CHAPTER I

INTRODUCTION

1.1 Research Background

The law of foreign direct investment (FDI) is one of the most dynamic areas of international law.[1] Gravitating towards this sphere, investors and Host State's come together and form a relationship which will, hopefully, be to their mutual advantage.

FDI in Indonesia came to light during and after the economic crisis of Asia in 1977. However, the concern regarding Foreign Direct Investment in Indonesia exists until present time as Ir. Hj. Joko Widodo, the President of Indonesia, addressed that Foreign Direct Investment constitutes as the key element to the economic growth in Indonesia. During his presidential period in 2015, the effect of FDI can be felt as Indonesia has reached Rp. 135.1 trillion of total investment, thus providing the ability to continue grow the infrastructures of the nation.[2] According to World Bank, Foreign Direct Investment improves labour conditions as it provides and widens the platform for labour of the Host-State, setting global industry standards and delivering infrastructures to local communities. FDI can benefit domestic firms, mainly through linkages and

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[1] Rudolf Dolzer and Cristoph Schreuer: *Principles of international Investment Law*. (Oxford: Oxford University Press, 2008), p.12.
[2] Bratandari, Salsabila. "Foreign Direct Investment: Solusi Untuk Indonesia?" KOMPASIANA, 20 Nov. 2015

demonstration channels: Linkages between foreign firms and local partners or suppliers can enhance the transmission of foreign firms' technology, knowledge and requirements that may help domestic suppliers upgrade their technical and quality standards. The demonstration effect, in which domestic firms imitate foreign technologies and managerial practices either through observation or by hiring workers trained by foreign companies, is another key channel that benefits companies in host countries.[3] In the short run, FDI was expected to solve lack of capital, absorb unemployment, extend the market price system and mitigate the external debt in Indonesia.[4] It becomes more evident that the FDI inflow is acknowledged as a key factor of economic development especially for developing countries such as Indonesia as it provides the major financial sources to transfer of technology, organizational and managerial practices and skills, as well as access to international markets.[5]

The task of this thesis is to critically review the established position regarding the distinction that exists between compensable indirect and non-compensable regulatory expropriation by states as well as the legal protection for investors to protect their investment from an arbitrary act from the government, specifically an illegal expropriation on foreign investment. It is commonly asserted that indirect expropriation by states will merit swift and adequate

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[3] Hermesauto. "Foreign Investment Will Do Good for Indonesia: Jakarta Post." The Straits Times, THE JAKARTA POST, 15 Nov. 2018, Available at: www.straitstimes.com/asia/se-asia/foreign-investment-will-do-good-for-indonesia-jakarta-post.
[4] Setiawan, Gandy. "The Impact of Foreign Direct Investment on Indonesia's Economic Growth", *Reports*, 2002, p.3.
[5] International Monetary Fund, *Determinants of, and the Relation Between, Foreign Direct Investment and Growth: Summary of the Recent Literature*, (International Monetary Fund: IMF Publishing, 2001), p.9.

compensation for investors that suffer damage to their property. However, the results of indirect expropriation of the exercise in regard to the state regulatory practices will not produce in such award to investors. In order to convince the distinction between these two practices must clearly be identifiable. Moreover, the concepts used to construct these doctrines must be sufficiently robust to withstand logical scrutiny. Some scholars use the word 'taking' as a neutral term to refer all types of acquiring foreign property.[6]

Throughout this thesis, the rulings of investment tribunals and the writings of scholars on how this distinction has been drawn, created and subsequently defended in international investment law. Furthermore, it also seeks to grapple with the challenges that appear evident in reconciling the rights of states and investors when dealing with a claim of expropriation. The intention in doing so appraise the accepted wisdom, and to highlight the underpinning rationale so as to demonstrate the fundamental flaws that have created the current state of affairs in international investment law.

With the growth of FDI internationally, legal protection of the said investment has become the main concern for investors as well as government institutions around the world. Legal protection can be interpreted as a guarantee for investors and government institutions, in which a standard is invented in order to avoid conflicts for foreign investors and the Host State. The Bilateral Investment Treaties had been accepted by most government institutions as means of protection for foreign investors. The first signed BIT was in 1959 between

[6] Ignaz Seidl-Hohenveldern, *International Economic Law*, (London: Kluwer Law International Law, 1992), p. 139.

Germany and Pakistan, the number of BITs signed between countries had grown significantly ever since.[7] By definition, BIT is a treaty signed between two states which confers rights to third parties, the investors of one signatory county who control assets in the other signatory country. The purpose of the BIT is to promote and protect international investment. BITs promote investment across borders by committing host governments to good regulatory practice (thus reducing political risk). They protect investment by granting investors the right to sue the host government in case of breach and in many instances, while circumventing the domestic court system.[8] To date, the United Nations Conference on Trade and Development (UNCTAD) records that 178 countries are involved in at least one BIT, with more than 2900 BITs signed among these countries.[9]

Prior to the BIT, customary international law did not provide foreign investors with much legal recourse. In the event of expropriation, aggrieved investors could not directly sue the host government, but rather had to petition their governments for indemnification.[10] The dispute settlement mechanism is revolutionary because it not only grants foreign investors the ability to sue the host directly, but in many cases, it also gives them access to legally binding, international arbitration. Typically, adjudicative authority is delegated to ICSID, an affiliate of the World Bank.[11]

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[7] Kirayoglu, Suzanne Fach. “The Bilateral Investment Treaty: Its Origins and Effects.” Electronic Theses, Treatises and Dissertations, 2014. p. 39
[8] *Ibid*
[9] UNCTAD, “International Investment Agreements Navigator”, 2013. P. 38
[10] Bubb, Ryann J, and Susan Rose Ackerman. “BITs and Bargains: Strategic Aspects of Bilateral and Multilateral Regulation of Foreign Investment.” 2007.
[11] Kirayoglu, Suzanne Fach. “The Bilateral Investment Treaty: Its Origins and Effects.” Electronic Theses, Treatises and Dissertations, 2014. p. 40

Prior to World War II, the primary governing mechanism for foreign investment was national law.[12] The United States was signing Friendship, Commerce and Navigation treaties (FCNs) on a bilateral basis as early as the 1800s.[13] The content of these treaties were the forerunners of what can be found in today's BITs and the investment chapters of free trade agreements. FCNs included standards for treatment, such as most favored nation and national treatment, and compensation in the event of expropriation. One major difference, however, is that these early treaties focused solely on property rather than today's broader concept of investment. If a treaty did not exist, then customary international law, was called upon.

Customary international law obligates the host country to a minimal standard of treatment. It was formulated most explicitly in the 1930s during a diplomatic exchange between the government of Mexico and United States Secretary of State, Cordell Hull. After gaining independence Mexico enacted a series of land reforms which led to the seizure of U.S. property.[14] The Hull Rule, as it came to be known, required host states to pay "prompt, adequate, and effective" compensation in the event of expropriation. The meaning of these terms is somewhat ambiguous but have been interpreted to mean the following: Prompt compensation does not only refer to a period of time, but also defines the appropriate means of compensation. It excludes non-marketable, long-term bonds, whose full value may not be realized until a much later date. Adequate

[12] UNCTAD "Comprehensive Study Interrelationship between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)", 1999.
[13] Guzman "Capital Market Regulation in Developing Countries" 1998.
[14] UNCTAD "Comprehensive Study Interrelationship between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)", 1999.

compensation protects the value of the investment from being downgraded due to expropriation. It is generally defined as the fair market value prior to the taking or alternatively, the present value of future profits. Effective payment is defined as payment with a stable or hard currency, like the U.S. dollar for instance. It wasn't until around the turn of the century that international investment became controversial. Governments were increasing taking measures that affected foreign investment. Many newly independent states nationalized their natural resources sectors. In Mexico and Central and Eastern Europe, land reforms led to a rise in expropriations. With the advent of the Soviet Union, the entire economy was nationalized.[15] This trend exposed the weaknesses of customary international law.

Its legitimacy was called into question. Customary international law is followed only to the extent that the majority of all states abide by it. Yet by the turn of the twentieth century, the countries of Latin America, having achieved independence, began promoting their own doctrine for the treatment of foreign investment. The Calvo Doctrine[16], as it came to be known, placed jurisdiction over international legal disputes firmly within the host country's legal system and directly challenged the legitimacy of customary international law.[17] The initial focus of the post-war period was reconstruction. The 30 Year's Crisis had led to

[15] UNCTAD "World Investment Report: The Shift Towards Services", 2004.
[16] The Calvo Doctrine is a foreign policy doctrine which holds that jurisdiction in international investment disputes lies with the country in which the investment is located. The Calvo Doctrine thus proposed to prohibit diplomatic protection or (armed) intervention before local resources were exhausted. The legacy of the Calvo Doctrine is evident in the BIT's investor-state dispute mechanism, requiring that all local legal remedies be exhausted before international remedies are sought.
[17] Kirayoglu, Suzanne Fach. "The Bilateral Investment Treaty: Its Origins and Effects." Electronic Theses, Treatises and Dissertations, 2014. p. 12

the collapse of the international monetary and trading system, much of which was thought to be as a result of protectionism during the inter-war period.

To generate prosperity, the U.S. sought to create international institutions that removed barriers to international exchange and promoted the free flow of capital and traded goods. From the perspective of the developed world, multilateralism as well as market-liberalism were the foundations for reconstruction. However, in regard to international investment, these goals met with opposition and proved difficult to achieve. The first attempt at multilateralism was The Havana Charter of 1948. Intended to create the International Trade Organization, The Havana Charter was the first attempt to formulate the rules governing international investment.[18]

In reaction to the growing power of the developing world and the triumph of the principle of sovereignty, capital-exporting countries made yet another attempt at a multilateral agreement on international investment under what was to be called the Convention on the Protection of Foreign Property. The 1967 draft was prepared and approved by the OECD Council, but was never opened for signature.[19] The failure of these multilateral attempts to protect investment abroad along with the growing power of the South and the rights of the state can each be said to have paved the road for the introduction of the bilateral investment treaty. The BIT was significant in two respects. First, it addressed the interests of the

[18] UNCTAD"World Investment Report: The Shift Towards Services", 2004
[19] UNCTAD "World Investment Report: Investment, Trade and International Policy Agreements", 1996; UNCTAD "World Investment Report: Foreign Direct Investment and The Challenge of Development", 1999

developed world by providing protections against uncompensated expropriation.[20] Second, unlike multilateral attempts at cooperation, bilateral treaties could be successfully negotiated.

One of the most topical areas within the field of international investment law would be expropriation. Arguably, the subject of the greatest debate in this field is the difference that is said to exist, between compensable expropriatory acts and non-compensable expropriatory acts.[21] In the past the distinction was said to have been quite clear, until it was complicated by the expansion of the concept of expropriation in international law.[22] Central to this challenge is the question of the relationship between the essential regulatory powers, the 'police powers' and the legitimate protection of investors in international investment law. From the doctrinal point of view, the main controversy lies in distinguishing what the standard international investment law vocabulary is commonly described as indirect expropriation from bona fide, police power regulatory expropriation.[23] The basic framework, in principle, is very clear: Indirect expropriation is a form of expropriation that can be caused by regulation. However, it is distinct from direct expropriation due to the fact that while it does not transfer title of property, it still attracts the principle of compensation. Opposed to this is the idea of regulatory expropriation which is distinguished from indirect expropriation, not

[20] Vandevelde, "Fixing International Law or Fixing Castro", 1999

[21] Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law*, (Victoria: University of Victoria ,2005), p.13; Higgins Rosalyn, *The Taking of Property by the State: Recent Developments in International Law*, (Boston: Recueil des Cours 259), p. 331.

[22] M. Sornarajah, The International Law on Foreign Investment, (Oxford, 2012), p.363

[23] Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law*, (Victoria: University of Victoria ,2005), p.25

because regulation is involved but the fact that there is no compensation due to be paid to aggrieved investors.

Both international investment law scholarship and tribunal practice broadly reflect that states are entitled to regulate domestic affairs under the rubric of police powers. However, there is often some confusion as to what precisely the concept of 'police powers' actually means[24], which causes some concern in the context of investment disputes where a state's adoption of regulatory measures results in no compensation being paid to the investor.

In international investment law it is a well-recognized rule that a state's expropriation of the property of foreign investors, whether exercised for public purposes or not, warrants swift and adequate compensation.[25] However where a state expropriates the said property through the use of 'police powers' and in pursuit of bona fide public interest, it is often assumed also that there should be no requirement to compensate investors for any detrimental impact they may have suffered.

The work of this thesis requires independent research by the author. The author is able to conclude the authenticity of this thesis as the topic of this thesis has not been covered by students in UPH nor by anyone outside the campus of UPH. Certainly this fact is concluded in extent to the desktop research of the author.

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[24] Vicky Been and Joel Beauvais, *The Global Fifth Amendment? NAFTA's Investment Protections and the Misguided Quest for an International "Regulatory Takings" Doctrine*, (New York: New York University Press, 2003), p.53

[25] OECD "Indirect Expropriation" and the "Right to Regulate" in International Investment Law", OECD Working Papers on International Investment, (2004, OECD Publishing) p.2

1.2 Research Questions

Based on the brief analyzation above, as follows would be the research questions for this thesis:

1. What are the reasons for a state to exercise a regulatory measure namely, indirect expropriation of a foreign direct investments?
2. What are the legal protections for investors to protect their investment from indirect expropriation executed by a state?

1.3 Research Purpose

In general, the purpose of this Thesis is to give the readers better understanding about the fundamental concept of denial benefits clauses in international investment treaties and also to answer the designated problems which are:

1. To analyze and go in depth to why a nation should indirectly expropriate a foreign direct investment and explore the consequences of such measure to both parties.
2. To analyze and provide the necessary means for investors to protect their investment against arbitrary act by the state, specifically on illegal indirect expropriation.

1.4 Research Benefits

In this chapter, the author would like to breakdown the benefits of this thesis. The author believes that this thesis is beneficial in two aspects namely theoretical benefits and practical benefits.

1.4.1 Theoretical Benefits

It is the hope of the author that this research could contribute the the expansion of knowledge and wisdom towards this particular state measures, indirect expropriation as well as contributing to the expansion of knowledge and wisdom towards this particular state measures, indirect expropriation.

1.4.2 Practical Benefits

With the availability of this research, it is the hope of the author that this research may serve as a guideline for potential investors in determining their business policies and plans in the future. In any event that potential foreign investors have concerns over their business plan, they could very much look up to this research and it is the hope of the author that their concerns are comforted by this research. It is also the hope of the author that this research could serve as an alternative means for the continuos business policies of current foreign investors in the future. In any event that they found an inhibition for their current investment, may this research serve as a guideline in finding the best solution for their investments. With a structured and defined explanations of this particular state measure, may the current investors find a sense of security for their current and potential investments.

1.5 Framework of Writing

CHAPTER I: INTRODUCTION

The first chapter will discuss about the establishment and means of this particular research. This chapter includes the background, the conception of the problems, purpose of research, benefit of research and the framework of writing.

CHAPTER II: LITERATURE REVIEW

The second chapter will consist of the theoretical overview over the main discussion of this research. This chapter would include the introduction to the specific topic of the research. The second chapter would answer the questions mentioned in Chapter I using an enhanced explanation of the particular topic. This chapter will consist of various theories and concepts found in different sources; books, journals, cases, websites, thesis, laws, etc.

CHAPTER III: RESEARCH METHODS

The third chapter of this research would include research and literature methods for this research. It would serve as a guideline of the author's approach towards gathering his research material. This chapter would include the basic understanding of the different types of research methods, types of data, data analysis technique and research approach. In

each sections, the author will mention which methods he will be using in formulating the research.

CHAPTER IV: DISCUSSIONS AND ANALYSIS

The fourth chapter analyzes: *first*, what measures issued by the government that constitute as an indirect expropriation as well as the requirements to enact a lawful indirect expropriation. *Second,* the legal protection for foreign investors to protect their investments.

CHAPTER V: CONCLUSION AND RECOMMENDATIONS

The fifth chapter is the last and closing chapter. This chapter consists of two prongs; conclusions and recommendations. The conclusion is aimed to the designated problem that had been discussed and carefully analyzed. The recommendation is designed as suggestions from the Author to solve the existing issue.