824afa-1623-11e4-8210-00144feabdc0.html#axzz3G9R5v900>> [accessed 22 September 2014].

⁴⁰ The most commonly stated example of this is the 'Lauder cases' where two arbitration tribunals gave different decisions within ten days of one another to essentially the same set of facts for disputes brought under two different BITs: see above n 28.

⁴¹ The Argentine cases on Article XI of the US–Argentina BIT are a good example of such

interpreted differently by different tribunals.

One of the chief reasons for a wide range of sovereign decisions of host states being caught in the broad net of investor-state dispute settlement is often the vague and broad language of BITs.⁴² For example, imprecise and broad provisions like Fair and Equitable Treatment (*FET*) become suitable candidates for broad and inconsistent treaty interpretations.⁴³ The textual indeterminacy of BITs has resulted in divergent and inconsistent legal conclusions.⁴⁴ Such indeterminacy has given a fair degree of discretion to ITA tribunals to interpret the terms occurring in BITs and hence indulge in 'law-making' activity,⁴⁵ which is deeply problematic because the job of an arbitral tribunal is to 'interpret the law made by countries' and not to 'make law for countries' in the name of interpretation.

The backlash against the ITA system is evidenced by state practice.⁴⁶ Some states have terminated their BITs and thus pulled out of international investment law.⁴⁷ One such country is Ecuador, which has witnessed third-highest claims by foreign investors after Argentina and Venezuela.⁴⁸ In 2008, Ecuador denounced nine of its BITs.⁴⁹ In July 2009, the Russian Federation terminated the provisional

inconsistency: see above n 25.

⁴² See Schill, above n 7, 67–8; Wells, above n 6, 342; Spears, above n 6, 1040; J E Alvarez & K Khamsi, 'The Argentine Crisis and Foreign Investors', in K Sauvant (ed), *Yearbook on International Investment Law and Policy* (2009) 379, 472–8; M A Clodfelter, 'The Adaptation of States to the Changing World of Investment Protection through Model BITs' (2009) 24 *ICSID Rev—FILJ* 165.

⁴³ For example, Vandevelde, writing on the FET provision, states that 'because the language by its terms can apply to virtually any instance of host-state conduct, it is potentially a basis for recovery in any situation': Vandevelde, above n 2, 203.

⁴⁴ For a detailed discussion on such inconsistent decisions, see Franck, above n 6, 1558–82. See also A Reinisch, 'The Future of Investment Arbitration', in C Binder et al (eds), *International Investment Law for the 21st Century: Essays in Honour of Christoph Schreuer* (2009) 894, 905–8.

⁴⁵ S W Schill, 'System Building in Investment Treaty Arbitration and Lawmaking' (2011) 12 *German LJ* 1083, 1092–3.

⁴⁶ O E Garcia-Bolivar, 'Sovereignty vs. Investment Protection: Back to Calvo?' (2009) 24 *ICSID Rev—FILJ* 464, 470–4. See also the public statement issued by many leading academics on ITA: <<http://www.osgoode.yorku.ca>> [accessed 22 September 2014].

⁴⁷ Even if a country terminates its BITs, customary international investment law (i.e. the law of diplomatic protection) will continue to apply for the protection of foreign investment: J Crawford, *Brownlie's Principles of Public International Law* (8th edn, 2012) ch 28.

⁴⁸ Allen & Overy, *Ecuador Establishes Commission to Audit its Bilateral Investment Treaties* (13 November 2013) <<http://www.allenoverly.com/publications/en-gb/Pages/Ecuador-establishes-Commission-to-audit-its-Bilateral-Investment-Treaties.aspx>> [accessed 22 September 2014].

⁴⁹ UNCTAD World Investment Report, *Global Value Chains: Investment and Trade for Development* (2013) 108. Ecuador has also established a commission to audit its BITs: Allen & Overy, above n 42.

application of the Energy Charter Treaty.⁵⁰ In September 2012, South Africa terminated its BIT with Belgium and Luxembourg, and the following year the same state terminated BITs with Spain and Germany.⁵¹ These decisions were taken after a review of South Africa's entire BIT programme in light of an investment treaty arbitration challenge from foreign investors for South Africa's Black Empowerment Programme.⁵² Similarly, Venezuela sent a notice terminating its BIT with Netherlands because it felt that the particular BIT interfered with the implementation of policy changes in its energy sector.⁵³ Recently, Indonesia expressed the intention to terminate all 67 of its BITs.⁵⁴ India is re-thinking its BIT programme after a spate of ITA notices issued by foreign investors challenging decisions of the Indian Supreme Court and the Indian Parliament.⁵⁵ There have also been instances of countries denouncing the convention on the International Centre for Settlement of Investment Disputes (ICSID). Bolivia and Ecuador gave up their membership of ICSID⁵⁶ and in 2012, Venezuela sent a notice to the World Bank denouncing the ICSID convention.⁵⁷

This contestation against ITA is not restricted to developing countries. State practice amongst developed countries also shows concerns about investment treaties encroaching upon host state's regulatory power. For example, in response

⁵⁰ A Hadfield & A Amkhan-Banyo, 'From Russia with Cold Feet: EU-Russia Energy Relations, and the Energy Charter Treaty' (2013) 1 *International Journal of Energy Security and Environmental Research* 1.

⁵¹ S Woolfrey, 'Another BIT Bites the Dust' (*Tralac*, 30 October 2013) <<http://www.tralac.org/discussions/article/5342-another-bit-bites-the-dust.html>> [accessed 1 July 2014].

⁵² *Piero Foresti, Laura de Carli & Others v South Africa*, ICSID Case No ARB(AF)/07/01.

⁵³ L E Peterson, 'Venezuela Surprises Netherlands With Termination Notice of BIT' (*IA Reporter*, 16 May 2008) <http://www.iareporter.com/articles/20091001_93> [accessed 22 September 2014].

⁵⁴ C Tevendale & V Naish, 'Indonesia Indicates Intention to Terminate all of its Bilateral Investment Treaties' (*Lexology*, 20 March 2014) <<http://www.lexology.com/library/detail.aspx?g=96317cf9-e366-4877-b00c-a997ed3389c5>> [accessed on 29 September 2014]

⁵⁵ For more on India's BIT programme and the re-think, see P Ranjan, 'India and Bilateral Investment Treaties – A Changing Landscape' (2014) 29 *ICSID Rev—FILJ* 419.

⁵⁶ ICSID, *List of Contracting States and other Signatories to the ICSID Convention*, <<https://icsid.worldbank.org>> [accessed 22 September 2014]. For a detailed discussion on the legal effect of these denunciations see A Tzanakopoulos, 'Denunciation of the ICSID Convention under the General International Law of Treaties', in R Hoffmann & C J Tams (eds), *International Investment Law and General International Law: From Clinical Isolation to Systemic Integration?* (2011) 75. Bolivia has faced three ITA disputes so far: *Agua del Tunari SA v Bolivia*, ICSID Case No ARB/02/3; *Guaracachi America Inc (USA) and Rurelec PLC (UK) v Bolivia*, PCA Case No AA406; *Quiborax SA, Non Metallic Minerals SA and Allan Fosk Kaplún v Bolivia*, ICSID Case No ARB/06/2.

⁵⁷ ICSID, *Venezuela Submits a Notice Under Article 71 of the ICSID Convention* (Press Release, 26 January 2012) <<https://icsid.worldbank.org>> [accessed 22 September 2014].

to the notice given by Philip Morris (Asia) Limited challenging Australia's tobacco regulations,⁵⁸ Australia decided not to have investor-state dispute resolution mechanism but only an inter-state dispute settlement mechanism.⁵⁹ Similarly, in 2001, the NAFTA Free Trade Commission (FTC)—a body composed of the representatives of all the three NAFTA states—issued a note of interpretation aimed at limiting and rejecting the expansive interpretation given by arbitral tribunals on the meaning of FET.⁶⁰ Canada, in response to concerns expressed as to the effect of investment treaties on Canada's regulatory power, adopted a new model BIT in 2004.⁶¹ In sum, the backlash against ITA has been global.

3 Can Proportionality be allowed under the Unique Structure of ITA?

Against this background of backlash against ITA, let us discuss whether the unique structure of ITA allows for the application of proportionality analysis. Using proportionality analysis as the method of review in ITA will grant arbitrators a significant discretion to second guess the regulatory measures adopted by host states by weighing and balancing the benefit of these measures with the effect on foreign investment. Thus, the concern is that such weighing and balancing by the arbitral tribunal runs the risk of very important public policy objectives being trumped by interests of investors in situations where the arbitral tribunal is of the view that costs of the effect outweigh the benefit. However, the question to be asked is that if judges in domestic legal systems can undertake proportionality analysis to adjudicate disputes that involve conflict between, say, right of an individual and a governmental regulatory measure to pursue a public

⁵⁸ 'Philip Morris sues Australian Government over Tobacco Laws' (*The Guardian*, 21 November 2011) <<http://www.theguardian.com/world/2011/nov/21/philip-morris-australia-tobacco-laws>> [accessed 22 September 2014].

⁵⁹ US–Australia FTA does not contain investor-state dispute resolution. See Australian Department of Foreign Affairs and Trade, *Gillard Government Trade Policy Statement: Trading Our Way to more Jobs and Prosperity* (Policy Release, April 2012) <<http://www.acci.asn.au>> [accessed 22 September 2014]. Note however that the new Australian government led by Tony Abbott has decided that it will decide on investor-state dispute settlement provisions on a case-by-case basis, thus signaling a change in the previous policy: L Nottage, 'Investor-State Dispute Settlement Back for Australia's Free Trade Agreements' (*University of Sydney Blog*, 17 December 2013) <http://blogs.usyd.edu.au/japaneselaw/2013/12/isds_back.html> [accessed 22 September 2014].

⁶⁰ Salacuse, above n 2, 225.

⁶¹ A Newcombe, 'Canada's New Model Foreign Investment Protection Agreement' (*ITA Law*, August 2004) <<http://italaw.com/documents/CanadianFIPA.pdf>> [accessed 1 September 2014].

objective that allegedly infringes the individual's right,⁶² then why not arbitration tribunals in international investment law?

The answer to this question lies in the structure and nature of ITA. It is important to note that key characteristics of domestic legal system such as institutional safeguards and constitutional features like 'independence of the judiciary', 'appellate review', 'separation of powers', and a written constitution that gives judges the right to decide which compelling interest should prevail, are all absent in ITA. ITA is a unique system of resolving disputes between foreign investors and host states where only one party (the foreign investor) can in the ordinary course of events bring claims (against a host state)⁶³ and where the private law adjudicative model followed in international commercial arbitration is used to check the sovereign regulatory power of host states.⁶⁴ This system is characterised by party-appointed *ad hoc* arbitrators, who, unlike the judges of domestic courts, are not embedded in the political and social system of the communities whose disputes they decide⁶⁵ and have inadequate knowledge of the overall legal, political and social context related to the dispute.⁶⁶ Consequently, these party-appointed arbitrators are less suitable to adopt a method of review that would require them to weigh and balance complex value-laden regulatory objectives that host states wish to pursue against the effect on foreign investment.⁶⁷ The dangers associated with a significant grant of discretion to arbitration tribunals undertaking proportionality analysis is also recognised by the advocates of proportionality analysis in ITA.⁶⁸ The response

⁶² See A S Sweet & J Mathews, 'Proportionality Balancing and Global Constitutionalism' (2008) 47 *Columbia JTL* 73; M Khosla, 'Proportionality: An Assault on Human Rights?: A Reply' (2010) 8 *J Const L* 298.

⁶³ There are only four instances where ICISD has registered claims by state or state entities against foreign investors: see C N Brower and S Blanchard, 'What's in a Meme? The Truth About Investor-State Arbitration: Why it Need Not, and Must Not, be Repossessed by States' (2014) 52 *Columbia JTL* 689.

⁶⁴ Van Harten, above n 6, 103.

⁶⁵ W W Burke-White & A V Staden, 'Private Litigation in a Public Law Sphere: Standard of Review in Investor-State Arbitrations' (2010) 35 *Yale JIL* 283, 323; V Lowe, 'Regulation or Expropriation' (2002) 55 *Current Legal Problems* 447, 464–5. Even those who advocate the use of proportionality test in ITA accept this criticism of the proportionality test. See Kingsbury & Schill, above n 11, 104.

⁶⁶ It is also argued that ITA arbitration is heavily influenced by the style and culture of ICA and the arbitrators are not grounded in public international law or trained to settle public law questions. See T Walde, 'Interpreting Investment Treaties: Experiences and Examples', in C Binder et al (eds), *International Investment Law for the 21st Century* (2009) 724, 725–6.

⁶⁷ Burke-White & Staden, above n 65, 323.

⁶⁸ Kingsbury & Schill, above n 11, 104; Kulick, above n 11, 171–3.

to overcoming these problems is not very satisfactory as they mostly relate to the correct adoption of the proportionality test.⁶⁹ However, as we will discuss below, ITA tribunals have often faltered in applying the three-step proportionality test.

Also, questions are often raised about how impartial and independent the ITA system is. For example, it has been argued that that appointment of arbitrators is influenced by the positions taken by them in other arbitrations and in academic writings.⁷⁰ There are also issues related to conflicts of interest and independence where, for example, an individual may act as an arbitrator in one dispute and as counsel in another dispute at the same time,⁷¹ or where an individual, wishing to win future appointment as an arbitrator, seeks to safeguard their reputation amongst investors or host states.⁷² It has also been argued that there is statistically significant evidence to show that arbitrators favour 'the position of claimants over respondent states' and favour 'the position of claimants from major Western capital-exporting states over claimants from other states' thus evidencing a systemic bias.⁷³ Another interesting empirical study, on dissenting opinions in ITA, shows that in 34 out of 150 arbitral awards where a dissenting note was given, nearly 100 per cent of dissents favoured the party that appointed the dissenting arbitrator, thus, raising concerns about neutrality.⁷⁴

The objective here is not to be unnecessarily alarmist about the ITA system and argue for sweeping changes such as elimination of investor-state arbitration

⁶⁹ Kingsbury & Schill, above n 11, 104.

⁷⁰ B Pirker, 'Seeing the Forest Without the Trees – The Doubtful Case for Proportionality Analysis in International Investment Arbitration' (Society of International Economic Law, 2011) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1926166> [accessed 25 August 2014].

⁷¹ P Sands, 'Conflicts and Conflict in Investment Treaty Arbitration: Ethical Standards for Counsel', in C Brown & K Miles (eds), *Evolution in Investment Treaty Law and Arbitration* (2010) 19.

⁷² Van Harten, above n 6, 167–74. See also Walde, above n 66, 731–2. According to one study, certain arbitrators are repeatedly appointed either by the state or by the foreign investor based on their reputation of being pro-state or pro-investor. According to this study, 15 arbitrators have decided 55 percent of the known investment treaty disputes as of 2012. See Corporate Europe Observatory, 'Who Guards the Guardians? The Conflicting Interests of Investment Arbitrators' (Paper, 2012) <<http://corporateeurope.org/trade/2012/11/chapter-4-who-guards-guardians-conflicting-interests-investment-arbitrators>> [accessed 8 October 2014].

⁷³ G Van Harten, 'Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration' (2012) 50 *Osgoode Hall LJ* 211.

⁷⁴ A J Van den Berg, 'Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration', in M Arsanjani et al (eds), *Looking to the Future: Essays on International Law in Honor of W Michael Reisman* (2011) 821. See also J Paulsson, 'Moral Hazard in International Dispute Resolution' (Lecture given at the University of Miami School of Law, 29 April 2010) <http://www.arbitration-icca.org/media/0/12773749999020/paulsson_moral_hazard.pdf> [accessed 8 October 2014].

as some others do.⁷⁵ However, the issues flagged here cannot be dismissed altogether⁷⁶ and they do raise questions about the independence of the ITA system to impartially adjudicate disputes between investors and host states. Whether on the basis of these concerns, can one conclude that there is systemic bias⁷⁷ in ITA against host states and in favour of foreign investors is a question that cannot be addressed here.⁷⁸ Nevertheless, the fact that many states have started contesting the ITA system, as discussed above, and that there is more and more talk of improving and reforming the investor-state dispute settlement system,⁷⁹ shows that the concerns flagged above have some merit.⁸⁰ Consequently, in a system of dispute resolution where questions are raised about impartiality and independence of arbitrators, arguing for the use of proportionality analysis, which grants significant discretion to arbitrators to judge complex value-laden policy objectives of host states and thus play the role of an activist, could further dent the credibility of the system.

4 Proportionality in the ITA System

Now, let us critically look at how ITA arbitral tribunals have applied the principle of proportionality. ITA tribunals that have so far applied the principle of proportionality have not always followed the analytical three-step structure

⁷⁵ See, e.g., 'Open Letter from Lawyers to the Negotiators of the Trans-Pacific Partnership Urging the Rejection of Investor-State Dispute Settlement' (Letter, 8 May 2012) <<http://tpplegal.wordpress.com/open-letter/>> [accessed 10 October 2014]

⁷⁶ Some dismiss these concerns as rhetorical by often citing empirical work in defense of the ITA system: see Brower & Blanchard, above n 63. However, those who critique the ITA system also rely on empirical studies: see Van Harten, above n 73; Van den Berg, above n 74. Thus, it is not appropriate to call these concerns as rhetorical—the better approach would be to deal with the criticisms and improve the system.

⁷⁷ It is important that systemic bias is distinguished from actual bias. The argument here is not that arbitrators have an actual bias against host states or in favour of foreign investors.

⁷⁸ See the debate between S Frank and G Van Harten in K Sauvant (ed), *Yearbook on International Investment Law and Policy* (2010-11) 859.

⁷⁹ A full issue in *Transnational Dispute Management* focusses on the question of how to improve the investment treaty arbitration system: <<http://www.transnational-dispute-management.com/journal-browse-issues-toc.asp?key=52>> [accessed 8 October 2014]. See also UNCTAD, *IIA Issues Note 2: Reform of Investor-State Dispute Settlement: In Search of a Roadmap* (24 May 2013) 1–2, <<http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4-en.pdf>> [accessed 12 October 2014].

⁸⁰ Even those who defend the ITA system recognise the concerns and critiques flagged above and thus offer 'interpretative' solutions like use of public law method including the use of principle of proportionality in interpreting BITs: Schill, above n 6, 57.

mentioned above, which shows the problematic application of this method by tribunals.

One of the first ITA disputes which made somewhat elaborate reference to the principle of proportionality is *Tecmed v Mexico*.⁸¹ The tribunal cited the jurisprudence of the European Court of Human Rights (ECtHR)⁸² to support the proportionality test when determining indirect expropriation.⁸³ The tribunal held that ‘there must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.’⁸⁴ While most commentators who support proportionality analysis in ITA cite the *Tecmed* decision in support of their argument, Henckels (who also advocates proportionality in ITA) has argued that the *Tecmed* tribunal’s methodology to apply the proportionality test was flawed.⁸⁵ For example, the *Tecmed* tribunal proceeded directly to a strict proportionality review without undertaking the suitability and necessity stages, which is deeply problematic because benefits from the measure are being weighed and balanced against the restriction of the investor’s right without deciding whether the regulatory measure is suitable or whether less restrictive alternative measures are available to the host country.⁸⁶ Also, the tribunal ‘essentially discounted responding to concerns [of community pressure to shift the landfill] as a legitimate objective’ to be pursued by Mexico.⁸⁷ This shows the inherent dangers with a proportionality analysis where the *ad hoc* arbitral tribunal gets to decide which public objectives are legitimate and worth pursuing—not the state.

Other tribunals have endorsed the approach adopted by the *Tecmed* tribunal.⁸⁸ For example, the tribunal in *El Paso v Argentina* cited *Tecmed* and said

⁸¹ ICSID Case No ARB(AF)/00/2 (Award, 29 May 2003).

⁸² *Mellacher and Others v Austria* [1989] ECtHR App 10522/83, 11011/84, 11070/84, 24; *Pressos Compania Naviera and Others v Belgium* [1995] ECtHR App 17849/91, 19; *James and Others v UK* [1986] ECtHR App 8793/79, 19–20.

⁸³ *Tecmed v Mexico*, para 115.

⁸⁴ *Tecmed v Mexico*, para 122.

⁸⁵ Henckels, above n 11, 232. See also Leonhardsen, above n 11.

⁸⁶ Henckels, above n 11, 233.

⁸⁷ *Ibid*, 232. See also *Tecmed v Mexico*, paras 133–48.

⁸⁸ *LG&E v Argentina*, para 195; *Azurix v Argentina*, ICSID Case No ARB/01/12 (Award, 14 July 2006), para 312; *El Paso v Argentina*, para 241; *Joseph C Lemire v Ukraine*, ICSID Case No ARB/06/18 (Decision on Jurisdiction and Liability, 14 January 2010), para 285; *Deutsche Bank AG v Sri Lanka*, ICSID Case No ARB/09/2 (Award, 31 October 2012) para 522; *Occidental Petroleum Corporation and Occidental Exploration and Production Company v Ecuador*, ICSID Case No. ARB/06/11 (Award, 5 October 2012), paras 402–4. The arbitral tribunal in *Fireman’s Fund v Mexico*, below n 162, said after noting that the principle of proportionality was used by the *Tecmed* tribunal, ‘The factor is

that 'proportionality has to exist between the public purpose fostered by the regulation and the interference with the investors' property rights'.⁸⁹ However, there was no mention of steps of suitability and necessity preceding this strict proportionality review. Also, the tribunal's analysis on determining indirect expropriation does not show, in a clear and rigorous way, how the tribunal applied the strict proportionality review.⁹⁰ Even in cases related to determination of violation of a FET provision, the proportionality principle—whilst referred—has often been applied in a truncated manner,⁹¹ raising doubts about whether it is fully established in ITA.⁹²

One recent arbitral tribunal that used the principle of proportionality is *Occidental v Ecuador*.⁹³ The core issue in this case was whether issuance of *caducidad* (termination) of the contract between the claimant (Occidental) and Petroecuador⁹⁴ by the Ecuadorian government amounted to breach of the BIT between the US and Ecuador.⁹⁵ The tribunal examined the legality of this regulatory measure by undertaking a proportionality analysis, which was couched in the following terms: first, whether any meaningful alternative short of declaring *caducidad* was available to Ecuador (whether there were alternative measures); and second, whether in any event issuance of *caducidad* was a proportionate response.⁹⁶ The tribunal did not talk of the suitability stage of the proportionality review, and found that there were alternative measures available to Ecuador and thus the measure adopted was not necessary.⁹⁷ It further went on to find out whether the measure was proportionate and concluded that it was not.⁹⁸ It is submitted that this is an incorrect application of the proportionality review where step three (proportionality *stricto sensu*) should be

used by the European Court of Human Rights [...] and it may be questioned whether it is a viable source of interpreting Article 1110 of the NAFTA'.

⁸⁹ *El Paso v Argentina*, para 243.

⁹⁰ *Ibid*, paras 244–8.

⁹¹ See *EDF (Services) v Romania*, ICSID Case No ARB/05/13 (Award, 2 October 2009) para 293. See also R Klager, *Fair and Equitable Treatment in International Investment Law* (2011) 244–5.

⁹² Klager, above n 91, 245. See also E Crawford, 'Proportionality', in R Wolfrum (ed), *The Max Planck Encyclopedia of Public International Law* (online edn, 2011) MN25.

⁹³ Above n 88.

⁹⁴ See *Occidental v Ecuador*, paras 186–200.

⁹⁵ For the facts of this case, see B Sabahi & K Duggal, '*Occidental Petroleum v Ecuador*: Observations on Proportionality, Assessment of Damages and Contributory Fault' (2013) 28 *ICSID Review—FILJ* 279.

⁹⁶ *Occidental v Ecuador*, para 426.

⁹⁷ *Ibid*, paras 428–36.

⁹⁸ *Ibid*, paras 442–52.

pursued only when the second step (necessity) has been satisfied. If the impugned regulatory measure is not necessary, then undertaking proportionality *stricto sensu* is superfluous.

5 Proportionality and the Text of BITs

We now turn to showing that use of proportionality analysis in interpreting BITs will violate the clear textual language of the treaty and thus not be in consonance with the customary rules of treaty interpretation.⁹⁹ It can be safely said that an ITA tribunal is bound to interpret a BIT using the customary rules of treaty interpretation, which are codified in the Vienna Convention on Law of Treaties (VCLT). These rules of treaty interpretation, after an ‘initial silence’¹⁰⁰ and ‘ensuing hesitation’,¹⁰¹ have been fully recognised by the International Court of Justice (ICJ).¹⁰² The World Trade Organization’s (WTO) Appellate Body has frequently affirmed the customary character of the VCLT.¹⁰³ A system whose neutrality is under doubt will gain credibility if it applies the widely recognised rules of treaty interpretation (where the text is the single most important of the analysis) to interpret BIT provisions in a rigorous manner rather than trying to be activist or undertaking value-driven interpretation.¹⁰⁴ This paper takes

⁹⁹ See J Calamita, ‘International Human Rights and the Interpretation of International Investment Treaties – Constitutional Considerations’, in F Baetens (ed), *Investment Law Within International Law: Integrationist Perspectives* (2013) 164.

¹⁰⁰ T Bernardez describes the period from 1970–80 as the period of ‘initial silence’ where the ICJ did not make references to VCLT: S T Bernardez, ‘Interpretation of Treaties by the International Court of Justice following the Adoption of the 1969 Vienna Convention on the Law of Treaties’, in Gerhard Hafner et al (eds), *Liber Amicorum: Professor Ignaz Seidl-Hohenveldern in Honour of his 80th Birthday* (1998) 721, 723.

¹⁰¹ Bernardez describes the period from 1980–90 as the period of ‘ensuring hesitations’ of the Court with regard to VCLT: *ibid*, 727–9. .

¹⁰² R Gardiner, *Treaty Interpretation* (2008) 14–15. See also *Arbitral Award of 31 July 1989 (Guinea-Bissau v Senegal)*, ICJ Reports 1991 p 53, 69–70; *Avena and other Mexican Nationals (Mexico v United States of America)*, ICJ Reports 2004 p 12, 48.

¹⁰³ For more on treaty interpretation by the Appellate Body of the WTO, see I Van Damme, *Treaty Interpretation by the WTO Appellate Body* (2009). For a debate on VCLT rules for treaty interpretation see M McDougal ‘The International Law Commission’s Draft Articles Upon Interpretation: Textuality Redivivus’ (1967) 61 *AJIL* 992.

¹⁰⁴ For a discussion on how international tribunals actually interpret treaties and what explains the divergence, see J Pauwelyn & M Elsig, ‘The Politics of Treaty Interpretation: Variations and Explanations Across International Tribunals’, in J L Dunoff et al (eds), *Interdisciplinary Perspectives on International Law and International Relations* (2013) 445. In context of the WTO treaty it has been argued that the AB applies the VCLT rules comprehensively, often going through each and

the example of expropriation provisions and provisions on monetary transfer to show that this will be the case.

5.1 Conceptual difficulty in using the proportionality principle to determine indirect expropriation

The use of a proportionality test in the determination of indirect expropriation will lead to conceptual obfuscation by ignoring clear treaty language¹⁰⁵ in those BITs where the textual focus, to determine indirect expropriation, is on the 'effect' of the regulatory measure on investment.¹⁰⁶ Let us take Article 5(1) of India–Germany BIT as a representative example of such expropriation provisions found in many BITs:

Investments of investors of either contracting party shall not be expropriated, nationalised, or subjected to measures having effect equivalent to nationalisation or expropriation in the territory of the other contracting party except in public interest, authorised by the laws of that party, on a non-discriminatory basis and against compensation.

Giving ordinary meaning to the words occurring in the above provision on expropriation in accordance with VCLT Article 31(1) it is clear that host state is not precluded from expropriating a foreign investment. However, a host state can adopt regulatory measures tantamount to expropriation if the objective is to achieve some public purpose, provided the regulatory measure is non-discriminatory and due compensation is paid to the foreign investor. In other words, the text clearly recognises that a non-discriminatory regulatory measure aimed at achieving a public purpose could still amount to expropriation.¹⁰⁷ Ultimately, it is the payment of compensation that will make this expropriation lawful or unlawful. Thus, to prove whether the above provision has been breached, two

every step or interpretative guideline given in the VCLT: see G Abi-Saab, 'The Appellate Body and Treaty Interpretation', in M Fitzmaurice et al (eds), *Treaty Interpretation and the Vienna Convention on the Law of Treaties: 30 Years On* (2010) 99.

¹⁰⁵On how international tribunals actually interpret treaties and what explains the divergence, see Pauwelyn & Elsig, above n 104.

¹⁰⁶There are other BITs which also mention factors other than 'effect' to determine indirect expropriation.

¹⁰⁷Vandeveld, above n 2, 302.

things have to be satisfied: first, the state should have expropriated foreign investment (i.e. expropriation has taken place); and second, this expropriation should not be in public interest, or if it is in the public interest, should not have been duly compensated (i.e. should be unlawful).

Since a proportionality test will involve weighing and balancing the effect on foreign investment with the public purpose that the host state wishes to achieve, it will involve taking 'public purpose' into account to determine indirect expropriation although the phrase 'measures having effect equivalent to nationalisation or expropriation' contains only 'effect' as the criterion to determine indirect expropriation. In the above provision on expropriation, 'public purpose' exists as a criterion to determine whether expropriation is lawful and not to determine expropriation *per se*,¹⁰⁸ which is the first of the two analytical steps to be performed in interpreting the expropriation provision. Using public purpose to determine whether foreign investment has been expropriated will result in a strange situation where, on the one hand, the treaty requires that foreign investment should not be expropriated unless there is public purpose and accompanied by compensation, and, on the other hand, the argument that regulatory measures tantamount to expropriation would not give rise to a claim for compensation if adopted for public purpose.¹⁰⁹

Reliance on 'public purpose' to determine indirect expropriation, even if the expropriation provision in the BIT mentions only 'effect', is often achieved by arguing that under customary international law a state does not commit an expropriation and is not liable for adopting general regulatory measures that are commonly accepted as part of states' police powers.¹¹⁰

While many authorities support the right of the host state to regulate for *bona fide* public purpose even if it considerably affects foreign investment;¹¹¹

¹⁰⁸Ibid. See also A K Hoffmann, 'Indirect Expropriation', in A Reinisch (ed), *Standards of Investment Protection* (2008) 151; *Fireman's Fund Insurance Company v Mexico*, para 174; *Corn Products International v Mexico*, ICSID Case No. ARB(AF)/04/01 (Decision on Responsibility, 15 January 2008), para 89. See also *Siemens* at para 270, which said that purpose is a criterion to determine whether expropriation is in accordance with the BIT and not for determining whether expropriation has taken place. The arbitral tribunal in *Chemtura* adopted the same approach as tribunals in *Fireman Fund Insurance* and *Corn Products*. See *Chemtura Corporation v Government of Canada*, UNCITRAL/NAFTA (Award, 2 August 2010) para 257.

¹⁰⁹See also *Azurix v Argentina*, para 311; Kulick, above n 11, 205–6.

¹¹⁰Henckels, above n 11, 225; Kingsbury & Schill, above n 11, 90–91; *Saluka v Czech Republic*, paras 254–62.

¹¹¹*Saluka v Czech Republic*, paras 254–62; *Methanex v Mexico*, para 410; *Feldman v Mexico*, paras 103, 112. See also *Sedco Inc v National Iranian Oil Co*, Interlocutory Award (1985) 9 Iran–US CTR 248,

what is challenging is to answer whether this right has any limits. According to the proponents of the proportionality principle, this limit will be crossed if the effect on foreign investment is disproportionate to the importance of the public purpose pursued by the state. Apart from the complications of whether enough institutional safeguards exist in the system for tribunals to decide this question, this could lead to situations where this right will have no limits such as in cases where the alleged public interest to be pursued is very high. In other words, any effect including 'substantial deprivation' of foreign investment will not be expropriation as long as this effect is proportionate to the significance of public interest pursued by the host state. This would defeat the very purpose of having expropriation provisions in BITs.¹¹² The purpose of expropriation provision in BITs is to prohibit host states from shifting the burden of realising a public purpose onto foreign investors alone.¹¹³ It has also been argued that 'historically, police powers have never been meant to cover regulations amounting to expropriations, except perhaps in situations where there is a state of emergency or a state of necessity'.¹¹⁴ In other words, it is one thing to state that a host state has the right to adopt non-discriminatory regulatory measures for public purpose; quite different to decide how this will be applied in light of the fact that this very host state has accepted restrictions on its right by entering into a BIT containing the above-mentioned expropriation provision.¹¹⁵ The tribunal in *ADC*

275; L B Sohn & R Baxter, 'Draft Convention on the International Responsibility of States for Injuries to the Economic Interests of Aliens' (1961) 55 *AJIL* 545; G C Christie, 'What Constitutes a Taking of Property under International Law' (1962) 33 *BYIL* 307; Newcombe & Paradell, above n 2, 357–8.

¹¹² Vandevelde, above n 2, 296.

¹¹³ Ibid; T Weiler, 'Methanex Corp v USA – Turning the Page on NAFTA Chapter Eleven?' (2005) 6 *JWIT* 903, 919. See also J Paulsson & Z Douglas, 'Indirect Expropriation in Investment Treaty Arbitrations', in N Horn & S M Kröll (eds), *Arbitrating Foreign Investment* (2004) 145, 157.

¹¹⁴ F Vicuna, 'Carlos Calvo, Honorary NAFTA Citizen' (2002) 11 *NYU Environmental LJ*, 19, 27. See also B Mostafa, 'The Sole Effects Doctrine, Police Powers and Indirect Expropriation under International Law' (2008) 15 *Australian ILJ* 267, 273. The *Restatement Third of the Foreign Relations Law of the United States* states that a 'state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if not discriminatory.' It is important to note that phrases like 'loss of property' and 'economic disadvantage' refer to those situations that are below the threshold of substantial deprivation. There is difference between 'economic disadvantage' and 'substantial deprivation'.

¹¹⁵ The concern that non-inclusion of public purpose into determination of expropriation will reduce the regulatory space of host countries to adopt measures in public interest is not correct if one adopts the 'substantial deprivation' test for determination of indirect expropriation. In other words, it is not any adverse 'effect' on foreign investment that will constitute expropriation

*v Hungary*¹¹⁶ said that while a sovereign nation possesses the inherent right to regulate its domestic affairs, the exercise of this right must have its boundaries.¹¹⁷ The tribunal recognised that the relevant BIT provided such boundaries.¹¹⁸ The *Azurix* tribunal found the criterion that 'host state is not liable for economic injury that is the consequence of bonafide regulation within the accepted police powers of the state' insufficient to determine indirect expropriation and recognised that a legitimate measure serving a public interest could give rise to a compensation claim.¹¹⁹

Another difficulty regarding the use of the proportionality principle when determining indirect expropriation will arise with differing language of the expropriation provision in different BITs. For example, compare the language of the above-mentioned provision with the language of some other BITs on expropriation, which provide an annex for interpreting expropriation provisions like India-Singapore BIT. The annex states:

The Parties confirm the following understanding with respect to the interpretation and/or implementation of Chapter 6 on Investment of the India-Singapore Comprehensive Economic Cooperation Agreement (the 'Agreement') [...]

(d) the determination of whether a measure or series of measures of a Party in a specific factual situation, constitute measures as referred to in paragraph (b) above requires a case-by-case, fact-based inquiry that considers, among other factors:

(i) the economic impact of the measure or series of measures, although the fact that a measure or series of measures by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that measures having effect equivalent to nationalization or expropriation, has occurred;

but only that 'effect' that results in 'substantial deprivation' of foreign investment. This high threshold will allow ample space to the host state to adopt a number of regulatory measures for public purpose. It is only justifiable that if any regulatory measure crosses the high threshold of 'substantial deprivation', the host state should pay compensation to foreign investor. See R Moloo & J Jacinto, 'Environmental and Health Regulation: Assessing Liability under Investment Treaties' (2011) 29 *Berkley JIL* 1, 24; Mostafa, above n 114, 282–4; see also *Impregilo v Argentina*, para 270.

¹¹⁶ *ADC v Hungary*, ICSID Case No ARB/03/16 (Award, 2 October 2006).

¹¹⁷ *ADC v Hungary*, paras 423–4.

¹¹⁸ *Ibid.*

¹¹⁹ *Azurix v Argentina*, para 310.

- (ii) the extent to which the measure or series of measure interfere with distinct, reasonable, investment-backed expectations;
- (iii) character of the measure or series of measures, including inter alia, their intent, objectives, purpose, and degree of nexus between the measures and outcome or effects that forms the basis of the expropriation claim.¹²⁰

Thus, the annex provides that in the determination of the expropriation provision, one has to take into account not just the economic impact of the measure on foreign investment but also the character of the measure and its purpose. In other words, this provision provides a clear indicator that both effect and purpose should be taken into account in determining indirect expropriation.¹²¹ This language is very different from the language of the expropriation provision in the India–Germany BIT discussed above. In the India–Singapore BIT, there is textual support to have some kind of weighing and balancing or undertake proportionality-type analysis whereas there is no such indication in the text of the expropriation provision in India–Germany BIT. Using same method of review (i.e. proportionality in both India–Germany BIT and India–Singapore BIT), ignores the difference in language of the two treaty texts and thus is not in accordance with the canons of treaty interpretation recognised in the VCLT.

5.2 Proportionality Analysis in Monetary Transfer Provisions (MTPs)

MTPs in BITs regulate the transfer of funds related to investment in and out of a country. A typical MTP in a BIT identifies the ‘transfer’ or ‘payment’ to which the provision applies and also provides the conditions governing such transfers such as whether the transfer is to be made in foreign currency and whether the transfer can be made promptly.¹²² In most BITs, MTPs cover all ‘transfers’ or ‘payments’ related to investment.¹²³ Further, depending on the treaty language, MTPs cover

¹²⁰ Such expropriation provisions are also to be found in the US–Chile FTA, Chapter 10, Annex D, No 4(a); the 2004 US Model BIT Annex B; and the Australia–Chile FTA, Annex 10-B, No 3(a).

¹²¹ It has been argued that expropriation provisions of this nature have created confusion: Montt above n 7, 287. Also Kurtz has argued that presence of such expropriation provisions in Australian BITs, which reflect a crude transplant of US Supreme Court decision in *Penn Central Transportation Co v New York City*, 438 US 104, 124 (1978) is puzzling: Kurtz, above n 8, 693.

¹²² Vandeveld, above n 2, 317.

¹²³ Ibid.

both inflows and outflows of funds.¹²⁴ These 'transfers' include: additional capital to maintain and increase investment; net operating profits, including dividends; repayment of any loan including interest; proceeds from sales of their shares, etc.¹²⁵ Most MTPs are worded broadly and are unqualified, as is Article 7 of the Indian Model BIT,¹²⁶ which states that India shall permit transfers of all funds related to investment and does not provide any exception or deviation from this obligation.

Thus the following question arises: if India were to impose restrictions on transfers or payments by foreign investors for any public policy concern and if a foreign investor challenges this as a violation of the MTP, how will an arbitral tribunal decide? On the basis of the argument that under customary international law, countries have the right to impose restrictions on transfers of funds,¹²⁷ (similar to the one used in expropriation) advocates of proportionality will contend that a tribunal should decide this question by using the three-step proportionality test, which would include weighing and balancing the benefit of the regulatory measure imposing restriction with the cost imposed on foreign investor. Thus, if the benefit flowing from restricting the transfer of funds is proportional to the restriction imposed on the right of the investor, then the

¹²⁴Ibid, 319.

¹²⁵See Article 7, Indian Model Text of Bilateral Investment Promotion and Protection Agreement, <http://finmin.nic.in/the_ministry/dept_eco_affairs/icsection/Indian%20Model%20Text%20BIPA.asp> [accessed 1 October 2014]

¹²⁶For example, the MTP in Article 7 of the Indian Model BIT is worded in a very broad fashion:

Repatriation of Investment and Returns:

(I) Each Contracting Party shall permit all funds of an investor of the other Contracting Party related to an investment in its territory to be freely transferred, without unreasonable delay and on a non-discriminatory basis. Such funds may include:

- (a) Capital and additional capital amounts used to maintain and increase investments;
- (b) Net operating profits including dividends and interest in proportion to their share-holdings;
- (c) Repayments of any loan including interest thereon, relating to the investment;
- (d) Payment of royalties and services fees relating to the investment;
- (e) Proceeds from sales of their shares;
- (f) Proceeds received by investors in case of sale or partial sale or liquidation;
- (g) The earnings of citizens/nationals of one Contracting Party who work in connection with investment in the territory of the other Contracting Party.

¹²⁷A Turyn & F P Aznar, 'Drawing the Limits of Free Transfer Provision', in M Waibel et al (eds), *The Backlash Against Investment Arbitration* (2010) 51.

impugned measure should be held legal.

However, the use of such proportionality analysis would go against the language of the text, making it clear that the obligation on the host country is to permit 'all' transfers 'freely' and 'without delay'. No exception is recognised in the treaty with respect to this provision. These words show that the countries have 'contracted out' of general international law, maintaining the right to impose restrictions on transfer of funds as far as bilateral flows between the two countries are concerned.¹²⁸ Similarly, arguments for using proportionality analysis can also be made by relying on the argument that the International Monetary Fund (IMF) Articles allow countries to impose restrictions on transfer of capital accounts.¹²⁹ However, the MTP in a BIT is *lex specialis* in relation to both the IMF provisions and the customary international law provision because it deals only with those aspects of transfer of funds that relate to investment.¹³⁰ Conversely, the IMF Articles and customary international law on monetary sovereignty deal with the issue of transfer of funds on all transactions not just related to foreign investment.

Another problem with respect to use of proportionality in MTPs, like the expropriation provision, will arise with differing treaty language. For example, some BITs allow host country to adopt restrictions on transfer of funds provided they are 'necessary' to deal with problems related to balance of payments.¹³¹ The treaty however does not define when it can be said that it is 'necessary' to restrict the rights of the foreign investor to freely transfer funds in and out of the country. This puts the onus on the arbitral tribunal to decide what is 'necessary'. Provisions such as these provide some textual basis to undertake proportionality analysis although even here the argument could be for a less restrictive alternative measure test. The more important point for our purposes is that if proportionality analysis is used even in MTP provisions of the kind present in the Indian Model BIT, then that would erode the textual difference between

¹²⁸ For more on 'contracting out' of general international law, see J Pauwelyn, *Conflict of Norms in Public International Law* (2004).

¹²⁹ See Article VI.3, IMF Articles; see also J Gold, 'Exchange Contracts, Exchange Control, and the IMF Articles of Agreement: Some Animadversions on *Wilson, Smithett & Cope Ltd v Terruzzi*' (1984) 33 *ICLQ* 777, 778–9.

¹³⁰ P T Muchlinski, 'Trends in International Investment Agreements: Balancing Investor Rights and the Right to Regulate: the Issue of National Security', in K Sauvant (ed), *Yearbook of International Investment Law and Policy* (2010) 35, 60; *Continental Casualty v Argentina*, paras 243–4.

¹³¹ See Article 17(2)(b) of the Korea-Japan BIT: 'Measures referred to in paragraph 1 of this Article [...] shall not exceed those necessary to deal with the circumstances' given in Article 17(1) which related to protection of country from balance of payments crisis or situations of extreme financial difficulty.

such provisions and MTPs of the kind present in Korea–Japan BIT.

Kingsbury and Schill, who advocate for the use of proportionality in the ITA system, argue that this method of review ‘is not proposed as an alternative to the rules on treaty interpretation under the VCLT’.¹³² However, as the above discussion shows, use of proportionality in those provisions on expropriation where the focus is solely on ‘effect’, will actually end up ignoring the clear language of the text and thus not be in consonance with the rules of VCLT. Moreover, Kingsbury and Schill argue that the proportionality analysis should be used by tribunals in situations where the rules of treaty interpretation do not indicate priority of one right or interest over the other.¹³³ However, the discussion above shows that rules of treaty interpretation indicate which right should prevail in cases of expropriation where ‘effect’ is the sole factor provided by the text (once the ‘effect’ crosses the threshold of substantial deprivation, which right should prevail is clearly recognised by the treaty) and where the MTPs are broadly worded without any exceptions.

6 Reliance on EC and WTO Jurisprudence to Support Proportionality in ITA?

Most scholars who advocate for proportionality in investment treaty arbitration rely heavily on the jurisprudence of European courts, such as the ECtHR, and the WTO.¹³⁴ As has been discussed, the *Tecmed* tribunal supported the use of proportionality in investment arbitration through reliance on the jurisprudence of ECtHR.¹³⁵ However, there are certain aspects not highlighted in these writings which crucially show that one has to be very careful in cross-regime reliance, otherwise it could amount to unfinished transplants of legal principles from one system to another without appreciating the contextual and institutional differences.

First, the use of proportionality in the WTO jurisprudence on GATT Article XX¹³⁶ has a textual basis. GATT Article XX(b), for example, states that a

¹³² Kingsbury & Schill, above n 11, 78.

¹³³ Ibid.

¹³⁴ See Schill, above n 7; Henckels, above n 11; Kulick, above n 11.

¹³⁵ See *Tecmed v Mexico*, paras 115–22.

¹³⁶ GATT Article XX allows member countries to deviate from their WTO obligations in order to pursue certain non-trade goals provided certain conditions are satisfied. Further: M Trebilcock et al, *The Regulation of International Trade* (2012), 681–4; S Lester et al, *World Trade Law: Text, Materials and Commentary* (2012), 363–73.

WTO member country can adopt measures for protection of public health provided it is 'necessary' to do so.¹³⁷ The WTO appellate body, in order to interpret the word 'necessary'¹³⁸ has developed a two-tier test involving both proportionality and less restrictive alternative measure reasonably available.¹³⁹ The test involves, first, the proportionality or the weighing and balancing test, which will compare different factors like the importance of the regulatory value pursued, the contribution made by the challenged measure to the regulatory value and the restrictive effect of the measure on international trade; second, if the first step yields a preliminary conclusion of the measure being 'necessary', then the second step should compare this measure with other least trade restrictive measures which are reasonably available to the importing country.¹⁴⁰ Whether 'necessary' connotes proportionality or only less restrictive alternative test can be debated, however, the presence of the word 'necessary' in GATT Article XX gives some textual basis to argue for proportionality test.

Similarly, the ECtHR has also relied on words like 'necessary' found in the text of the European Convention on Human Rights to use proportionality as a method of reviewing state action.¹⁴¹ In investment treaty arbitration, arguments for using

¹³⁷ GATT Article XX provides: 'Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures: (b) necessary to protect human, animal or plant life or health [...]'

¹³⁸ The word 'necessary' can also be interpreted using the less restrictive alternative measure test.

¹³⁹ See C Bown & J Trachtman, 'Brazil – Measures Affecting Imports of Retreaded Tyres: A Balancing Act' (2009) 8 *World Trade Review* 85, 87. For WTO jurisprudence on 'necessary' in GATT Article XX see Appellate Body, *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, WTO Doc WT/DS161 and 169/AB/R (11 December 2000) (*Korea – Beef*); Appellate Body, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes*, WTO Doc WT/DS320/AB/R (25 April 2005) (*Dominican Republic – Cigarettes*); Appellate Body, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WTO Doc WT/DS285/AB/R (7 April 2005) (*US – Gambling*); Appellate Body, *Brazil – Measures Affecting Imports of Retreaded Tyres*, WTO Doc WT/DS332/AB/R (17 December 2007) (*Brazil – Tyres*).

¹⁴⁰ A D Mitchell & C Henckels, 'Variations on a Theme: Comparing the Concept of Necessity in International Investment Law and WTO Law' (2013) 14 *Chi JIL* 93; M M Diu, 'Autonomy in Setting Appropriate Level of Protection under the WTO Law: Rhetoric or Reality?' (2010) 13 *JIEL* 1077, 1093. The word 'necessary' can also be interpreted by using the less restrictive alternative measure test.

¹⁴¹ In *James and Others v United Kingdom* Article 1 of Protocol No 1, which was to be interpreted, contains the word 'necessary'. Similarly, in *Handyside v United Kingdom* [1976] ECtHR App 5493/72, a case involving censorship, the provision to be interpreted was ECHR Art 10(2), which contains the word 'necessary', which was used by the ECtHR to adopt a proportionality analysis.

proportionality analysis are often made without any textual basis. For example, in the expropriation provision given in the India–Germany BIT, or in the MTPs of the kind laid out in the Indian Model BIT mentioned above, there is no mention of the word ‘necessary’ and thus no textual basis to use proportionality.

Second, the proponents of proportionality in ITA, while relying on the jurisprudence of GATT Article XX, do not point out that use of weighing and balancing by the WTO Appellate Body is not without its share of criticism. The proportionality test in WTO has been critiqued for encroaching onto the host country’s sovereignty because it allows the WTO adjudicator to compare trade and non-trade values and, based on this assessment, the adjudicator can replace the importing country’s assessment with his/her own assessment.¹⁴²

Third, there are key differences between EU treaties and the network of BITs. For example, the normative values that bind the EU cannot be cross applied to the network of 3,000 BITs, which have different goals such as providing protection to foreign investment in return for greater foreign investment inflows.¹⁴³ Kurtz has argued that the use of proportionality test in the context of the EU is to further the normative goal of positive integration of the EU and is in fact a part of judicial activism,¹⁴⁴ itself being a response to the failure of the legislative arm of the EU to further this goal.¹⁴⁵ No such normative goal is to be pursued by BITs.

¹⁴²Bown & Trachtman, above n 139, 85; D H Regan, ‘The Meaning of ‘Necessary’ in GATT Article XX and GATS Article XIV: The Myth of Cost-Benefit balancing’ (2007) 6 *World Trade Review* 347; J Kurtz, ‘Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis’ (2010) 59 *ICLQ* 325, 366–8.

¹⁴³J W Salacuse and N P Sullivan, ‘Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and their Grand Bargain’ (2005) 46 *Harvard ILJ* 67. It has been argued that BITs do not necessarily result in more foreign investment inflows: E Aisbett, ‘Bilateral Investment Treaties and Foreign Direct Investment: Correlation Versus Causation’, in K Sauvart et al (eds), *The Effect of Treaties on Foreign Direct Investment* (2009) 395; L Poulsen, ‘The importance of BITs for foreign direct investment and political risk insurance: revisiting the evidence’, in K Sauvart (ed), *Yearbook on International Investment Law and Policy* (2009–2010) ch 14. However, that is a separate point. The real issue here is what is the object and purpose of the BIT as reflected in the treaty. If it is attracting foreign investment by providing protection to investors, then the treaty interpreter has to take this context into account notwithstanding its desirability from a normative point of view.

¹⁴⁴On judicial activism of the ECtHR, see G Letsas, ‘Strasbourg’s Interpretative Ethic: Lessons for the International Lawyer’ (2010) 21 *EJIL* 509, 518–20.

¹⁴⁵Kurtz, above n 142, 373. See also M P Maduro, *We the Court: The European Court of Justice and the European Economic Constitution – A Critical Reading of Article 30 of the EC Treaty* (1998); C Button, *The Power to Protect: Trade, Health and Uncertainty in the WTO* (2004), 211–212; C Henckels, ‘Balancing Investment Protection and the Public Interest: The Role of Standard of Review and Importance of Deference in Investor-State Arbitration’ (2013) 4 *JIDS* 197, 203–4.

7 What Should the Tribunal do? Is a Deferential Proportionality Analysis an Answer?

If one rejects the argument that tribunals should undertake a full-fledged intrusive proportionality analysis or, in other words, a proportionality analysis which is not deferential to the host state, then the obvious question will be what should the tribunal do? Can it adopt a deferential proportionality analysis? Henckels, while conceding to some of the criticisms leveled against the use of principle of proportionality in ITA, has argued that these problems can be overcome by an arbitral tribunal according deference to host countries while undertaking proportionality analysis.¹⁴⁶ She argues that 'a deferential approach to strict proportionality is preferable to an intrusive approach whereby arbitrators substitute their own opinions as to the appropriate balance which requires understanding of the society whose authorities' measures are at issue'.¹⁴⁷ In other words, according to Henckels, tribunals in the third step of the proportionality analysis related to strict proportionality should interfere only if the regulatory measure is 'manifestly disproportionate in light of its expropriatory effect'.¹⁴⁸ In this residual review, weighing and balancing will not take place for every impugned regulatory measure as long as the requirements of suitability and necessity have been satisfied but only for the 'obviously disproportionate' cases. This might give rise to the question whether the third analytical step is illusory. Henckels argues that this residual review of strict proportionality is not illusory because not proceeding to this stage may result in the measure being adjudged lawful even if the impact of the measure on investment is severe 'relative to the importance of the measure and its objective or where the measure and its objective could not reasonably be regarded as significant and important *vis-à-vis* its expropriatory effect'.¹⁴⁹

The residual review of the strict proportionality stage appears to be better than arbitral tribunals undertaking proportionality *stricto sensu* in each case without according much deference to the host state. Henckels' proposal will ensure that arbitral tribunals stay away from undertaking proportionality *stricto sensu* for impugned regulatory measures except for cases falling in the category of 'obviously or manifestly disproportionate'.

However, the question to be asked is how will different arbitral tribunals decide the 'obviously disproportionate' category of cases? One way of doing this

¹⁴⁶ Henckels, above n 11.

¹⁴⁷ Ibid, 252.

¹⁴⁸ Henckels, above n 11, 253. See also *LG&E v Argentina*, para 195.

¹⁴⁹ Ibid, 254.

could be to determine whether the impact on foreign investment is severe (e.g. the substantial deprivation of foreign investment). However, arbitral case law on expropriation, shows that tribunals differ from each other on when can it be said that impact on foreign investment is severe or that foreign investment has been substantially deprived.¹⁵⁰ Some arbitral tribunals have adopted the legal approach (e.g. control over investment) to determine the question of substantial deprivation.¹⁵¹ On the other hand, some arbitral tribunals have emphasized the “economic approach” (e.g. substantial deprivation of the economic value of investment) to determine substantial deprivation of foreign investment.¹⁵² In other words, determination of severity of impact will hinge on discretion and subjective assessment of different arbitral tribunals.¹⁵³ Absence of any appellate review mechanism means that there is no body that could, harmonize these inconsistent approaches or decisions or as Kurtz puts it, ‘discipline unprincipled judicial activism’¹⁵⁴ of ITA tribunals. This, in turn, will only aggravate the existing ITA jurisprudential maze.

Further, it is not just severity *per se* of the impact that will matter. This severity will have to be assessed in relation to the importance of the objective or the public purpose pursued by the state. In other words, the tribunal will indulge in proportionality *stricto sensu* even when the interference is not severe *per se* but ‘severe’ in relation to the importance of the public purpose pursued. The tribunal would reach such conclusion despite there not being any other alternative measure reasonably available to the host state to achieve the aforementioned public objective. Again, as discussed before, this is fraught with problems because it gives wide discretion to arbitral tribunals.

In sum, restricting strict proportionality to ‘obviously disproportionate’ cases, on the face of it, appears to accord deference to the host state and limits

¹⁵⁰ See Montt, above n 7, 260–262; T Walde & A Kolo, ‘Environmental Regulation, Investment Protection and Regulatory Taking in International Law’ (2001) 50 *ICLQ* 811, 837–8.

¹⁵¹ See *Enron v Argentina*, para 245. Similarly, in *CMS v Argentina* the tribunal held ‘control over investment’ as integral to determining substantial deprivation (para 263). See also *PSEG Global Inc v Republic of Turkey*, ICSID Case No ARB/02/5 (Award, 4 June 2004) para 278.

¹⁵² *Telenor v Hungary* required ‘a major adverse impact on economic value of the investment’ (para 64) and *Parkerings-Compagniet v Lithuania*, ICSID Case No ARB/05/8 (Award, 11 September 2007) requiring substantial decrease in the value of the investment as one of the requirements to determine indirect expropriation (para 455). See also *Total SA v Argentina*, para 195.

¹⁵³ The only exception to this could be the impact of the regulatory measure that results in total deprivation of foreign investment. However, in real life, most cases would not have reached this highest threshold and thus the challenge will be how to identify that the impact of the regulatory measure on investment is severe.

¹⁵⁴ Kurtz, above n 142, 368.

the discretion of the arbitral tribunal during the balancing stage. However, difficulties surrounding determination of 'obviously disproportionate' cases will mean that in reality there will be less deference accorded to host state, and arbitral tribunals could end up undertaking strict proportionality for most impugned regulatory measures. Additionally, the critique related to absence of textual basis to undertake proportionality analysis and the risk of ignoring the clear textual language, as discussed above, is also applicable to the deferential proportionality review.

The focus of the arbitral tribunal should be on the text of the BIT. So, if the text of the expropriation provision in the BIT clearly states that the focus should be only on 'effect' on foreign investment to determine indirect expropriation or where the MTPs in a BIT clearly state that host state is under an obligation to transfer 'all' funds related to investment without exception, the evidence clearly is that the states, as makers of international law, have decided where the balance should lie. There could be debates on whether this is 'correct' balance or not.¹⁵⁵ However, an ITA tribunal has no textual or institutional mandate to ignore the text and re-do this balance by undertaking a proportionality analysis.

There could be certain issues, which tribunals shall have to decide on their own because of lack of textual clarity such as questions related to standard of review (most BITs do not provide any textual basis for what should be the standard of review).¹⁵⁶ However, as Henckels has argued, a distinction needs to be made between standard of review and method of review.¹⁵⁷ Proportionality is not a standard of review but a method of review because, depending on the deference accorded to the host state, it could be strict or deferential.¹⁵⁸ The method of review should have close resemblance to the text. Thus, in situations where the text provides that the tribunal has to determine whether the regulatory measure adopted is 'necessary' to achieve a particular objective, the method of review should be 'least restrictive alternative measure' test or the necessity

¹⁵⁵ See generally H Kelsen, 'The Pure Theory of Law and Analytical Jurisprudence' (1941) 55 *Harvard LR* 44.

¹⁵⁶ On standard of review in ITA see Henckels, above n 145; J Arato, 'Margin of Appreciation in International Investment Law' (2014) 54 *VaJIL* (forthcoming). Also see generally, F Ortino, 'The Investment Treaty Arbitration as Judicial Review' (2013) 24 *American Review of International Arbitration* 437, 462; Y Shany, 'Toward a General Margin of Appreciation Doctrine in International Law?' (2005) 16 *EJIL* 907.

¹⁵⁷ Henckels, above n 145. Kulick argues, for example, that margin of appreciation can be used to fine-tune necessity and proportionality *stricto sensu* analysis: Kulick, above n 11, 195. Cf Burke-White & Staden, above n 65.

¹⁵⁸ Henckels, above n 145.

test. The tribunal should first ask whether the regulatory measure adopted is suitable to achieve the public interest or objective identified by the state. If yes, then the second step will be to find out whether there is an alternative measure less-investment restrictive or less-restrictive of the rights of foreign investor that will achieve the same public interest. This alternative measure should not be a mere theoretical possibility, but should be reasonably available to host state.¹⁵⁹ In other words, adopting the alternative measure should be something that is within the means (technical, economic) of the state. If the answer to the second question is 'no', then the impugned regulatory measure should be held 'necessary' and thus, legal.

Some difficulty might arise as to what should be the method of review in cases where either the language of the text is too vague and imprecise, as is the case with most FET provisions, and thus no textual indication of where the balance between investment protection and host state's regulatory power should lie, or in cases where the text does not provide any guidance (i.e. no mention of words like 'necessary' or any other nexus requirement linking measures with regulatory objective—this will happen while interpreting non precluded measures provisions in BITs).¹⁶⁰ In such cases also, necessity review should be used by arbitral tribunals because it will involve less discretion and thus no second-guessing about the significance of the public interest that a host state wishes to pursue.

It is argued that not proceeding to the third analytical stage of actual weighing and balancing 'would allow the severe restriction of a right in order to protect a negligible public interest'.¹⁶¹ But then, this is precisely the point: who decides whether the public interest is negligible, the host state or arbitrators? Host state is best judge whether the public interest is negligible or important because an arbitral tribunal cannot fully comprehend and appreciate the actual conditions in which the host state identified the public interest to be pursued. Also, if the tribunal's concern is that host state should not abuse its regulatory power, which is indeed a legitimate concern, then, as Henckels herself admits, this can be addressed at the stages of suitability and necessity.¹⁶² One admits that there could be an odd case where indeed the impact on foreign investor could be

¹⁵⁹ See also *US – Gambling*, paras 309–11.

¹⁶⁰ See e.g. W Burke-White & A Von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties' (2008) 48 *Va JIL* 314.

¹⁶¹ Kingsbury & Schill, above n 11, 87; Henckels, above n 11, 254.

¹⁶² Henckels, above n 11, 254.

disproportionate. However, this is a cost that one will have to bear in a system characterised by many imperfections.¹⁶³

8 Conclusion

This paper has endeavoured to raise some questions regarding the use of proportionality in the ITA system characterised by *ad hoc* arbitration and scattered substantive law with no common or broad-based institutional framework. One recognises the significant role that proportionality analysis, as an important interpretative method, plays in domestic legal systems and in more coherent and developed legal systems like the EC or WTO to balance competing interests. However, one is unsure whether the same can be cross-applied to the ITA system, given the concerns related to neutrality and independence of ITA. Also, as the paper has shown, in many BITs, the application of proportionality test could in fact ignore the textual language of the BIT. One also has to be careful when relying on jurisprudence of European courts or the WTO Appellate Body to promote proportionality in ITA because of significant contextual differences between the two systems.

The ITA tribunal should be guided by the text of the BIT in interpreting treaty provisions using customary rules of treaty interpretation. In situations where a method of review has to be chosen to make a choice between compelling interests, the arbitral tribunal should use the least restrictive alternative measures test (i.e. the necessity test). This test will be deferential to the state's regulatory power by not second-guessing the significance of state's public interest. At the same time, by requiring host state to show that the measure adopted is suitable and that it is least-investment restrictive i.e. no other alternative measure is reasonably available to host state that would achieve the same public interest, the tribunal will also safeguard foreign investment from abusive regulatory measures. Consequently, this will result in improved decision making and bring more rigour in the interpretative process. Given the legitimacy concerns often associated with ITA, arbitral tribunals should be true to the text, be deferential to the state, and not undertake judicial activism.

The debate on proportionality analysis in ITA is part of the larger debate on who has the onus to balance investment protection and regulation in international investment law: arbitrators or states? The fact of the matter is that a large majority of BITs contain provisions whose plain and ordinary meaning show that

¹⁶³ Van Harten, above n 6.

preference is to be given to investment protection over regulation (as in the case of broad and unqualified MTPs discussed in this paper). There are limits as regards the extent to which treaty interpretation and judicial review can correct such imbalance between investment protection and regulation. The onus to rebalance investment protection with regulation should be on countries, the subjects and makers of international law. Recent state practice provides clear evidence of countries taking up this challenge. Countries have, slowly but surely, started entering into newer treaties or replacing extant treaties with a new generation of treaties which are more detailed, balancing investment protection with regulation and thus also reducing the scope for arbitral discretion.¹⁶⁴ It is this new and emerging state practice that will eventually address the concern over existing BITs failing to balance investment protection with host country's regulatory power.

¹⁶⁴P Muchlinski, 'Towards a Coherent International Investment System: Key Issues in the Reform of International Investment Law', in R Echandi & P Sauvé (eds), *Prospects in International Investment Law and Policy* (2012) 411; K Miles, *The Origins of International Investment Law: Empire, Environment and the Safeguarding of Capital* (2013) 351–72.