Protecting Foreign Investments against Expropriation Measures: Risks and Concerns Related to the New Draft Amendment of the Foreign Business Act of 1999

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1. INTRODUCTION

Thailand has long been recognized as one of the countries most open to foreign investment, especially foreign direct investment (FDI). Owing to the growing significance of foreign trade and investment, the Thai government has, in recent years, signed many bilateral and regional trade and investment agreements that guarantee to protect foreign investments against certain government measures that may unduly harm the investment.

Most investment agreements contain three major substantive provisions. First, the obligation of the host country toward investors and investments of the Party to the agreement is defined. Second, in case the host country is alleged to have breached such obligations, the affected private investor may settle the dispute through an international arbitration forum rather than through the domestic judicial system. Third, in case that a particular government measure is considered to be an act of "expropriation" or that which is "indirect or tantamount to expropriation," the private investor shall be promptly and adequately compensated as decided by the arbitration.

The rapid proliferation of investment protection agreements worldwide has resulted in surging investor-to-State investment dispute cases. The total number of known treaty cases between 1987 and 2006 reached 255; the majority of which (about 156 cases) were filed with the International Centre for the Settlement of Investment Disputes (ICSID) (UNCTAD 2006). According to UNCTAD (2006), of the seven decisions involving alleged expropriation rendered in 2006, just one was decided in favor of the investor.

Although past statistics may underscore the host country's continued sovereign rights to impose domestic regulations despite the investment protection agreements, a host country government nevertheless needs to spend time and resources in defending dispute cases and risks losing the confidence of other foreign investors. Thus, one of the most critical questions being addressed is how a government of the host country can avoid investor-to-State disputes arising from state measures that may have unintentionally negative impact on the interests of foreign businesses and thus be perceived to be an act of "expropriation" by a foreign investor.

In line with the aforementioned development in the global investment environment, it is the aim of this article to study the meaning of the phrase "expropriation and measures tantamount to the expropriation," as contained in the investment chapter of most bilateral trade and investment agreements. To do so, it is important to investigate legal decisions that have evolved over time.

In order to illustrate the issue at hand, it would be useful to examine whether the draft amendment of Thailand's Foreign Business Act of 1999 (B.E. 2542), which imposes stricter operating conditions on foreign businesses, can be taken as a measure tantamount to expropriation that breach the Thai government's obligation under various bilateral investment treaties (BITs) and free trade agreements (FTAs) to which Thailand is a signatory.

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2. IMPORTANCE OF INVESTMENT PROTECTION AND THE RELEVANT PROVISION IN THE EXPROPRIATION REGIME

Dee and Kevin (2000) found that liberalizing investment could help lower a country's production cost and hence, boost a country's comparative advantage, provided that supporting infrastructure, such as high-standard facilities, qualified human resources, and stringent laws and regulations, is adequate. Overseas investors would also benefit from increased cost competitiveness such that they could accumulate more capital and reinvest on a larger scale.

However, most direct investments involve large sunk costs – i.e., costs that cannot be recovered when operation ceases. Foreign direct investors cannot easily liquidate their assets and leave the country when regulatory environment of a host country unexpectedly becomes unfavorable, or even harmful, to investment. Therefore, many countries have tried to minimize the regulatory risks faced by investors as they relate to unpredictable changes, as well as any unfair practices by the host country governments, by signing agreements with their trade counterparts in order to preclude such regulatory uncertainties and their potentially unfavorable impacts.

Although private property rights are extremely important, a customary international law does not preclude host country governments from imposing regulations to protect the public interest. In this regard, the States concerned should have the power to "expropriate" those foreign investments provided that they do so:

(1) For public purposes only;
(2) On a non-discriminatory basis;
(3) With due process; and
(4) By providing sufficient compensation for the expropriation without delay.[1]

Failure to meet any of the above conditions may provide grounds for a foreign investor to file a case against the host State with an international arbitration forum, as stipulated in the agreement mutually accepted by both Parties.[2]

Although investment protection obligations in FTAs and BITs clearly specify that the States must pay compensation for carrying out any expropriation, the width and depth of its applicability depend on two crucial factors: the class of assets entitled to protection under the agreements and the criteria by which to identify the meaning of indirect expropriation or the measures tantamount to expropriation, which is governed by international law with regard to the investment protection regime.

3. SOME CRITICAL LEGAL ELEMENTS CONSTITUTING INDIRECT EXPROPRIATION OR MEASURES TANTAMOUNT TO EXPROPRIATION

3.1 Scope of Protected Assets under Investment Protection Laws

The class of assets protected under the investment agreement in most FTAs and BITs today is relatively broad, covering both tangible and intangible assets such as property rights, movable property, immovable property, intellectual property, equities, bonds, money claims, concessions, and permits, as well as contractual claims. However, certain agreements place restrictions on the type of investment that will be eligible for the protection.

For example, in the Agreement between the Kingdom of Thailand and Japan for an Economic Partnership (JTEPA)[3] protection applies broadly to both tangible and intangible assets. However, only assets associated with "FDI" are entitled to such protection. That is, assets associated with portfolio investments and any other forms of short-term loans made by foreign investors or other contracting parties are not covered in the investment protection clause.[4] This is different from that of the North American Free Trade Agreement (NAFTA)[5] and the BIT between Thailand and Germany, for instance, which provide protection for assets of all types of investment.[6]

3.2 Meaning of Indirect Expropriation

Generally, expropriation refers to the use of any measures by the host country government which result in the transfer of property rights from the private owner to the government itself or a third party for any purpose. Normally, the term "expropriation" appearing in the investment chapter of BITs and FTAs can be classified into two main categories: direct expropriation and indirect expropriation or any measure tantamount to expropriation.

Direct expropriation, or the actual taking of property, may occur in many ways and forms, such as the nationalization, confiscation, and dispossession of an investor's assets, as long as it involves directly taking control of the rights belonging rightfully to the private owners. On the other hand, indirect expropriation, or any measures tantamount to expropriation, does not involve a seizure of control over the rights of the investor. Rather, it may involve a government measure that may "interfere" with the usage of the property rights instead of taking direct control of the assets. Also, on many occasions, it has been construed by international arbitral tribunals that indirect expropriation could cover a wide range of policy measures, such as the imposition of an

arbitrarily disproportionate tax rate, the forced sale of equity, and the denial of access to legal materials and labor supply by other juristic entities.

Although most international investment protection agreements contain provisions regarding indirect expropriation, not many of them provide guidelines or principles on how such measures can be identified in practice. An OECD study (2004) and Reinisch (forthcoming) indicate some crucial legal elements that identify whether or not a government is engaged in an indirect expropriatory action. The three common criteria by which a government measure may be considered an act of expropriation are:

(1) degree of interference with property rights;
(2) legal transparency and consistency; and
(3) consistency with investor's reasonable expectations.

3.2.1 Degree of interference with property rights

Most international decisions treat the severity of the economic impact caused by a government action as an important element in determining whether it rises to the level of expropriation requiring compensation. International tribunals have often refused to require compensation when the government action did not remove essentially all or most of the property's economic value. There is a broad support for the proposition that the interference has to be "substantial" in order to constitute expropriation; for example, when it deprives the foreign investor of fundamental rights of ownership, or when it interferes with the investment for a significant period of time.

For example, in the Pope & Talbot case, the Canadian government's export restrictions on softwood lumber were alleged by American softwood lumber exporters to be an act of expropriation as it resulted in reduced profits. In this specific case, the NAFTA tribunal noted that despite the said restriction, the American investor continued to export considerable quantities of lumber and to earn substantial profits on those sales. It was thus concluded that "the degree of interference with the investment's operations due to the Export Control Regime did not rise to the level of expropriation."[7]

Similarly in Feldman case, the NAFTA tribunal held that Mexican's government measures that denied an American cigarette producer certain tax refunds did not constitute an expropriation although it acknowledged that the investor effectively lost the ability to export cigarettes and any profits derived as a result of the tax regulation. However, the panel viewed that since exports played only a minor role in the American company's overall business undertakings, the particular government measure did not substantially affect the interests of the private investor.

3.2.2 Legal transparency and consistency

The degree of transparency with which the government measure was implemented and the consistency of the disputed rules or regulations with the country's other laws and its legal system constitute another criterion for determining whether a government measure can be considered expropriatory.

For example, in the Metalclad case, the Mexican municipal government refusal to grant a permission to construct and operate an underground landfill to an American company, Metalclad, was found to be non-transparent and inconsistent. First, the municipal's decision to declare the area where the landfill was going to be constructed as wildlife preservation was non-transparent in that the decision appeared to be rushed and very sudden. Furthermore, such a denial of the use of the land was inconsistent with the written assurance of the company's right to operate the landfill without the need of municipal's approval given by the Federal Government, on which the claimant had initially relied before the commencement of the construction.[8] As a result, the tribunal concluded that the measure can be considered to be an indirect expropriation for which the firm must be properly and duly compensated according to NAFTA.

After the Metalclad case, tribunals have become more cautious in finding expropriation on the basis of non-transparent government behavior. For example, in the Feldman case the tribunal did not find indirect expropriation in bureaucratic behavior that fell short of what one would reasonably expect. An implicit transparency obligation was discussed in the case where certain actions of the Mexican tax authorities were allegedly "so arbitrary as to constitute expropriating action." The tribunal, however, rejected this claim, not because it did not believe in the non-transparency of the governmental actions, but rather because it considered "doubtful that lack of transparency alone rises to the level of violation of NAFTA and international law, particularly given the complexities not only of Mexican but most other tax laws."[9]

According to the finding of the Feldman case, the tribunal found it undeniable that the claimant found it difficult to deal with the tax officials and in some respects had been treated in a less than reasonable manner. However, the tribunal thought that such treatment did not rise to the level that could violate international law under Article 1110 of NAFTA.

3.2.3 Consistency with investor's reasonable expectations

A country may indeed impose any regulatory changes that may have adverse effects on the investment returns of a foreign investor. The critical issue is whether the rules or regulations introduced are within

the scope of an investor's legitimate and reasonable expectations.

In the Metalclad case, the tribunal's finding of an indirect expropriation was based on the fact that the denial by the local government of a construction permit necessary to operate a waste disposal facility contradicted with the investor's legitimate and reasonable expectations. This is because the investor had obtained an official letter from the central government indicating that only a permit from the federal government is required to launch the landfill project.

4. GOVERNMENTAL ACTION CONTRADICTING INTERNATIONAL LAW ON INVESTMENT PROTECTION: A CASE STUDY OF THE NEW DRAFT AMENDMENT ON THE FOREIGN BUSINESS ACT

The Foreign Business Act of 1999 (B.E. 2542) spells out the conditions under which foreign persons may operate businesses in Thailand. In particular, it prescribes businesses that are prohibitive to foreign persons contained in three separate lists.

List 1 determines businesses that are sensitive to local culture. There are nine businesses on this list, such as farming, publication of newspapers, and radio and television broadcasting. Aliens are strictly prohibited from operating in these businesses.

List 2 includes businesses relating to national safety, security, art and culture, traditional and folk handicraft, natural resources, and the environment. This list consists of 13 business operations.[10] Foreign persons are prohibited from operating in these businesses unless permission is obtained from the Minister of Commerce.

List 3 prescribes businesses that required protection on the ground that local operations are not yet competitive. There are 21 business categories on this list, including "all service business except those prescribed in the ministerial regulation," which makes the list extensive. Foreigners are allowed to operate in these businesses with permission from the Director-General of the Commercial Registration Department, with the approval of the Foreign Business Committee.

Given that the law imposes many restrictions on the scope of operation of a foreign entity, the definition of a "foreign person" is indeed extremely important in determining the scope of rights of a particular juristic person. The current law defines a foreign entity as follows:

(1) A natural person who is not of Thai nationality;

(2) A juristic entity that is not registered in Thailand;

(3) A juristic entity incorporated in Thailand with foreign ownership accounting for one-half or more of the total number of shares and/or registered capital; or a limited partnership or ordinary registered partnership whose managing partner or manager is a foreigner.[11]

The above definition of a foreign entity that relies solely on direct equity holding allows foreigners to assume "effective control" of a legally Thai company by:

(a) arranging preferential shares through articles of association or agreement that grant "preferential voting rights" to foreign investors so that a foreign shareholder may own only 49 percent of the equity share but control almost two thirds of the voting shares if each preferential share carries two votes. Such an arrangement is commonplace (Sopon 2002; and Deunden, Suneeporn and Sarinee 2006).

(b) arranging for additional indirect equity holding by buying up equity shares in the Thai partner.

After the military coup d'état in September 2006, the provisional government of Thailand, under the leadership of Prime Minister Surayud Chulanont, proposed an amendment of the Foreign Business Act of 1999 to close the legal loophole. The draft amendment of the Foreign Business Act defines a foreign company as a legal entity in which the majority of either the direct equity share or the **voting share is held by foreign natural or legal persons**.[12] Consequently, a company in which foreign shareholders hold a minority equity share but a majority voting share through preferential share arrangements would now be considered a foreign rather than a Thai juristic person. And, if the particular company happens to be operating in one of the businesses that appear in lists 1 to 3, the foreign shareholders would be forced to sell down their shares in order to reduce their voting rights to a minority share unless there is a grandfathering clause that shields all incumbent investments from this major regulatory change.

According to the provisional clause in the draft Foreign Business Act, all companies operating in one of the three lists of prohibited business that became a foreign juristic person under the new law will be granted a permit to operate automatically, but must be obtained within one year from the date in which new Act comes into force.[13] However, for those operating in businesses in lists 1 and 2 must also reduce their equity and voting shares to comply with the new law in three years.[14] For those operating in businesses in list 3 may continue to operate with existing equity structure until its cessation.[15]

It is uncertain whether the mandatory divestiture affecting investors operating businesses on List No. 1 and List No. 2 could be construed as an indirect expropriation, which requires compensation. However, from an affected party's point of view, the legal

amendment may be considered an act of indirect expropriation due to the following reasons.

First, the loss of effective corporate control resulting from the mandatory divestment of the voting share may be considered as a serious deprivation of property rights tantamount to an indirect expropriation.

Second, the proposed change in the Foreign Business Act may be perceived to be "beyond" reasonable expectations of an investor for two reasons. First, the proposed amendment was tabled by an unelected government established by the military authorities that undertook the coup d'état. The sudden shift in the country's political environment and hence, its economic policy directions, was unexpected by most investors. Second, the legal amendment, which represents a roll back in Thailand's investment liberalization, is inconceivable for most foreign investors as Thailand, as a member of the WTO, has made binding commitments in the General Agreement on Trade in Services (GATS) that guarantee foreign investors market access not less than that stipulated under the Foreign Business Act of 1999. The issue whether such an amendment constitutes a violation of Thailand's commitments in the GATS, however, is still an on-going debate. In this regard, it is likely that the claimants could challenge the government for interfering with business conditions and their objective investment expectations.

Third, the transitional provision that provides for a more generous grandfathering provision for foreign businesses operating in list 3 can be seen as unreasonably discriminatory and non-transparent.

5. CONCLUSIONS AND RECOMMENDATIONS

The investment protection obligation in bilateral investment agreements and the investment chapter of various free trade agreements provides that the State must pay compensation for both direct and indirect expropriation.

Although the line between what is considered to be a legitimate regulatory measure and what is considered to be a measure that is tantamount to an indirect expropriation requiring compensation has not yet been clearly articulated, some criteria have emerged from past arbitral decisions.

When analyzing the international law governing expropriation and the awards rendered by arbitral tribunals on international investment protection, a careful review of much of the research carried out so far has found some important criteria that commonly form the basic foundation for actions which are presumed to result in indirect expropriation requiring compensation. The conditions are, for example, (1) the degree of interference with property rights, (2) legality, transparency, and consistency, and (3) the interference with an investor's reasonable investment expectations.

Based on the list of criteria and based on State practices and existing jurisprudence, which is not exhaustive and may evolve over time, there is a risk that the new draft of the Thai Foreign Business Act (No…) B.E…. might be construed as a measure effecting expropriation that would require the host country government to pay compensation without delay to foreign investors subject to forced divestiture who are protected under the investment chapter of various international agreements, e.g., BITs and FTAs.

To avoid private to State disputes arising from the proposed legal amendment, the Thai government should make sure that (1) the new draft Act applies only to the new investors, (2) all business operations are equally grandfathered, and (3) the proposed legal change has been subject to thorough cost and benefit assessment and sufficient public scrutiny with a greater dissemination of the findings for further public debate in order to boost greater transparency and due process to the legislative procedure.

ENDNOTES

[1] Article 102.1 of the Agreement between the Kingdom of Thailand and Japan for an Economic Partnership (JTEPA), Article 1110.1 of the North American Free Trade Agreement (NAFTA) or Article 4 of the Treaty between the Kingdom of Thailand and the Federal Republic of Germany concerning the Encouragement and Reciprocal Protection of Investments (effective on 20 October 2004).

[2] Article 106 of JTEPA, Section B of Chapter 11 of NAFTA or Article 9 of the Treaty between the Kingdom of Thailand and the Federal Republic of Germany concerning the Encouragement and Reciprocal Protection of Investments (effective on 20 October 2004).

[3] This agreement had not yet been signed at the time of this writing, although the official text of the basic agreement has been agreed by both Parties.

[4] Article 91 (j)(i)-(iii) of JTEPA.

[5] The member countries are Canada, Mexico and the United States of America.

[6] Article 1139 of NAFTA and Article 1.1 of the Treaty between the Kingdom of Thailand and the Federal Republic of Germany concerning the Encouragement and Reciprocal Protection of Investments (effective on 20 October 2004).

[7] Pope & Talbot, Inc. v. the Government of Canada, UNCITRAL, Interim Award on Merits, June 26, 2000, para. 96, http://www.investmentclaims.com/decisions/Pope-Canada-InterimAward-26June2000.pdf.

[8] Metalclad Corporation v. the United Mexican States, ICSID Case No. ARB (AF)/97/1, Award August 30, 2000 (NAFTA), paras. 106-107, http://www.investmentclaims.com/decisions/Metalclad-Mexico-Award-30Aug2000-Eng.pdf.

[9] Marvin Feldman v. Mexico, ICSID Case No. ARB (AF)/99/1, Award, December 16, 2002 (NAFTA), para. 100, http://www.investmentclaims.com/decisions/Feldman-Mexico-Award-16Dec2002-Eng.pdf.

[10] These businesses include manufacture of firearms, ammunition, gunpowder, explosives, domestic transportation, production of carved wood, silkworm farming, weaving of Thai silk, production of Thai musical instruments, mining and rock quarrying.

[11] Article 4 of the Foreign Business Act of 1999 (B.E. 2542).

[12] Article 3 of the Foreign Business Act (No…)(B.E…).

[13] Article 10 paragraph 1 of the Foreign Business Act (No…)(B.E…).

[14] Article 10 paragraph 2(1) of the Foreign Business Act (No…)(B.E…).

[15] Article 10 paragraph 2(2) of the Foreign Business Act (No…)(B.E…).

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