Expropriation clauses: a natural extension of domestic takings law or much more?

Denise Grab
December 10, 2004
EEP 131
Professor Larry Karp

The United States has always supported the notion that citizens should be protected from unjust seizures of their property by government. The Takings Clause in the Fifth Amendment of the United States Constitution provides that "private property [cannot] be taken for public use, without just compensation." Initially, this clause applied only to direct seizure of property, but as time progressed, the courts decided in a number of cases that a "taking" need not be an outright seizure of property (Appleton 2002). When a government action vitiates the value of a property, this may be considered a compensable taking. Throughout the latter part of the 20th century, neoliberal economists and lawyers began to advocate for a broader definition of takings. Members of this "property rights movement" maintained that any government action that diminished the value of property in any way—so-called "regulatory takings"—should be compensated. The theory of regulatory takings was first articulated by University of Chicago Law Professor Richard Epstein in a 1985 book entitled *Takings: Private Property under the Power of Eminent Domain*. Members of the property rights movement have advocated that the takings notion should apply to all regulations, including environmental regulations like the Endangered Species Act, which place restrictions on what property owners can do on their land. US courts, however, have not favored sweeping application of the takings clause. A number of requirements must be met before a takings claim will be awarded. In spite, or perhaps because of these restrictions, neoliberals have tried to extend the applicability of the takings notion in an international setting through expanding the scope of expropriation clauses in investment treaties.

Expropriation clauses have long been part of investment treaties between nations. These clauses guarantee foreign investors protection against seizure of their property by

countries in which they invest. The goals of these clauses is to encourage investment in foreign countries by limiting the downside risk from potential expropriation of the investment—a very real concern in some countries. Initially these clauses covered only direct seizure of property, but over time their scope expanded to cover indirect expropriation, as well. Under indirect expropriation, a country uses some means, such as regulation or taxation, other than direct seizure to take away the value of an investor's assets. The North American Free Trade Agreement (NAFTA) includes an especially broad provision on expropriation. Article 1110 provides that

> No party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:
> (a) for a public purpose;
> (b) on a nondiscriminatory basis;
> (c) in accordance with due process of law and [National Treatment]; and
> (d) on payment of compensation… .

This wording does not require that actual expropriation occur, merely actions "tantamount to … expropriation." Thus, environmental or social regulations could be considered tantamount to expropriation under this definition. Indeed, in several NAFTA cases, governments have been found liable for environmental regulations. Though NAFTA does not have the authority to prohibit governments from creating such regulations, it can force them to compensate the aggrieved party. This can give multinational corporations a great deal of leverage over foreign nations (Been and Beauvais 2003). In fact, investment treaties like NAFTA are one of the few, if not the only, mechanisms by which individuals and private corporations may sue and gain compensation from foreign, sovereign nations. The negotiations for the now-defunct Multilateral Agreement on Investment (MAI), and the current negotiations for the Free

Trade Area of the Americas (FTAA) have both included expropriation clauses similar to the one in NAFTA (Geiger 2002, Wiltse 2003). Many environmentalists and advocates of national sovereignty fear that enacting such expropriation clauses will further harm countries' abilities to enact legislation to protect the health of their citizens and ecosystems as they see fit.

Moreover, these broad expropriations clauses may provide foreigners more protection than domestic investors. Most countries' takings doctrines are not nearly as developed as the United States', and many countries do not provide compensation for indirect takings at all (Williams 2003). Critics have argued that, instead of providing foreign investors security comparable to that faced by residents, expropriations clauses like NAFTA's provide compensation that far exceeds that which a domestic investor would receive. In many cases, the compensation even exceeds what would be awarded under traditional US Takings law and resembles more closely what would be awarded under a more radical notion of regulatory takings. Some critics have even argued that NAFTA's expropriation clause resulted from a conscious attempt on the part of members of the property rights movement to codify the notion of regulatory takings (Grieder 2001). This leads to the question of how closely expropriation clauses resemble US takings law, in general, and the theory of regulatory takings, in particular. Further, one must consider the appropriateness of integrating US notions of takings into international agreements. This paper examines the similarities and differences between expropriation clauses and US takings jurisprudence on a number of key elements in takings claims, concluding that NAFTA's expropriations statute defines takings far more broadly than the US takings doctrine does, resembling in some cases the tenets of regulatory takings doctrine. The

paper then continues on to discuss the pros and cons of a broad application of takings theory in international law and potential modifications to the NAFTA agreement to address the shortcomings.

At the heart of any takings or expropriation claim is the question of property rights. In order to receive retribution, a party must clearly prove that his property rights have been taken away. Determining that bulldozing a house is a seizure of property is easy enough. The issue of what constitutes property becomes more complicated, however, when dealing with indirect expropriations. Is market access considered property? What about monetary profits? US takings law tends to favor a narrower definition of property rights than NAFTA tribunals have thus far (Shenkman 2002, Been and Beauvais 2003, Porterfield 2004). The US Supreme Court has decided that "business in the sense of the activity of doing business, or the activity of making a profit is not property in the ordinary sense (*College Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd.* 1999). In both the *Pope & Talbot, Inc. v. Government of Canada* (*Pope & Talbot*) and the *Loewen Group v. the United States* cases, NAFTA tribunals found that an imposition of monetary liability on a company alone constituted an expropriation (Shenkman 2002, Been and Beauvais 2003).

Another key issue in takings claims is the extent to which property rights must be diminished for the action to be considered a taking. Again, NAFTA tribunals have seemed to favor a broader interpretation than US courts. The Supreme Court held in *Lucas v. South Carolina Coastal Counci* (*Lucas*) that a "regulation that denies all economically beneficial or productive use of land" constitutes a "categorical" taking. When a regulation does not eliminate all value of the property, the Supreme Court has

rejected "the proposition that diminution in property value, standing alone, can establish a 'taking' (*Penn Cent. Transp. Co. v. New York City* 1978)." The extent of the diminution of value must be examined in each case to determine if its severity warrants the granting of a takings claim (Shenkman 2002). In particular, the diminution of value must be determined relative to the entire parcel of property—the so-called "parcel-as-a-whole" rule (*Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency* 2002). Though property rights advocates argue in favor of applying the notion of "conceptual severance"—the splitting up of property rights into separate components (by space, time, or function) to determine the value of a taking—US courts have, for the most part rejected this idea (Been and Beauvais 2003). Conceptual severance would make a loss seem more significant than the parcel-as-a-whole rule, since the percentage of lost asset value would be larger with a smaller total asset value. Not only have NAFTA tribunals allowed the application of conceptual severance—for example in the *Pope & Talbot, S.D. Myers, Inc. v. Government of Canada* (*S.D. Myers*), and *Metalclad Corp. v. United Mexican States* (*Metalclad*) cases—but they have also required a lower level of diminution of value for a regulation to be considered an expropriation (Shenkman 2002, Porterfield 2004). In terms of conceptual severance, the panel concluded that the elimination of one potential land use—a hazardous waste disposal site—on the Metalclad land constituted an expropriation. In US takings law, this would likely have been considered inappropriate functional severance and would not have been decided in favor of Metalclad (Porterfield 2004). In terms of the level of loss required to constitute an expropriation, the *Metalclad* decision required only "significant" impairment of the

investment value to constitute a compensable expropriation, not the destruction of nearly all value as required under US takings law (Porterfield 2004).

Even if the property nature and severance requirements are met, under US takings jurisprudence, an appropriation does not necessarily constitute a compensable taking. The Supreme Court found in *Lucas* that if a restriction applies to a proposed use of property that was prohibited under "background principles of law" in place at the time the property was acquired, the claimant never possessed the rights to that use in the first place, and the restriction, therefore, cannot constitute a taking (Shenkman 2002). For example, under state nuisance laws, individuals cannot use their property to annoy or harm others. Many environmental restrictions, such as the denial of mining permits, fall under the broad blanket of state nuisance law, according to the Supreme Court, and may be exempt from takings claims (Shenkman 2002). International law includes a similar notion of "police power"—the precept that a country is not responsible for the unintentional loss of property or other economic disadvantage to an investor from non-discriminatory, ordinary actions of the state, such as taxation and regulation (Shenkman 2002). However, "police power" is not clearly defined, and a number of NAFTA panels, such as in the *Metalclad* case, have ruled against nations that tried to implement regulations that they claimed were non-discriminatory and intended to promote public and environmental health. Under US takings law, these claims would likely have been dismissed under the "background principles of law" doctrine.

A related criterion in deciding a takings case in US courts is the extent to which the regulation undermines the property owner's reasonable investment-backed expectations (*Palazzolo v. Rhode Island* 2001). This requirement attempts to prevent

shrewd investors from investing in heavily regulated land at a discount, intending to collect money later from a takings claim when their development requests are denied (Shenkman 2002). NAFTA tribunals, on the other hand, have given little consideration to whether the claimant's investment expectations were reasonable. In the *S.D. Myers* case, for example, the NAFTA panel ignored the issue of whether S.D. Myers' expectation that Canada would allow the exportation of Polychlorinated Biphenyls (PCBs) was reasonable, given the requirements of the Basel Convention and the North American Agreement on Environmental Cooperation (Been and Beauvais 2003).

There are also several procedural differences between US takings law and NAFTA expropriations law that also favor investors' claims under the NAFTA system. One procedural requirement under US law is that the case must reach "ripeness" before the court will hear it. According to the ripeness rule, for a federal court to hear a claim, the government entity implementing the regulations must have reached a final decision about the property in question and the plaintiff must demonstrate that he has exhausted the state procedures for obtaining compensation (Porterfield 2004). Without the ripeness rule, the full scope of a regulation's economic impact on the plaintiff would not be clear (Shenkman 2002). Another important US procedural rule in takings cases is "abstention," where a federal court can decline to hear a case challenging state regulations when it might interfere with the state regulatory scheme (Porterfield 2004). NAFTA expropriation cases have ignored both of these procedural requirements. For example, both the *Metalclad* and *Robert Azinian and others v. United Mexican States* cases did not require the investor to exhaust national remedies before filing a NAFTA Chapter 11 claim (Been and Beauvais 2003). Also, in *Metalclad*, the NAFTA tribunal

did not wait until a final government decision was issued about permissible alternative uses of the proposed hazardous materials disposal site (Been and Beauvais 2003).

Based on all of these substantive and procedural differences between the application of US takings law and NAFTA's expropriation law, NAFTA appears to reimburse people for takings in more cases than traditional US law. Though some attorneys and policymakers claim that the doctrines are essentially the same (Appleton 2002), it remains clear that the NAFTA expropriation clause has broader applicability than US takings law. The NAFTA expropriation clause is narrower in scope than a strict regulatory takings notion, which would advocate that any diminishment at all of value due to a regulation should be compensated. However, by requiring a much smaller percentage of overall diminishment, by allowing conceptual severance, by limiting applicability of police power, and by easing US procedural requirements, the NAFTA expropriation clause, in some cases, resembles the radical doctrine of regulatory takings more than it does traditional US takings law.

NAFTA's expropriation clause has the potential to award—and indeed has awarded—compensation to investors that they would not be entitled to under traditional US takings law. In some cases, the outcomes resemble principles of a more radical regulatory takings view. Is this a problem or not?

Perhaps the most obvious difficulty with the disparity between traditional takings law and international expropriation cases is the potential for foreign investors to receive more favorable legal treatment than residents in a takings case. Since US takings law is far more comprehensive than most other countries', definitely more so than Canada's and Mexico's (Schneiderman 1996), and since the NAFTA expropriation clause is even

broader than US takings law, it is clearly possible for foreign investors to receive more favorable treatment than domestic investors—the opposite of the National Treatment standard in NAFTA and other agreements. This conflicts with the Calvo Doctrine, an international principle previously and still used by many developing countries, especially in Latin America. The Calvo Doctrine stated, among other things, that foreigners should be subject to the same treatment given to citizens, meaning that in takings cases they should only be able to seek redress in local courts (Vicuna 2002, Wiltse 2003). This doctrine has declined in popularity, but many people oppose the notion of a foreigner receiving preferential treatment over a resident. This disparity in treatment may also causes investors to prefer to invest abroad than in their own country, or to push for a broader regulatory takings notion in the United States and other countries using fairness as a justification (Schneiderman 1996, Been 2002a).

Another major problem with the disjoint between domestic takings law and NAFTA expropriations law results from the federal system of government in each of the NAFTA nations. The US, Mexico, and Canada all have separation of powers between a federal level of government and a state/provincial level of government, with some sovereignty vested in each level (Been 2002b). Though state and local governments invoke the majority of regulations, especially environmental and land-use regulations, under NAFTA an investor can sue only the federal government for compensation. This creates a complicated situation, where federal governments may be forced to defend and pay compensation for expropriations they did not initiate. For example, in the *Metalclad* and *Methanex Corp. v. United States* cases, the Mexican and US governments were considered at fault for actions of states and localities. Lower levels of government have

no ability to defend their actions, since NAFTA tribunals exclude all individuals but the federal government and the investor (Been 2002b). Moreover, the federal governments can find themselves financially responsible for state's actions that they have little, if any, control over. As it stands now, the US government cannot sue states to recover money lost in a NAFTA suit over a state regulation, though Congress could pass laws permitting such lawsuits (Been 2002b). The federal government has a bit more leeway in *ex ante* regulation influence. Though it cannot directly compel a state to act in a certain way, it can make the receipt of federal funds conditional on given actions or, in particular cases, it can preempt state laws with federal laws (Been 2002b). In this way, broad expropriation clauses like NAFTA can threaten not only national sovereignty, but also state sovereignty to some degree.

Some individuals claim that the extension of the definition of an expropriation beyond traditional US takings law is a positive step, as it helps to internalize the costs of regulation on landowners. According to this theory, the government will not choose the efficient level of regulation unless the government must pay the full cost of its regulations (Been 2002a). However, as NYU Law Professor Vicki Been explains (2002a), this theory assumes that the governmental decision-making process is equivalent to that of a profit-maximizing firm. This is clearly not the case, as political incentives are not equivalent to monetary, profit incentives. In addition, if the government does not fully internalize the benefits of the regulation, due to incomplete valuation techniques or other reasons, the outcome will be uncertain and may include perverse consequences (Been 2002a). Another argument in favor of broad definitions of expropriation is that these clauses provide insurance on investments, thereby stimulating capital flow into

impoverished regions (Been 2002a). However, given this argument, it is unclear why the expropriation clause must include a *broader* definition of "takings" than US law (incorporating both *ex post* and *ex ante* takings), since many scholars agree that US takings law adequately provides insurance against expropriation (Been 2002a).

Given these uncompelling arguments for maintaining a broader scope for compensable expropriation under NAFTA and the potential difficulties associated with differing takings definitions at the national and international level, it could make sense to restrict the definition of expropriation under NAFTA to a maximum standard more closely resembling US takings law. However, even if the capacity exists for NAFTA tribunals to decide takings cases differently than the domestic courts, this potential is only problematic if the decisions are appreciably different in practice. Though a number of the initial NAFTA cases have diverged from what the results would likely be under domestic law, a number of experts feel that these cases are initial anomalies, and the problems will be remedied as the bugs are worked out of the system. Daniel Esty, the US Environmental Protection Agency's chief negotiator for NAFTA, stated that the intent of Article 1110 was to resemble existing US takings law, not a radical notion of regulatory takings (Esty 2004, pers. comm.). He expressed faith that the decisions of future tribunals will conform more closely to a traditional takings notion; indeed, he said he already sees this change occurring. Once a number of farfetched claims are repudiated by the tribunals, Esty conjectured, the cost of filing frivolous claims will become prohibitive, and such cases will markedly decrease in number (Esty 2004, pers. comm.). Other experts assert that even though expropriations clauses may result in a slight broadening of US takings law, normal regulatory action—environmental or otherwise—

will never come before a NAFTA tribunal (Vicuña 2002). They claim that since the percentage effects of normal environmental regulation on revenue are quite tiny—between one and three percent on average in the US—these normal regulations will never be harmful enough to constitute a valid expropriations claim, which requires "significant" effects (Vicuna 2002). However, the numerical figures above are averages, so the regulation of a particularly environmentally damaging industry could be a larger percent of total revenue and provide a basis for a NAFTA takings claim. Plus, conceptual severing could make a small effect seem larger.

Overall, it is not completely clear that the disparity between traditional takings law and international expropriation law will have an overwhelmingly negative effect. However, a number of cases—*Metalclad*, *S.D. Myers*, and others—already decided by the tribunals underscore this disjoint and provide potential for future controversy. Though the need for reform to NAFTA Chapter 11 may not be vital, it would certainly help to clarify the definition of "tantamount to expropriation" in the chapter to conform more closely to US takings law, since Esty and other negotiators claim this was the intent of the measure anyway. In addition, NAFTA Chapter 11 is also being used as a model for future investment treaties, such as the FTAA. Avoiding the ambiguity in the definition of expropriation in this treaty and others would be prudent. Indeed, the US Trade Act of 2002 included a directive for US trade negotiators to ensure that foreign investors are not accorded greater rights than domestic investors (Williams 2003). This Act does not change the content of NAFTA, but hopefully it will act as an incentive for US trade negotiators to avoid creating further conflicts between domestic takings law and foreign expropriation law.

References

Appleton, Barry. 2002. Regulatory takings: the international law perspective. *New York University Environmental Law Journal* 11(1): 35-48.

Been, Vicki. 2002a. Does an international "regulatory takings" doctrine make sense? *New York University Environmental Law Journal* 11(1): 49-63.

Been, Vicki. 2002b. NAFTA's investment protections and the division of authority for land use and environmental controls. *Pace Environmental Law Review* 20: 19-61.

Been, Vicki and Joel C. Beauvais. 2003. The global Fifth Amendment? NAFTA's investment protections and the misguided quest for an international "regulatory takings" doctrine. *New York University Law Review* 78 (1): 30-143.

College Sav. Bank v. Fla. Prepaid Postsecondary Educ. Expense Bd., 527 U.S. 666, 675 (1999).

Epstein, Richard A. 1985. *Takings: Private Property Under the Power of Eminent Domain*. Harvard University Press, Cambridge. 362 pp.

Esty, Daniel C. Professor of Environmental Law and Policy, Yale University. 2004, personal communication.

Geiger, Rainer. 2002. Regulatory expropriations in international law: lessons from the Multilateral Agreement on Investment. *New York University Environmental Law Journal* 11(1): 94-109.

Greider, William. 2001. The Right and US trade law. *The Nation*. October 15, *at* http://are.berkeley.edu/courses/EEP131/Gieder.pdf.

The Loewen Group v. the United States, Award, *at* http://www.state.gov.

Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1028-32 (1992).

Metalclad Corp. v. United Mexican States, Award (ICSID (Additional Facility) Case No. ARB(AF)/97/1, Aug. 30, 2000), 16 ISCID REV.—FOREIGN INV. L.J. 168 (2001).

Methanex Corp. v. United States, First Partial Award, Aug. 7, 2002, *at* http://www.state.gov.

North American Free Trade Agreement, Chapter 11, Article 1110.

Palazzolo v. Rhode Island, 533 U.S. 606, 633 (2001).

Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 145 (1978).

Pope & Talbot, Inc. v. Canada, Interim Award, June 26, 2000, *at* http://www.appletonlaw.com.

Porterfield, Matthew C. 2004. International expropriations rules and federalism. *Stanford Environmental Law Journal* 23(3): 4-90.

Robert Azinian and others v. United Mexican States, Award. ISCID, *at* http://www.worldbank.org.

Schneiderman, David. 1996. NAFTA's takings rule: American constitutionalism comes to Canada. *University of Toronto Law Journal* 46 (4): 499-537.

S.D. Myers, Inc. v. Government of Canada, Partial Award, Nov. 13, 2000, *at* http://www.appletonlaw.com.

Shenkman, Ethan. 2002. Could principles of Fifth Amendment takings jurisprudence be helpful in analyzing regulatory expropriation claims under international law? *New York University Environmental Law Journal* 11(1): 174-197.

Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency, 216 F.3d 764, 774 (9th Cir. 2000).

United States Constitution, Amendment V.

Vicuña, Francisco Orrego. 2002. Carlos Calvo, honorary NAFTA citizen. *New York University Environmental Law Journal* 11(1): 19-34.

Williams, Jesse. 2003. Regulating multinational polluters in a post-NAFTA trade regime: the lessons of *Metalclad v. Mexico* and the case for a "takings" standard. *UCLA Journal of International Law and Foreign Affairs* 8: 473-502.

Wiltse, Jessica S. 2003. An investor-state dispute mechanism in the Free Trade Area of the Americas: lessons from NAFTA Chapter Eleven. *Buffalo Law Review* 51: 1145-1198.