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## **REGULATORY INCONSISTENCIES RESULTING IN EXPROPRIATORY MEASURES: THE DUTY OF THE STATE TO WARN, OR DUTY OF INVESTOR TO BE AWARE?**

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### **Abstract:**

*Regulatory inconsistencies of the host state, often based on the widely or vaguely construed rules, giving a way to expansive interpretation of the investor's actions as misconduct. This allows for the regulator to impose expropriatory measures as a remedy to an alleged misconduct, distancing from responsibility for misapplication of the rule behind the ambivalent legal framework. The key question with regard to the considered problem, is whether its a state duty to inform, or investor's duty to be aware of all possible consequences, pursuant to the principle of 'prudent investor'. Complexity of the issue necessitates to tackle the problem in multifaceted way, with application of the complex of Fair and Equitable Treatment (FET) standard constituents, as transparency, legitimate expectations, requirements for consistent, stable and predictable framework.*

### **Keywords:**

Foreign Direct Investment Law, Indirect Expropriation, Regulatory Measures, Transparency

### **International**

Irregularities inherent to the administrative systems, often being the result of application of the inconsistent laws and regulations, adopted without detailed elaboration or broadly formulated. These rules giving a way to ambivalent and unequivocal interpretation of the rule of law. This renders the regulatory authority the power to qualify the act of the investor as a breach, entitling to invoke expropriatory measures against the alleged misconduct. The obvious problem with the considered issue is that the actions of regulator does not reach the point of acting *ultra vires* over the rule in question. It's not excluded that such inviolability of the state may be envisaged by the legislative or higher executive authority of the state in designing the law aimed to regulate foreign investment. At this point, such intentional disorder may be even desirable for the state, striving to distant from potential claims behind the unequivocal regulatory framework. Instances of intentional ambiguities were early signified in the Joint Venture Law of the People Republic of China with its implementation regulations, that was giving a right to exercise considerable discretion in identifying appropriateness of the technology invested in Joint Venture by foreign investor.<sup>1</sup> The complexity of the problem suggests to examine the applicable legal framework in foreign investment law, under the independent international standards, either based on treaty or customary international law. The peculiarity of the matter is in presence of the rule in question in the national legal order, which requires consider the legal practice scrutinizing the municipal law.

The key question with regard to the considered situation is who should bear the responsibility over the consistent regulations resultant in negative consequences on the side of investor? Since the position of the state on the matter is predefined by liability of the investor for allegedly wrongful application of the rule, the due regard to the fairness requires to examine the possibility of application of independent legal order. The obvious problem there is that the dependence on national law in the case of application of regulation is inevitable that is being the source for rights

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and obligations of regulator. Reliance on national law when the matter concerned the sovereign ability to be bound by the treaty is prominently exemplified in *Yukos* case held according to the UNCITRAL Rules of Arbitration with biggest arbitration award, that was initially considered as a victory of shareholders and largest one GML in particular.<sup>ii</sup> However, in 2016 the Hague District Court set aside than decision based on non-ratification by the Russian Federation of the Energy Charter Treaty, which was required to perform pursuant to the national Constitution.<sup>iii</sup> The primacy of the national law in subjecting of the state to the international legal order was exemplary in this regard. Although it is known that non-signature state to the treaty can became the ‘real party’ to the agreement by the common intention of the signatory and non-signatory parties known from in *Dornod*.<sup>iv</sup> However, in the case if it’s done purposefully, for instance the attempts to transfer the national investment to a foreign company for the purpose of obtaining BIT protection, it can be qualified as an abuse of process. Seeking international remedies for pre-existing domestic dispute precluded the exercise of jurisdiction by ICSID in *Transglobal* case.<sup>v</sup>

Viable resemblance of the considered situation with the cases having lack of transparency urges to extrapolate its rulings with regard examined problem. The landmark cases of this category are known for instance, as proceeding with transaction without authorization of investor in *Mafezzini v Spain*,<sup>vi</sup> or interference of regulatory authority with the contract rights of third party, led to the failure of investor’s local partner to fulfil the contract, serving a basis for the investor’s activity in *CME v Czech Republic*.<sup>vii</sup> One of the distinctive features of these cases is the active position of the state, and possibility to distinguish the cause and effect relation of the state’s action with the consequences on the side of investor. However, obvious problem of the cases with inconsistencies, that it is the investor who under the improper rule is being a person who committed wrong. Herewith the burden of responsibility over the application of the rule is shifted to the investor. Situation is aggravated by unwillingness of the regulator to define the correct model of conduct, not excluding the purposefulness of that, for reserving the right to alter the required model of conduct with regard to the activity of every particular investor.

Some recall to the considered measure can be found in the *Teomed v Mexico*, where the replacement of the unlimited license on operation of landfill with the license of limited duration, that was resultant in lack of coherence, ambiguity and transparency in relation with investor.<sup>viii</sup> In *LG&E v Argentina*, the FET standard, required from the host state’s consistent and transparent behaviour, free of ambiguity that involves the obligation to grant and maintain a stable and predictable legal framework necessary to fulfil the justified expectations of the foreign investor.<sup>ix</sup> There is no doubt on the close connection of transparency with legitimate expectations on the side of investor, and potentially non communication of the proper mode of behaviour or absence of instructions for unequivocal rule can be qualified as acting not transparently. This affects the legitimate expectations of the investor, who relied on the adequate effect of the rule in question, in the case if its application substantially differs from ordinarily expected by the investor. The tribunal in *Crystallex* found that arbitrariness and lack of transparency and consistency lead to the violation of legitimate expectations on the side of investor.<sup>x</sup>

The difficulties for the investor in seeking the remedy on the grounds of legitimate expectations, is associated with its dependence on representations made from the side of the state, reasonably relied by the investor. In *Metalclad v Mexico*, state has assured that the investor had all necessary permits to operate the landfill,<sup>xi</sup> more or less clear representations based on somewhat an active role of the investor. While in considered situation we have passive role of the executive body, expressed in qualification of the conduct of investor as a wrongful, based on the inconsistent rule or regulation. Another problem concerned legitimate expectations is that the reliance of investor based on the inconsistent law, may be futile in creating specific legitimate expectations, because it is widely uncertain what to rely on. In *Mamidoil* the failure to obtain necessary permits hindered appearance of legitimate expectations and lead to the rejection of FET protection, as the absence of permits precluded rising of legitimate expectations.<sup>xii</sup> Although,

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granting the permits in the future, subject to the placement of bond and payment the taxes has been found as giving rise to legitimate expectations on the side of investor which requires the clarity of representations. The tribunal was sceptical on the possession of the right to permit by the investor, due to laying the matter of granting and withdrawal of licenses in the regulatory competence of the state.

The *MTD v Chile* can be exemplary in illustrating the regulatory inconsistencies where its application resulted in failure of the project of planned residential community due to inconsistencies with zoning regulations.<sup>xiii</sup> The state was found liable for ‘inconsistency of action between two arms of the same Government vis-à-vis the same investor’. Although it was given a proper recognition to the investor’s duty to inform itself on the country’s law and policy in principle,<sup>xiv</sup> tribunal recognized the duty of the state to apply the policies consistently, independently, and hence the act of approval of investment project by the state authority that was contrary to the urban policy of the government has breached the FET standard.<sup>xv</sup> With this regard the presence of the state’s duty of consistency outweighed the duty of investor to acknowledge itself. This is pointing on higher significance of this obligation being shortcut to the effect of FET, and also outlawing the conflicting decisions of the state authorities resulted in stagnation of the investment projects. Protection under the FET is being effective even when the issue of major concern over the responsibility for the inconsistent law is being difficult to establish, or it’s may be out of the jurisdiction of the tribunal.

While the rule in question may be properly applied causing the adequate effect to the legitimate expectations of the investor, often the problem is also concerned the exorbitant application of the rule. While it is so, it’s plausible to consider the application of ‘procedural propriety’ enabled in *Middle East Cement v Egypt*, where the seizure and sale of the ship in the auction went without proper notification of the owner.<sup>xvi</sup> The course taken by the tribunal may be instrumental for enabling the FET standard in the case of violation of procedural order in the process of application of the rule. In *Teemed v Mexico* one of the factors that led to the violation of FET standard was the absence of notification of the claimant on its intention that deprived the investor from taking the legitimate actions to question of the act.<sup>xvii</sup> Although widely construed rule may preclude the procedural violation, however the unreasonable action taken by the regulatory authority can be scrutinized by the tribunal under independent standard, even when such notification is not required by the national law. Similarly the “due process can be without even special reference covered, at least in part, by the requirement of ‘full protection and security’ and by the rule of ‘fair and equitable treatment’”.<sup>xviii</sup>

Assessment of exorbitant application of the rule is being hindered by the limitations on scrutinizing of decision making. As emphasized by *Tarcisio Gazzini*, “Investment tribunals are not meant to review or assess the exercise of regulatory powers by the host state. Quite the contrary their task is strictly limited to determining whether the host state has violated any of the limits imposed by the relevant BIT.”<sup>xix</sup> The tribunal in *S.D. Myers v Canada* was categorical in this regard, findings that “tribunal do not have an open-ended mandate to second-guess government decision-making”.<sup>xx</sup> The argument that the delving into decision making as such can be immaterial for the question of liability is having its merits, however there are instances when reasoning behind the process played a key role in defining the liability, through the analysis of the intentions served as a cause for actions. In situation when the reasons given to the investor was not corresponding to the actual motivation of the state as in *Bayindir v Pakistan*, it entailed finding the state acting under the bad faith,<sup>xxi</sup> resulted in the breach on the side of the state.

The good faith sourced in customary international law was instrumental in screening the conspiracy of the state in relation to the investor, however the breadth of standard raising the question on its interrelation with other

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constituents of FET. In *Saluka v Czech Republic* the expectation that the state will implement its policies bona fide was included the obligation to not manifestly violate the requirements of consistency, transparency, even-handedness and non-discrimination.<sup>xxii</sup> Obviously, overarching nature of bona fide can be non-conflicting and correlated with constituents of other applicable standards of treatment. Flexibility of the concept signifies that mala fides can strengthen the question on violation of FET,<sup>xxiii</sup> but essentially not substantial for its recognition.<sup>xxiv</sup> As it was emphasized in *Occidental v Ecuador*, the objective requirements over the consistency and transparency as constituents of FET does not depend on acting of the respondent in a good faith.<sup>xxv</sup>

Regarding the inconsistency of the application of regulations, there's not much of a doubt on possibility for the investor to trigger of the petition mechanism under the national law, existent in administrative procedures of the majority of jurisdictions, as well as making the act subject to the judicial review. "Under some international instruments and domestic legislation, other states or affected persons may enforce a state's duty to protect through the quasi-judicial or judicial procedures",<sup>xxvi</sup> It's presumed that administrative law of the host state will be determinative in procedural aspects of this claim. Although, it may be treated as subjecting the case to the national legal order, while the goal to achieve the balance of party's interests insists in application of independent standard. In the case when inconsistent law was intentionally designed to take advantage of undefined or not fully defined rule, departing from national legal order is having special reasonableness, with subjecting the matter to the international treaty and customary international law.

Incompliance of the actions of investor with the national law can be qualified by the state as questioning the legitimacy of the investment, in the case of presence of 'investment under national law' clause in the BIT or investment contract. The estimation of the magnitude of misconduct is necessary by the tribunal, as perceptions of regulator of this matter may be exaggerated. In *Tokeo Tokeles v Ukraine*, the minor procedural inconsistencies and incomplete registration, from the view of international tribunal does not entail disqualification of the investment from being such. The grounds for its ruling the tribunal found in the objectives of BIT, which was aiming the promotion of investment, rather than putting the investor under the undue scrutiny or disqualification by minor errors. In some extent, the fact of the registration of enterprise by the state as valid entity played in favour of that outcome. This causes a question on potential possibility for the state to be precluded from the denial of lawfulness of investment, based on the entry and establishment. It can also find some recall in the provisions of international law contending that unilateral acts and statements and conduct by the state may be a source of obligations based on the principle of estoppel.<sup>xxvii</sup>

Regarding the actions of investor over the inconsistent regulations, the question appears whether the investor can also be liable for alleged misconduct based on the duty to care. The attempts to develop a sort of 'reasonable man' standard, was prominent in international investment law practice, in the context of qualification for the protection under this ground. The *Methanex v USA* was prominent by reference to concept of 'prudent investor' who could have foreseen the future changes of law, in the prospective law banning the methanol.<sup>xxviii</sup> Without prejudice to the concept of prudent investor, the shift of the burden of circumspection to the investor is raising concern. Being alien to jurisdiction, investor may have inherent lack of awareness with all aspects and procedures of national law. This requirement can be overly demanding under the obligation to analyse the forthcoming not yet existent law, in varying levels of publicity to legislative process across the jurisdictions. Moreover, such analogy of reasonable man test, having its obvious state centered inclination in the foreign investment setting.

The concept of prudent investor can be contrasted with the duty of state to prevent any likelihood of improper interpretation of the regulation, in detriment to the investor, emphasized in *Metalclad v Mexico*.<sup>xxix</sup> In this case having

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the reference to the 'transparency' requirement on NAFTA, Art 102(1),<sup>xxx</sup> the duty of the state to warn was established as the requirement that "Once authority become aware of any scope for misunderstanding or confusion in this connection, it is duty of the state to ensure the correct position is promptly determined and clearly stated so that investor can proceed with all appropriate expedition in the confident belief that they acting in accordance with all relevant laws".<sup>xxxi</sup> Herewith the duty of the state to add clarity whenever there's actual or potential place for the ambiguity is clearly established. The ambiguity of the rule, upon which the state didn't act for its elimination, can potentially overturn the inviolability of the regulator over the inconsistent rule. Such an extended responsibility of the regulatory authority is also supported by its jurisdiction, whose duty to implement the law and ensure its correct application in the area, based on its assigned competence in its subject matter. Feedback in application of laws is essential elements in governance, urging that whenever the law is faulty to the condition that needs reconsideration, it necessitates the regulatory authority to communicate it to the body enacted the law with acknowledgement of defects, for the purpose of its amendment or annulment, based on inter-state horizontal coordination of activity within the state institutions. The interstate dispute settlement under the EU IIA, provide the basic remedy can be considered as withdrawal of inconsistent provisions negatively affected on the investor.<sup>xxxii</sup>

The responsibility for the absence of clarifications can be substantially raised by the change of regulatory framework. In *Occidental v Ecuador* in relation to the claim over the inconsistent practice of the state authorities in reimbursement of VAT, the violation have been caused by the important change of the legal framework on the investor and unsatisfactory and thoroughly vague clarifications from bodies in duty.<sup>xxxiii</sup> The important factor in considered case was that the alternation of legal framework prevented the entitlement of investor to the envisaged benefits. "Meeting the investor's central concern of legal constituency, stability, and predictability remain a major, but not the only ingredient of an investment-friendly climate in which the host state in turn can reasonably expect to attract foreign investment."<sup>xxxiv</sup> This requirement is also embodied in BIT practice, as "Each party shall maintain in its territory a legal framework apt to guarantee to investor the continuity of legal treatment, including the compliance, in good faith, of all undertaking assumed with regard to each specific investor".<sup>xxxv</sup>

"Stability is not only a concern for the investor but also a key component for states to attract foreign investments".<sup>xxxvi</sup> The criteria of 'stability and predictability' of the legal framework seems feasible as being concerned with overall effect of the law on the investment, rather than particular point of reference. With this respect the crucial question appears as to whether the state obliged not to alter the legal business environment under which the investment has been made, in order to meet the requirement of stability and predictability under the international law. The requirement to maintain stable and predictable legal framework may have far reaching implications, in the case of being treated as obligation 'not to alter' the legal framework similar to the widely replicated stabilization clause having controversy over its homogeneous effect. The more pragmatic approach can be in association of the state's duty to refrain from taking the drastic turn in legal framework of the investor, rather than limiting the power to legislate. The essential nature of legislative function supported by the principle of state sovereignty under the customary international law is supporting that position. In the context of the law making, the tribunal in *Parkerings v Lithuania*, stated that while it is 'prohibited for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power', 'there is nothing objectionable about an amendment brought to the regulatory framework existing at the time an investor made its investment'.<sup>xxxvii</sup> Obviously the necessary balance can be maintained in the case of legislative practice followed reasonable and equitable legislative measures towards the investor's regulatory climate. However, the obligation to provide stable and transparent legal framework under the FET in the treaty is subject to the legal order of the host state. Instable legal framework of the country in *Mamidoil*, lead to the inability to create the same level of legitimate expectations as in other jurisdictions.<sup>xxxviii</sup>

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In procedural level detecting the exorbitant and inconsistent application of the rule is possible when there is an occurrence of using a remedy not foreseen by the rule of law in question. In *Quiborax*, revocation of mining concessions by Bolivia due to customs and tax irregularities as a result of the audit, was conflicting with the national Mining Code that only foreseen the annulment instead of revocation. The state abrogated revocation with annulment of concessions to remedy the problem, however in eyes of the tribunal the strategy to legalize the revocation by annulment breached the FET. Moreover, the absence of notification on audit and not providing access to information on that, was found as incompatible with the due process, and also qualified as arbitrary and discriminatory under the both international law and national law of the host state.<sup>xxxix</sup>

In *Copper Mesa* arbitrariness of taking out of the due process in adoption of the resolutions terminating the permissions was found as not related to the regulatory measures and essentially expropriatory.<sup>xl</sup> However, the measure cannot be arbitrary if it's reasonably related to a rational policy of the state emphasized in *Electracabel*.<sup>xli</sup> In *Philip Morris* case the 80/80 Regulation increasing the size of the anti-health warnings to 80%, and the Single Presentation Regulation (SPR) established requirements to the graphic, complying with which necessitated to change of the brand, that investor treated as intellectual property violation. The regulations wasn't found expropriatory with regard to the Philip Morris's investment, and FET claim was rejected in absence of arbitrariness and breach of legitimate expectations.<sup>xlii</sup>

Inadequate response based on the proportionality test can be instrumental in signalling on the inconsistency in application of the law. Invalidation of licenses in *Khan Resources*, that although did not breached the Mongolian law, in tribunals view haven't been significantly reasoned by law. The proportionality analysis allowed for the tribunal to define that invalidation was not an appropriate penalty for the case even if the alleged violation would occur. This let the tribunal to find it as a denial of the due process in law.<sup>xliii</sup> Even upon improper response on the application of law, the position of tribunal was in necessity to remedy the situation by the state. Herewith, after invalidating the license, Mongolia had to reregister the license as there was no significant reason for violation the application requirement.<sup>xliv</sup>

The inadequate response from the regulatory authority to the investor's act, over the inconsistent law that has affected the activity of investor can have its resemblance with creeping expropriation. However, in considered case the regulatory measures may not come as multiple and coordinated, that lowering the chance to outlaw the measures. Under the inconsistent law it's rather comes as a single act, that may although be enough to paralyze the activity of the investor. This suggests the tribunal to take more selective and flexible approach in distinguishing the acts of the regulator. Sensitivity of the issue is reasoned by potential possibility for the regulatory measure to remain within the bona fide regulatory action of the state, however being expropriatory as of fact. Possibility of regulatory measures to be essentially expropriatory was specially signified in the *Tecmed v Mexico*.<sup>xlv</sup> The importance of the tribunal to be guided by the 'Sole Effect' doctrine is gaining special importance here, that allow to scrutinize the actions of the state, which are not expropriatory but having similar impact on the investor as of ultimate result.<sup>xlvi</sup>

The potential defence of the state over the inconsistent regulation may come in the form of positioning the body as applying the law, while the problem is in designing the law, hence reference to another body for the purpose of responsibility, based on division of competences of the state bodies. However, the principles of attribution coming out of the concept of 'unity of state' under the international law, insisting on responsibility of the state for all its bodies, of all levels and regions.<sup>xlvii</sup> Contrary the position of the state can also be in reference to the regulatory authority that is improperly applied the rule, and hence acted beyond its powers. Referring back to the rules of

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attribution under international law, the acting of its organ ultra vires and beyond the scope given by unequivocal rule or contravenes instruction cannot immunize the state from responsibility.<sup>xlvi</sup> Although it's not excluded that action of the non-public entity may not be attributable to the state as termination of the lease agreement by ANR, which was found not attributable to Poland, due to separate legal personality and exercise of operational autonomy.<sup>xlix</sup> Hence inconsistency of law giving the grounds for the regulatory authority to interpret the act out of its scope, or procedural instructions, or conflicting with the law of higher hierarchy, cannot prevent overall state responsibility under the international law. As supported by *SPP v Egypt*, where the state was precluded from finding the acts of official body as null and void, due to allegedly being contrary to the inalienable nature of the public domain, and not being taken in accordance of the procedural rules under the national law, was found as give a way to legitimate expectations.<sup>1</sup>

Without prejudice to reasonableness of the prudent investor to consider the host state law before investing, obviously state needs to take into account, that this creates the grounds for violation of legitimate expectations on the side of investor.<sup>li</sup> This is supported by the duty of state to take the measures to protect the rights and legitimate interest of the investors, to whom the law can cause a misinterpretation supported by *MDT v Chile*.<sup>lii</sup> Otherwise inconsistent norms may serve for the state as a tool to invoke expropriatory measures against the investor, whenever it finds it's necessary, possibly as a contra measure, or more detrimentally as a predesigned intention to expropriate. Traditional contradiction in rights of the state to regulate and right of the investor to be protected, in the context of duty of the state to warn, and duty of the investor to be aware of, can be considered as corresponding rather than contradicting, that can be enabled through the assistance, cooperation.

In the case of ambivalence it may be plausible for the investor to exercise the due diligence, and when possible to take the steps to preclude the potential adverse effect of the norm in proactive manner, whether it is newly adopted or preexisting law. As it was mentioned in *Parkering v Lithuania*, 'an investor's right to have legitimate expectations protected is contingent on those expectations being reasonable in light of the circumstances and on the investor having exercised due diligence.'<sup>liii</sup> According to OECD Principles for Private Sector Participation in Infrastructure, the private investor's observance of commonly agreed standards of responsible business conduct is necessary.<sup>liv</sup> Potentially the lack of actions from the investor to act upon the requirement of the legal framework could shift the responsibility on the investor. Denial by Dominican Republic of environmental license application to the investor *Corona* and absence of response for the consideration, led to the state's response that investor itself delayed the process by omitting documents and multiple changing of the project.<sup>lv</sup> ICSID lacked jurisdiction due to three years limitation period of the BIT in this case, which tells that the final outcome of this case is yet to come. Similarly in another completed case, warnings given by the ministries on necessity to obtain additional permits and disregard of that by the investor, led to the dismissal of the claims by the tribunal against Oman on the lack of merits.<sup>lvi</sup>

## Conclusion

Nowadays in foreign investment jurisprudence it is possible to distinguish the approach in outlawing inconsistencies of regulation based on ambivalent legal framework with considering the host state as faulty for adoption and implementation of these regulations. With all merits of the concept of 'prudent investor', it's barely possible to expect it in non-transparent and ambivalent legal framework. In the range of cases tribunals didn't supported the claims of violation by the investor of regulatory framework due to its insubstantial nature not threatening the purpose of investment. Lack of coordination or governmental bodies are subject to the rules of attribution of international law that prevent reference to division of competences among various state authorities to escape liability. The obvious lack of catching points in the cases with inconsistent regulations, in situation when regulatory actions are lacking to attain the threshold of expropriatory measures, are insisting in more complex approach in tackling the problem. The broader scope and flexibility of FET standard of treatment, comprising expansive range of criteria

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allowing to invoke against inconsistencies in laws and regulations, enabling relevant ones in accordance with the facts of every specific case. Violation of such a criteria as coherence and consistency supported in *MTD v Chile*, with requirement to maintain stable and predictable framework in example of *LG&E v Argentina*, or the transparency and legitimate expectations supported in *SPP v Egypt*, that were upheld even without a treaty guarantee of FET, offers a viable instruments to ensure protectability of the investment against the inconsistencies of regulatory framework and expansive application of regulations of the host state.

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lv *Corona Materials, LLC v. Dominican Republic*, ICSID Case No. ARB(AF)/14/3

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