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**PROTECTION TO FOREIGN INVESTMENT IN FACE OF
STATE REGULATORY POWER IN BRAZIL**

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ABSTRACT

The objective of this work is to assess the protection level of foreign investment vis-à-vis the regulatory measures of the State in Brazil compared to the protection awarded by International Law. In this context, reference is made to the internationalization process of the property right's protection by the domestic law systems of the developed countries, as well to the evolution of the role of the State and its reflexes on the protection of the property right in the International Law background. This paper also examines foreign investment protection in the multilateral, regional and bilateral arenas. It is verified that, notwithstanding the frustrated attempt at regulating investment protection in the multilateral arena, the developed countries were very successful in the bilateral arrangement, having imposed their rules through bilateral investment agreements. It is observed that the bilateral investment agreements in general provide clauses of foreign investment protection against damages caused by regulatory measures of the State (the well-known 'indirect expropriation' in International Law), as well as clauses on investor-State dispute settlements through an arbitral proceeding. In this context, a proliferation of arbitral proceedings originated from investment agreements has been verified as well as a great number of condemnations of States to pay huge indemnities to foreign investors on account of damages resulting from measures of the State's regulatory power, although it was exerted in a legitimate way, a fact that brought great apprehension to the international community. The latter discusses today to what point the granting of protection to foreign investment against indirect expropriation represents a threat to the sovereign power of the State to determine its public policies. As to Brazil, it has no international agreements concerning protection to foreign investment, reason for which disputes between foreign investors and the Brazilian State are settled in accordance with the Brazilian legislation and, with exceptions, under the state jurisdiction. In this particular, apart from the preservation of sovereignty of the Brazilian State in conducting its public policies, it is inferred, through assessment of the Brazilian legislation, doctrine and

jurisprudence, that the protection of the foreign investor is equivalent to the one granted to the national investor and quite extensive from the point of view of the substantive law, although it remains compromised by the low effectiveness of the jurisdictional system and by the payment regime adopted by the Brazilian State concerning condemnations resulting from judicial decisions. Finally, it is seen that, although the investor-State direct arbitral proceeding is still not allowed in Brazil, the institute of arbitration has been consolidating in the last years as a means of dispute resolution, nowadays existing a real pro-arbitral ambience in Brazil.

PREFACE

According to the United Nations Conference on Trade and Development (UNCTAD), “foreign direct investment (FDI) has the potential to generate employment, raise productivity, transfer skills and technology, enhance exports and contribute to the long-term economic development of the world’s developing countries.”¹

Knowing the benefits, developing countries have been struggling to attract foreign direct investment since the beginning of the eighties, given its capacity of producing wealth.²

This fact was emphasized by the increment in the flow of the world capitals on account of the globalization phenomenon, which, boosted by the technological revolution of the seventies and eighties, contributed to the falling of the physical boundaries of states.

In this context, the smashing majority of the developing countries started to favor a major flow of investments by the deregulation of sectors of their economies from the nineties on.

By the way, it is important to emphasize that the foreign investor does not search only for good markets, but also for markets with low risks and which grant protection to foreign capital. Such protection can be translated, in short, in the guarantee of maintenance of the invested capital’s integrity vis-à-vis potential state interferences, freedom of profits remittance to the country of origin, possibility of repatriation of capitals, and an efficient and neutral method of investor-State disputes settlement, particularly the arbitration.

In this sense, having as premises the frustration of the attempt to regulate the protection of foreign investment in the multilateral fora, dependence on foreign

1 Information found in [HTTP://www.unctad.org/Templates/StartPage.asp?intItemID=2527&lang=1](http://www.unctad.org/Templates/StartPage.asp?intItemID=2527&lang=1).

2 From the eighties on, many countries abandoned their policies of imports substitution and started to adopt an approach of more openness towards foreign investment.

investment by the developing countries to promote their economic development, as well as the understanding that the attraction of foreign investment lay, greatly, on the granting of protection to it, a pronounced proliferation in the signing of bilateral investment agreements (BITs) was observed, as from the eighties.

With regard to this study, it is important to point out that many BITs, particularly the most recent ones, provides for protection of foreign investment against measures which cause “indirect expropriation”, this means the measures taken by the State in applying its regulatory power, which, although do not aim at expropriating, are totally or partially equivalent to expropriation in the measure they cause substantial damages to the foreign investor.³

In this particular, it happens that there are no legal criteria in the BITs to distinguish the cases in which the damages caused to foreign investment because of acts by the regulatory power legitimately applied by the host State, cause indirect expropriation or not.

This deficiency, together with the proliferation of the number of international investor-State arbitrations involving the discussion on the occurrence of indirect expropriation, provoked great concern on the matter. The States have been condemned to indemnify foreign investors for acts resulting from the application of regulatory power, even if performed within the limits of legality.

In effect, according to the article entitled “UNCTAD alerts for the increase of legal actions in investments”, published in the ‘Jornal Valor Econômico’ (Newspaper for Economic Value), of November 30, 2004, the open disputes at the International Center for Settlement of Investment Disputes - ICSID reached 160, against only 5, a decade before, with half of the disputes opened in the three years before 2004 and all were by the private sector against governments.

³ In International Law, the interference in property resulting from acts of the regulatory power by the State is known as ‘*indirect expropriation*’, “*disguised expropriation*” or “*creeping expropriation*” – which should not be confused with the concept of indirect expropriation existing in the Brazilian Law, as is better explained later on.

In mentioning the emblematic experiences of Argentina and Mexico, countries against which a large number of legal actions were opened regarding investments – in the Argentine case, based on bilateral agreements of investment protection, and in Mexico, based on the North American Free Trade Agreement (NAFTA) – the referred article points out that the legal actions were on regulatory issues in the most diverse sectors, involving developing countries, in 60% of the cases.

In short, the referred article sends an alert directed by UNCTAD to the developing countries in the sense that special care be given when negotiating bilateral agreements of protection to investments, considering that the legal actions submitted to arbitration, besides requiring high expenses with lawyers (average cost of US\$ 1 million to US\$ 2 million), can cause high condemnations against the country.

Based on the above-mentioned information, the great concern that emerges from that regards the preservation of the sovereignty of the State on the determination of its public policies, because, differently from what happened in the period of liberalism, the current demands of the society require a more active role by the modern State. This is why the defense of the public interest necessarily requires a constant intervention in the economy by the State.

In this sense, from the moment a State signs an international agreement in which the protection to foreign investment against “indirect expropriation” is provided for, the public policies of this State – and consequently its sovereignty – are under permanent threat of contestation. It is precisely this that has shown the many legal actions taken to arbitration within ICSID .

In the case of Brazil, although there are no international agreements on investments in effect, with the exception of the Trade Related Investment Measures (TRIMs)⁴ and of the General Agreement on Trade in Services (GATS)⁵,

⁴ The agreements of TRIMs – Trade Related Investment Measures – mentioned in Annex 1A (Multilateral Agreements on the Trade of Merchandise) of the OMC Agreement, provides for the measures of discriminatory

both in the ambit of the World Trade organization – WTO, this has been a great direct foreign investment receiver since the Second World War, due to the size of its market, and beginning in the nineties, due to the opening of several sectors in the economy to private capital.

It is in this context that it is intended to proceed to the study of the protection to foreign investment in face of the *indirect expropriation* in Brazil, both from the point of view of the substantive law and from the aspect of the means of dispute settlement, including the state jurisdiction and arbitration.

In Brazil, the study of protection granted to foreign investment for damages caused by actions or omissions of the State, in the exercise of its regulatory power, requires that the institutes of state regulatory power, intervention by the State in the economy and state tort liability be examined.

The fact follows that the regulatory power of the State is nothing more than its regulatory power applicable to the most varied sectors of the society, be they economic or not. À propos, special attention must be given to the acting of the state regulatory power, specifically, in the economic domain – one of the aspects of State intervention in the economy – considering its obvious relevance with regard to the legal regime of the investment in general.

Following, the study of State tort liability will allow to check which are the limits imposed to the application of its regulatory power and which are the implications that can result from such exercise, even if circumscribed to the limits of legality.

Finally, the aim is to carry out a critical exam of the protection granted to foreign investment in view of the state regulatory power according to the Brazilian legislation, doctrine and case law.

treatment related to imported and exported merchandise, which restrict or distort their trade, not covering in the Agreement the issues of Access and treatment of foreign investment.

5 The GATS – General Agreement on Trade and Tariffs – mentioned in Annex 1B of the OMC Agreement, provides for the measures taken by the member-countries, which affect the trade of services covered by said agreement.

1. PROTECTION OF INTERNATIONAL LAW FOR FOREIGN INVESTMENT

1.1 INTERNATIONALIZATION PROCESS OF THE CONCEPT OF PROPERTY LAW

According to Sornarajah (1994, p.293-296), protection to property law with regard to the regulatory acts of the State in International Law results from a tendency to the internationalization of the concept of property right existing in the North American and European domestic systems. This tendency originates in the concern by the capital exporting countries, with regard to the security of investments made by its nationals abroad.

In short, it can be said that the permanent concern by all foreign investors is about protection to their investment considering the measures that the host State may take concerning the investment, together with the need to guarantee the remittance of the profits to his native country and the possibility of repatriation of the capital invested, whenever he so wishes.

Regarding this, the author points out that to understand the protection granted to property in international law, it is necessary to understand the notion and the evolution of property right in the afore-mentioned systems, particularly, in the North American law

In this sense, he mentions that the notion of property law underwent a radical transformation and had to adapt to the new reality. As a matter of fact, at a first moment, at the time of the Liberal State, of the *laissez-faire*, of the state non-interventionism, the need for protection was limited to the private property from the physical angle. However, to the point that there was an alteration in the State functions, having changed the manner and the frequency with which it interfered in the private sphere, private property also suffered restrictions under other aspects, besides the physical one.

The author adds that the recognition of the case law that property constituted a series of intangible rights was useful for this new reality of the State functions and that, therefore, expropriation was not restricted only to taking possession of all the group of rights, but would occur even when part of these rights suffered restrictions.

This was therefore the change in the notion of property right, both in the North American and the European system. In the North American system, protection to private property has been enjoying constitutional protection since the issue of the Fifth Amendment, which grants that private property will not be taken for public use, without fair compensation⁶. From thereon, its evolution took place in case law.

With regard to the European system, the European Convention of Human Rights, of November 4, 1950, did not initially recognize property right, which was later done by the First Protocol to the Convention, on March 20, 1952. This also had to deal with its changing notion⁷. In fact, the above-mentioned protocol in Article 1 of Protocol 1 established that:

Every natural or legal person is entitled to the peaceful enjoyment of its possessions. No one should be deprived of his possessions except in the public interest and subject to the conditions provided for by the law and by the general principles of international law.

The proceeding provisions shall not, however, in any way impair the right of a state to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

⁶ The final part of the Fifth Amendment to the Constitution of the United States of America provides: "*nor shall private property be taken for public use, without just compensation*".

⁷ The First Protocol to the European Convention of Human Rights became effective in 1954.

1.2 EVOLUTION OF THE ROLE OF THE STATE AND ITS IMPACT ON THE PROTECTION OF PROPERTY RIGHTS AT THE LEVEL OF INTERNATIONAL LAW

In a context of the search for protection to foreign investment, an issue with which the International law has been involved refers to the expropriation of foreign properties by the State and, particularly, to compensation to be paid to foreign investors as a result of damages suffered by them.

According to Sornarajah (*idem*, p.278-279), the initial development of International Law concerning liability by the State with regard to expropriation of foreign properties was in the context in which these were taken by the State, not for public interest, but to satisfy personal greed of certain governors – a phenomenon which was fairly common in States governed by dictators or oligarchies.

In this sense, both this kind of expropriation, which was known as confiscation – and the expropriations carried out in the context of economic programs – called nationalizations – were considered illegal by the International Law and, therefore, eligible for compensation.

This situation was only changed when a series of nationalizations emerged, as exemplified by those promoted by Latin American countries in view of the performance of economic programs⁸, as well as those taken place in countries recently become independent, as a way of taking back the control over their economy.

According to Cassece (2001, p.415):

The problem exploded again after the Second World War, when developing countries increasingly became politically independent and tried to get off the ground economically as well. They felt impelled to expropriate foreign property because their natural resources were to a large extent in foreign hands. One of the ways of achieving rapid economic advance lay in appropriating foreign assets without this constituting an excessive financial burden for the expropriating State.

⁸ Emblematic example of nationalization were the expropriations promoted by Mexico in 1917 and 1938.

Since then, nationalizations – previously considered illegal, as used to happen with the confiscation of foreign properties – began to be considered legal by the International Law, as long as they were not discriminatory and carried out for a public purpose. The referred legalization of the institute would obviously still require compensation.

However, as the State evolved from Liberal to Social, its role, which had previously been absent on the market, now became interventionist. This means that in the modern world, the State frequently intervenes in the private area with the intention of pursuing certain objectives, justified as public interest.

As a result, this modern role of the State provoked a new problem to call the attention of the International Law, that is, the fact that state interference in private property (and, consequently, in foreign investment), would often cause damages to private property, even though it did not have expropriation objectives.

In other words, it can be said that there are all sorts of lasting interferences by the State in property – here considered in its broader sense, i.e., covering both the physical and the abstract aspect – keeping in mind its power-duty to promote the defense of public interest, regarding, for instance, the consumer's protection, environmental measures, sanitary measures etc. They are interferences resulting from the State regulatory power, which are generally considered non-compensable.

On the other hand, although these same regulatory measures are exercised within the legality, they can cause damages to the foreign investor, beyond what would normally be acceptable to bear. The international doctrine agreed to call this situation *indirect expropriation*.

So the Gordian knot, not yet untied by International Law, refers to the adoption of an adequate criterion to distinguish, among the acts of the regulatory power exercised legitimately by the State, which ones would allow a compensation for the damages caused to foreign investors – acts constituting “indirect expropriation” – and which ones would not authorize a compensation.

1.3 FOREIGN INVESTMENT PROTECTION AT MULTILATERAL AND REGIONAL LEVELS

1.3.1 OVERALL CONSIDERATIONS

In view of the hostile posture towards foreign capital, one of the big concerns of investors throughout time has been the search for protection to investment made in foreign countries, considering the frequent cases of expropriation carried out by countries receiving the investments, whether for political, social or economic reasons. The reference here is to look for rules that protect the investment from the substantive point of view (that is, that guarantee the maintenance of integrity of the investment against illicit and arbitrary acts by the foreign State and, when violated, allow the receipt of a most comprehensively possible compensation) as well as rules that remit the resolution of disputes to an independent body outside the state jurisdiction of the host State of the investment.

In fact, it will not be sufficient to grant substantial protection to the foreign investment if the jurisdictional body that will assess the existence and extent of the violation to the foreign investor's right, has neither the independence to do so, nor if the mechanisms to implement the final decision are not effective.

In this sense, the evolution of the rules of international law regarding protection of the foreign investment in its substantial aspect is therefore pertinent and intimately overlapping, as well as the rules related to arbitration, as means of resolution of disputes (here also the rules of conflict of laws are considered), reason for which we shall discuss both together.

1.3.2 EVOLUTION OF THE RULES RELATED TO THE PROTECTION OF FOREIGN INVESTMENT AND TO ARBITRATION AT MULTILATERAL AND REGIONAL LEVELS

There were two typical ways in which an investor could defend his investment in a foreign expropriating State: direct pressure applied by the investor on the foreign host State of the investment, depending on the political force of the parties involved, or through diplomatic protection of his own country, with views on the search for compensation from the expropriating State, which sometimes caused diplomatic conflicts. It could culminate in what was known as 'diplomacy of the arms', as happened in the classical incident between Great Britain and the *Grand Colombia* in the first half of the 19th century (BLACKABY, 2005, p.111-119).

It was in this context that, in 1868, the jurist and diplomat Carlos Calvo published his masterwork "Theoretical and Practical International Law", in which he presented his theory on International Law – a theory which originated the so-called "Calvo Doctrine", which found fertile ground among the Latin American countries (Countries receiving foreign capital), leaving strong effects throughout the 20th century.

The "Calvo Doctrine" was based on two basic principles: sovereignty and national treatment. Sovereignty means that the sovereign countries were independent and should not suffer interference from other countries, be it by force or by diplomacy; by the national treatment principle, the foreigners should be submitted to the same laws and regulations as the nationals of the host country, as well as not having rights or privileges greater than those granted to the nationals of the host country, which implied that they should look for repairs of damages through the local courts.

This Doctrine was turned down by the industrialized countries (United States and Europe), which did not consider the local courts impartial with regard to the foreigners, resulting in a great divergence between the exporting and the receiving countries of the capital.

At the Second Peace Conference in the Hague in 1907, the ‘Convention for the Pacific Settlement of International Disputes’ was signed, finding a mid-term between the ‘diplomacy of arms’ and the uncertainty of the local law courts by determining the establishment of obligatory bilateral arbitration treaties, i.e., in case of eventual dispute, the host State of the capital and the State of the foreign investor would be obliged to sign an agreement regarding the resolution of the dispute by an independent arbitral tribunal. Otherwise, in case such agreement was not signed, the arbitration would remain in charge of an arbitral tribunal designated by the International Court in the Hague. This Convention was signed by all the Latin American countries.

The next step of the International Law was the celebration of the Geneva Protocol on Arbitration Clauses in 1923 – by which the participating countries agreed to recognize the validity of the arbitration agreements on the resolution of present or future disputes between private parties – and the Geneva Convention on the Execution of Foreign Arbitral Awards of 1927, being that neither had a good repercussion in Latin America, considering the great influence of the “Calvo Doctrine”⁹.

Subsequently, due to the great dissatisfaction with the Geneva Protocol and Convention, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards was signed in 1958. This came about as a result of an initiative by the International Chamber of Commerce of Paris - CCI, later embraced and improved by the Economic and Social Committee of the UN.

This Convention obliged the States to guarantee that their local law courts recognize the validity of the arbitration agreements and recognize and enforce all the arbitral awards issued outside the national territory, without the thorough analysis of the dispute in question – having been considered a great landmark in international arbitration, even though it did not initially receive a good reception

⁹ Brazil signed Protocol of Geneva of 1923, having been enacted by the Decree no. 21.187, of March 22, 1932.

among the Latin American countries, for the same reasons that the Geneva Protocol of 1923 and the Geneva Convention of 1927¹⁰ were rejected.

By the way, the Convention of New York was reflected nearly two decades later in the Inter-American Convention on International Commercial Arbitration (Panama Convention), celebrated in 1975 under the auspices of the Organization of American States – OAS.

In 1966, at the Convention on the Settlement of Investment Disputes between States and Nationals of Other States – the so-called Washington Convention – the International Center for Settlement of Investment Disputes – ICSID, an institution of the World Bank Group, based in Washington DC (USA) was set up.

The Washington Convention was conceived to attract investments by the States that, in exchange, would grant the foreign investors treatment with standards recognized by the international law and would consent, in advance, on the settlement of disputes by international arbitration, avoiding that these would become diplomatic conflicts among States.

Simultaneously, the idea was the creation of an institution specialized in the settlement of disputes related to investments in order to relieve the load represented by the direct involvement of the President of the World Bank and his staff in the settlement of disputes between governments and foreign investors, as happened on several occasions.

The Washington Convention provided that the Member States of the World Bank could sign the Convention, as well as other States that had signed the Statute of the International Court of Justice invited by ICSID's Administrative Council, by deliberation of two thirds of its members.

¹⁰ The Convention of New York became effective on June 7, 1959, 90 days after the deposit of the third ratification instrument to the Convention, currently being adopted by close to 140 member countries of United Nations. In South America, the Convention of New York was ratified by Ecuador (1962), Chile (1975), Colombia (1979), Uruguay (1983), Argentina (1989), Bolivia and Venezuela (1995), Paraguay (1997) and Brazil (2002).

It is interesting to record that the Convention was opened for signature in March 1965 and became effective on October 14, 1966, with the ratification by 22 States (United States, Cyprus, Iceland, Jamaica, Malaysia, Pakistan and 16 African countries). Currently there are 155 countries that signed the Convention, of which 143 countries deposited the ratification instruments of the Convention.

In Latin America, today, the Convention is in effect in 17 States, which signed it as from the 1980's. Of these, it is worth highlighting the South American countries and the respective years of the Convention's signature and entry into force, as follows: Argentina (1991, 1994), Chile (1991, 1991), Colombia (1993, 1997), Ecuador (1986, 1986), Guiana (1969, 1969), Paraguay (1981, 1983), Peru (1991, 1993), Uruguay (1992, 2000) and Venezuela (1993, 1995)¹¹. In the case of Brazil, the Convention was never signed for reasons that will subsequently be detailed.

This defensive posture by the Latin American countries explains two important factors: the first of them, as already mentioned above, speaks about those countries being rooted to the Calvo Doctrine until a good part of the 20th century – this Doctrine, based on the priority of the sovereignty and national treatment, was largely invoked to limit the interference of the developed countries; the second refers to the search for development, a theme that only became relevant in the scenario of International Law after the Second World War..

Therefore, to attempt to make their objectives feasible, the manner chosen by the developing countries was to act at international organizations and multilateral forums.

Related to this, it is worth mentioning the creation of the United Nations Conference on Trade and Development (UNCTAD), a permanent intergovernmental body created in the ambit of the United Nations Organization – UN, in 1964. It is the main body of the General Assembly of the United Nations and its goals are to maximize trade, investment and development opportunities of

¹¹ In Bolivia the Convention has been in effect since July 1995, having, however, denounced it in May 2007, no longer being in effect in that country since November 2007.

developing countries, as well as to give assistance to developing countries in their efforts to integrate into the world economy on an equitable basis.

It was created because of the little space that the developing countries found in the Economic and Social Committee¹² of the UN to deal with issues that worried them, such as the international market, multinational enterprises and the enormous disparity between developing and developed countries.

Besides this, in June 1964, at the end of UNCTAD's first session, the so-called Group of the 77¹³ was created, a coalition of 77 developing countries with the objective of organizing the countries of the South so as to promote their collective economic interests, improve the ability of group negotiation in the main international economic issues and stimulate the South-South cooperation for development¹⁴.

This confronted action of the developing countries culminated with the proposition of a "New World Economic Order" through a series of resolutions that were approved at the UN General Assembly, in 1974. The target of this new proposal was the revision of the international economic model conceived in Bretton-Woods, after the Second World War, in favor of the so-called "Third World" countries, so as to diminish the power inequality of the economic relations among industrialized countries and developing countries.

In effect, the Resolutions nos. 3,201 and 3,202, both of May 1, 1974, were approved, covering the "Declaration on the Establishment of a New International Economic Order" and the "Programme of Action on the Establishment of a New International Economic Order", the last of them trying to implement the principles declared in the Resolution 3,201/1,974. Furthermore, Resolution no. 3,281, of December 12, 1974 was also approved, introducing the "Charter of Economic

12 The Economic and Social Committee is one of the five main agencies of UN, next to the General Assembly, the Council of Security, the Secretariat and International Court of Justice.

13 Although the Group of the 77 currently has 130 members, the name of the Group was maintained for the historic meaning.

14 One of the divisions of the Group of the 77 is the Group of the 24, an inter-governmental group formed in 1971, by 24 member countries of the Group of the 77, whose objective is the harmonization of the position of the developing countries with regard to monetary and financial issues of the development.

Rights and Duties of States”, which established the principles that should rule the economic and political relations among the States.

Sornarajah (*op.cit.*, p.191-194) shows that, in the context of this process, there was also, in the ambit of the UN, an attempt to draft a code of conduct with regard to the multinational enterprises, a process that lasted for over a decade, not achieving, however, a good result, considering the enormous difference in positioning among developing and developed countries.

The author adds that, despite the position adopted by the developed countries, these were forced to a change of attitude, since the quick changes in the international economy also led these countries to receive foreign investments. This obviously did not mean the abandonment of their theses, but a change to a more concessional position in face of the reality presented.

Thus, with regard to the treatment of foreign investment among developed countries, in 1976, at the Organization for the Economic Co-operation and Development – OECD (organization created in 1960, bringing together the main industrialized nations), the “Guidelines for Multinational Enterprises” that constitute recommendations of voluntary adhesion directed to the multinational enterprises, considering the conduction of business in a responsible manner in a diversity of areas, were approved.

It must be noted that, in 1992, the World Bank (*International Bank for Reconstruction and Development - IBRD*) – institution conceived in Bretton-Woods and dominated by developed countries – also formulated guidelines, determining, contrary to what UNCTAD had done, the manner in which the multinational entities should be treated by the investment host countries.

It is also important to mention one of the efforts that most attracted attention with regard to the attempt to regulate foreign investment at the multilateral level. In effect, at OECD, in 1995, negotiations regarding the future constitution of a Multilateral Agreement on Investments – MAI) began, with a view on the regulation

of foreign investment among the members of that organization, also including eventual interested non-member countries.

According to the order granted to the MAI negotiators, the objective was to conceive a wide multilateral structure for the international investment, in which high standards would rule, both to liberalize the investment regimes and protect the investment, besides effective procedures of settlement of disputes. A propos, in spite of the efforts undertaken, an accumulation of factors led to the decision, in December 1998, to interrupt negotiations¹⁵.

With regard specifically to the issue of protection to foreign investment against "indirect expropriation", a study by the United Nations Conference on trade and Development - UNCTAD, entitled "Lessons from the MAI" (1999, p.18) showed that there had been strong resistance from the non-governmental organizations – NGO's, mainly because of what had been observed regarding the experience at the North American Free Trade Association - NAFTA, under which several licit governmental regulatory acts were the object of opposition by foreign investors through arbitration.

One of the arguments against the referred protection was that it could try to nullify many state regulatory acts, considering that it could be interpreted to mean that any regulatory act that led to a limitation of profit capability could be contested as an act that constitutes *indirect expropriation*.

The fact is that, so far, in spite of the innumerable attempts to regulate the question in the multilateral area, none of them was successful due to the difference of outlook among the importing and exporting countries of capital.

On the one hand, the developing countries have been struggling for a long time to preserve their sovereignty, one of the expressions of this sovereignty being precisely the possibility to determine which foreign investment legal regime is the

¹⁵ Opposition of the non-governmental organizations, the limited interest of the business community and the election of left-center governments in some member-countries of the OCDE are among the factors that brought about the interruption of the negotiations with regard to the MAI.

most adequate for their economic policy¹⁶. In this sense, all these countries are interested that foreign investment be submitted to their national legislation as well as their jurisdiction.

On the other hand, the developed countries – aware that the mitigation of the risks offered to the investments carried out by their nationals abroad is necessary – try to achieve, at any cost, the prevalence of the International Law in detriment of the national legal systems of the host countries of those investments.

In spite of their position in defense of a “New International Economic Order”, the developing countries had to give in to the reality of dependence on foreign investment to promote their economic development. In effect, with the hindrance of the multilateral way, the developing countries understood that the only way to attract foreign investments would be to sign Agreements on Promotion and Protection of Investments in a bilateral way. This is why they were forced to a change of posture, which mainly happened as from the eighties, as will be seen later on.

Finally, in the regional plan, the agreements of free trade that incorporated specific chapters on investments dealt with their protection and provided for the Investor-State arbitration as mechanism to settle disputes, as follows: a) Chapter 11 of the North American Free Trade Treaty (NAFTA), signed between the United States, Canada and Mexico, and in effect since January 1, 1994¹⁷; b) Chapter 10 of the Dominican Republic-Central America Free Trade Agreement (DR-CAFTA), signed in 2004 by the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and the Dominican Republic; c) the Chapter on the Settlement of Disputes of the Energy Charter Treaty, of 1994 (in effect since 1998),

16 According to CARREAU (1990, pg. 421), certain countries (both developed and under development) consider that their sovereignty demands a rigid control in the admission of foreign investments.

17 Chapter 11 of NAFTA provides that no State-Part can, directly or indirectly, nationalize or expropriate an investment of an investor of another State-Part in its territory or adopt a measure equivalent to nationalization or expropriation of such investment (the so-called “indirect expropriation”, in international law), except: a) for a reason of public interest; b) for non-discriminatory reasons; c) according to the corresponding legal process; d) if granted to the foreign investment treatment equal to that of the international law, including fair and equivalent treatment and total protection; e) through payment of indemnity.

and adopted by 51 States and the European Community and d) Chapter 10 of the Chile-United States Free trade Agreement, of 2003 (KALICKI & MEDEIROS, 2007, p.63).

With regard to the Mercosul, in 1994, the Colonia Protocol was signed for the Reciprocal Promotion and Protection of investments within MERCOSUL and the Buenos Aires Protocol on the Promotion and Protection of Investments by Non-Members of MERCOSUL, which will be discussed later.

1.4 PROTECTION OF FOREIGN INVESTMENT AT BILATERAL LEVEL

The Bilateral Investment Treaties (BITs) – are agreements signed between two countries for the reciprocal promotion and protection of investments that may be carried out by investors of each in the territories of one and the other country. They are agreements that deal exclusively on the issue of foreign investment.

Several authors relate BITs to the old Bilateral Treaties of Friendship, Trade and Navigation that, although began to be signed in the 18th century with the main purpose of international trade expansion, went on to give more specific attention to the issue of investments after the Second World War¹⁸.

Although BITs are signed based on reciprocity – which supposes the existence of a two-way investment flow - for Carreau and Juliard (1990, p.424), - the fact is that this reciprocity is merely formal, due to the fact that such agreements are concluded, in most of the cases, between developed countries (traditional exporters of capital), on the one hand, and developing countries (traditional importers of capital), on the other.

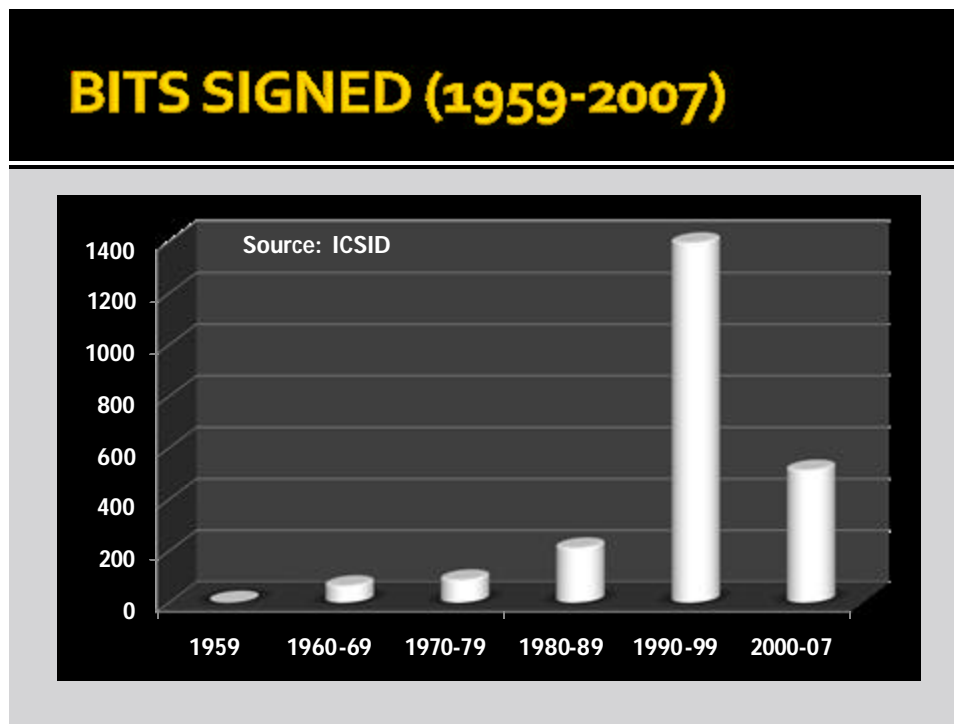
One important contribution to the development of BITs was made by the program of protection and guarantee to investments developed by the United States and administered by the Overseas Investment Corporation (OPIC). According to Moisés (1998, p.27), this program was conceived in the context of the

¹⁸ The first Treatment of Friendship, Trade and Navigation was filmed between the United States and France, in 1778.

Marshall Plan to protect the North American investments in the post Second War Europe. Its objective was to ensure such investments against risks of nationalization, expropriation, impossibility of repatriation of capital or of remittance of profits. This system, by the way, later inspired the creation of the Multilateral Investment Guarantee Agency - MIGA), in 1985¹⁹.

The signing of the first BIT took place between Federal Germany and Pakistan, in 1959. Since then, four decades followed in which a constant increase of signing of BITs was verified, besides the fact that there was a boom in 80's and 90's.²⁰

According to the data available at ICSID's website, the overall number of BITs signed in the world from 1959 to 2007 is as follows:



¹⁹ The MIGA, created by the Convention of Seoul, in 10.12.1985, is an international institution of cooperation, linked to the World Bank, whose main objective is the offer of guarantee against non-commercial risks that can affect foreign investment.

²⁰ According to Kalicki and Medeiros (2007, p.57-86), today there are more than 2,392 BITs in existence, involving more than 176 countries.

With regard to this amazing multiplication of BITs, it must be mentioned that the developing countries, in spite of their position in favor of a “New International Economic Order”, had to accept the reality of dependence on foreign investment to promote their economic development and the attempt of the developed countries that were then trying to make their interests prevail through the bilateral way.

In effect, as the multilateral way was hampered, the developing countries understood that one of the most effective ways, if not the most important one, to attract foreign investments would be by signing BITs, for which they were obliged to change their posture, which happened, mainly, as from the 80's.

Concerning the phenomenon, the very clarifying lesson of MOISÉS (*op.cit.*,p.XVI), follows:

One of the bases of the New International Economic Order, as it was initially proposed in the 70's, in the United Nations, was to increase the solidarity potential among the different nations to diminish the growing inequalities among people and nations. The search for this order was abandoned with the opening of markets, free trade and deregulation. It became out of the purpose to talk of new order, since the economic facts surpassed the theories. The developing countries, continuously more dependent on foreign assistance, could no longer defend the previously formulated principles.

In short, there was a kind of “Counter-Reform” of the developed countries in the investment world, very successful due to the great dependence on foreign capital by the developing countries. According to Kalicki & Medeiros (2007, p.57-86), the objective of BITs was to get rid of one of the main obstacles to the attraction of direct foreign investment to developing countries, whatever the political risk, associated to unstable governments, corruption and concerns about availability, neutrality and efficiency of the local law courts. They add that, with BITs, the risks of foreign investors were significantly mitigated by the granting of standards of internationally recognized treatment and by the possibility to access the impartial *fora* to present claims for eventual damages brought about to their investment, without the need to have to resort to diplomatic protection.

Among the international standards of protection to foreign investors of substantive character that are normally included in the referred agreements, the authors mention the 'fair and equitable treatment', the 'non-discriminatory treatment', the 'more favored nation treatment', 'security and total protection', 'free transfer of funds' and the 'prohibition of expropriation without compensation'.

With regard to the manner of settlement of disputes, they mention that such agreements, in general, provide for the possibility that the investor can choose between: a) international arbitration under the Convention of the ICSID when, both the investor's native country and the host country have ratified the Convention; b) international arbitration under the rules of the Additional Facility adopted at the ICSID (in the case that one of the parties has not ratified the ICSID Convention); c) *ad hoc* arbitration under the rules of the United Nations Commission on International Trade Law (UNCITRAL).

1.4.1 EFFECTIVENESS OF BILATERAL INVESTMENT AGREEMENTS IN ATTRACTING DIRECT FOREIGN INVESTMENT

With regard to bilateral investment agreements, two important issues emerge: the first one is concerning the effectiveness of the agreements to attract investments; the second refers to the burden borne by the host country when signing a protection agreement to investments, considering the restrictions imposed to its sovereignty.

Regarding the first point, much has been discussed on the effectiveness of bilateral investment agreements to attract direct foreign investment (FDI), not having consensus on the issue.

An example of this discussion can be confirmed in the article entitled "*Do Bilateral Investment Treaties increase Foreign Direct Investment to Developing Countries?*", by Eric Neumayer and Laura Spess, from the *London School of Economics and Political Science* (NEUMAYER & SPESS, 2005, p.3), where asserted that most of the studies produced on the issue were made from the legal

aspect and that, due to the lack of studies that showed clear quantitative evidences that BITs attract foreign investment, observers have been pessimistic with regard to such effectiveness²¹. To corroborate this point of view, one must remember the cases of Brazil and Mexico²², important direct foreign investment host countries, independently of bilateral investment agreements.

In the referred paper, prepared from an economic perspective, another three economic studies on the issue are mentioned, of which two refer to the period of 1980-2000 (Hallward-Driemeier, 2003; Tobin & Rose-Ackerman, 2005) and the other one regarding the period of 1991-2000 (Sallacuse & Sullivan, 2005).

Neumayer & Spess (*Idem*, p.4) refer that in their study, Hallward-Driemeier did not find any statistically significant effect in the sense that bilateral investment agreements influence in the direct foreign investment flux; in the second study, that Tobin & Rose-Ackerman detected a negative effect in the high level risk cases and a positive effect in low level risk ones, with most of the developing countries included in the high risk category; and that, in the third study, Sallacuse & Sullivan confirmed a positive effect only in the investment agreements in the United States, but not for the other OECD countries²³.

Criticizing the above studies because they were based on a restricted sample of countries, Neumayer & Spess (*ibidem*, p.4) record having performed a study related to 1970-2001, on a group of 119 countries, and sustain providing the first rigorous quantitative evidence in the sense that the bilateral investment agreements have a positive effect on the foreign investment movement for the developing countries – an effect that, at times, is conditioned to the institutional quality level, but that is always positive and significantly different from zero for all levels of institutional quality.

21 The authors remind us the lesson of SORNARAJAH ('State Responsibility and Bilateral Investment Treaties', *in* the Journal of Trade Law, 20:79-98, 1986) for whom attraction of foreign investment depends more on the economic and political climate than that of the creation of a legal protection structure.

22 According to constant information of the ICSID site on Internet, Mexico signed its first bilateral investment agreement in 1994, having today a total of 23 bilateral investment agreements signed, of which 22 are in effect.

23 OCDE currently has a total of 30 member-countries.

Finally, citing the understanding of Hallward-Driemeier in the sense that BITs are only effective when an environment of good institutional quality is found, Neumayer & Spess (*ibidem*, p.4) recorded that the results of their research provided limited evidence that BITs could function as substitutes to an environment of poor institutional quality.

In turn, Yackee (2007, p.1) refutes the work developed by Neumayer & Spess and, with small methodological changes, collect results that suggest that BITs are significant for the direct foreign investment movement in countries that present low risk, being that the size of this effect grows as the risk diminishes.

By the way, in spite of this confirmation, Yackee (*idem*, p.4-9) points out four theoretical reasons for which he understands that BITs should not be expected to provoke great increase in direct foreign investment, as follows: a) there is very little quantitative evidence that foreign investors take into consideration the existence of BITs when deciding where to invest; b) since a long time ago, investors prefer to protect their interests through investment contracts, which allow them to obtain specific guarantees, much more detailed and precise than the ambiguous guarantees normally included in BITs; c) the costs of political risk offered by the investment host countries are low, since the investors, when deciding where to invest, pay particular attention to the experience of old and current investors; and d) even though BITs work, there is probably a reduction of their effectiveness as they proliferate, considering the reduction of the competitive potential of the capital importing countries.

In this sense, concludes Yackee (*ibidem*, p.21), the influence of BITs to attract direct foreign investment is much less than Neumayer & Spess suggest.

1.4.2 RESTRICTIONS IMPOSED BY BILATERAL INVESTMENT AGREEMENTS ON SOVEREIGNTY OF FOREIGN INVESTMENT HOST STATES

With regard to the burden supported by the foreign investment host countries as a result of the signature of bilateral investment agreements, it is mentioned that the States that sign the referred agreements, grant treatment of international law standards to the foreign investor, among which protection to the property right against nationalization, expropriation or measures of equivalent effect, if not for public interest, on non-discriminatory bases, in conformation with the due process of law and through compensation payment, as well as the unilateral right to institute international arbitration to settle eventual controversies between investor-State.

With regard to the objective of this study, it is important to mention that, under the expression of “*measures of equivalent effect*”, it includes the measures that cause *indirect expropriation*, expression used in International Law referring to the measures taken by the State in the exercise of its regulatory power that, although do not have the purpose of expropriating, are totally or partially equivalent to it, as substantial damages are caused to the foreign investor.

By the way, it must be pointed out that the investment host country, when granting the foreign investor protection against measures resulting from the regulatory power of the State at higher levels than those for the domestic investor, ends up by restricting its sovereign power, to the point that it is susceptible to the opposition to its public policies whenever the foreign investor feels he has suffered damages as a result of such measures.

Quoting Peterson (2004 *apud* NEUMAYER e SPESS, *op.cit.*, p.10-11):

The extent of interference with domestic regulatory sovereignty developing countries succumb to in signing BITs is enormous. In fact, virtually any public policy regulation can potentially be challenged through the dispute settlement mechanism as long as it affects foreign investors. Often, foreign investors need not have exhausted domestic legal remedies and can thus bypass or avoid national legal systems, reaching straight for international arbitration, where they can freely choose one of the three panelists, their

consensus is needed for one other panelist and where they can expect that the rules laid out in BITs are fully applied.

With regard to this point, it must be highlighted that great concerns arose from the moment in which the number of arbitrations concerning investments began to proliferate, mainly because many of them involved the discussion on the regulatory measures of the State, as we shall cover in the next topic.

1.5 ABILITY TO RECEIVE COMPENSATION AND THE COMPENSATION STANDARD IN INTERNATIONAL LAW IN THE CASE OF DIRECT AND INDIRECT EXPROPRIATION OF FOREIGN INVESTMENT

The ability to receive compensation and the extent of damages caused to foreign investment were always a very controversial issue that divided exporting and importing countries of capital, with positions expressed from total compensation, defended by capital exporting countries to non-payment of compensation, sustained by the countries of the socialist block, due to their Marxist ideals.

Sornarajah (*op.cit.*,p.358) observed that the discussion revolves around the compensation owed as a result of legal expropriations/nationalizations, since for the illegal ones, another set of considerations would be required. Besides, he points out that the discussion on the compensation standard is based on arbitral decision, which are considered soft law in international law, i.e., without legal binding strength.

According to the author, there would still not be a firm definition of what total compensation would be, but only loose formulations in the sense that such standard would include *damnum emergens* and loss of profits, which would allow the jurists to explore what they understand comes under such standard²⁴.

24 GRAY points out (1990, 179-80 *apud* SORNARAJAH. *Op. cit.* p. 361) that total indemnity “does not have only one, fixed and locally determined meaning”. This observation has to be made, according to the author “because there is a temptation by writers to choose cases on the basis of their preconception with regard to meaning of what is total compensation”.

It is important to observe that, although at the beginning of the 20th century, there was already a consensus among the main countries in the world that the *prompt and adequate* compensation standard should be used in the case of expropriations of foreign investments, such standard was only better articulated when the American oil companies were nationalized by the Mexican Government in 1938 (CASSECE, 2001, p.415).

At the time, although the nationalization promoted to carry out economic programs was still considered illegal, there was a change in the posture defended by the United States.

In effect, in a note directed to the Mexican ambassador, in April 1940, Cordell Hull, North American State Secretary in the Franklin Roosevelt administration, stated that the “*the United States government recognizes the right of a sovereign state to expropriate for public interest*”, but that “*under any rule of right or equity, no government has the right to expropriate private property, regardless of the purpose, without the immediate, adequate and effective compensation*”.

Here was born the so-called “Hull formula”, of ***prompt, appropriate and effectiv compensation***, defended as a standard of compensation by the developed countries.

On the other hand, the developing countries, influenced by the Calvo Doctrine, defended an ***appropriate compensation***, under the terms of the legislation in force in the expropriating country. This positioning became fairly evident in the UN Resolutions that dealt with the States’ Permanent Sovereignty over their Natural Resources (Resolution no. 1,803, of December 14, 1962, and Resolution no. 3,171, of December 17, 1973), as well as the UN Resolution that dealt with the “Charter of Economic Rights and Duties of States” (Resolution no. 3,281, of December 12, 1974), which states the following:

Resolution n° 1803/1962:

The General Assembly,

(...)

Declares that:

(...)

1. The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned.

(...)

4. Nationalization, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid **appropriate compensation** in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law. In any case where the question of compensation gives rise to a controversy, the national jurisdiction of the State taking such measures shall be exhausted. However, upon agreement by sovereign States and other parties concerned, settlement of the dispute should be made through arbitration or international adjudication.

Resolution n° 3171/1973:

The General Assembly,

(...)

3. Affirms that the application of the principle of nationalization carried out by States, as an expression of their sovereignty in order to safeguard their natural resources, implied that each State is entitled to determine the amount of **possible compensation** and the mode of payment, and that any disputes which might arise should be settled in accordance with the national legislation of each State carrying out such measures;

Resolution n° 3.281/1974:

Article 2

1. Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities.

2. Each State has the right:

(...)

(c) To nationalize, expropriate or transfer ownership of foreign property, in which case **appropriate compensation** should be paid by the State adopting such measures, taking into account its relevant laws and all the circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State and by its tribunals, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means.

With regard to the Resolution that approved the “Charter of Economic Rights and Duties of States” Brownlie writes (1998, p.545), *verbis*:

What effect these formulations have on customary international law? Such resolutions are vehicles for the evolution of state practice and each must be weighed in evidential terms according to its merits. The Charter has a strong political and programmatic flavor and does not purport to be a declaration of pre-existing principles. The opinion has been expressed that Article 2(2) (c) is regarded by many states as an emergent principle, applicable *ex nunc*. In the first place, the language harks back to paragraph 4 of the 1962 Resolution (*supra*). Secondly, the attitude of states opposed to Article 2 indicates all too clearly that governments are aware of the need to ‘contract out’ of such formulations by reservations of position either by explanations of negative votes and abstention or by the making of specific reservations after adoption of a resolution by consensus (without formal vote).

On his part, Sornarajah (*op.cit.*,p.406) observed that such Resolutions were approved by the General Assembly of the United Nations, without the support of the capital exporting countries. In this sense, leaving aside the debate on whether the referred Resolutions constituted a source of Law or not, the author adds that these, at least, express the wish, on behalf of the capital importing countries, in rejecting the “Hull formula”. After all, in spite of the great effort made by the developing countries against the “Hull Formula”, the standard of “ready, appropriate and effective” compensation was amply adopted in the international investment agreements, being largely accepted today in the international law level.

Simultaneous to the discussion on the standard of compensation to be adopted as a result of the direct expropriations, more recently the ability of receiving compensation by damages caused to foreign investment as a result of measures taken by the regulatory power of the State has been discussed.

In general, there are no legal criteria in bilateral investment agreements that distinguish between cases in which damages caused to foreign investors, as a result of regulatory acts legitimately exercised by the host State, deserve compensation or not.

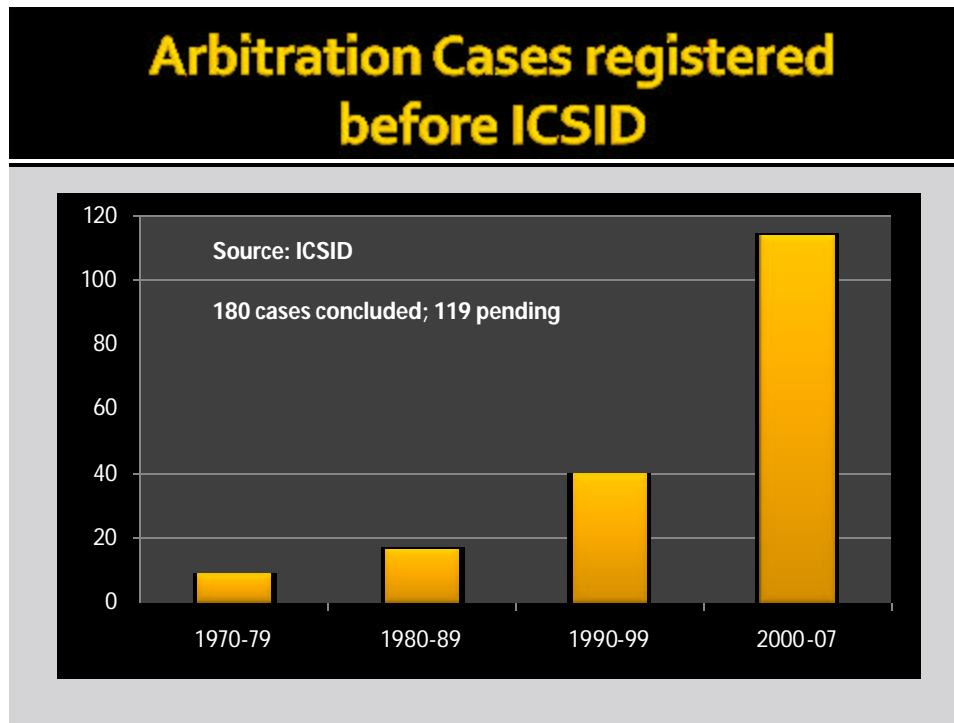
This omission, together with the fact of the frightening growth of international arbitrations involving the discussion of compensation as a result of alleged damages due to state regulatory measures, has caused great concern and discussion on the issue. On this subject, Kalicki & Medeiros (2007, p.64/65) stated the following:

In the last two decades there has been a dramatic increase of investor-State arbitrations. Statistics show that from only 20 cases filed in ICSID's first 20 years (1966 to 1985), ICSID's caseload including cases brought under the Convention and its Additional Facility, grew to almost 180 cases filed in the next 20 years (1986 to 2005). There have been 148 ICSID cases filed in the past six years alone and at least 9 lodged in the first trimester of 2007. Overall, ICSID now has resolved 116 investor-State cases, and another 110 are presently pending. The number of non-ICSID cases has also grown considerably in the last years. It is estimated that there have been 65 ad hoc arbitrations decided under the UNCITRAL Rules, 18 cases administered by the Stockholm Chamber of Commerce, and 4 cases before the International Chamber of Commerce. At least 70 governments – 44 of them in the developing world, 14 in the developed countries and 12 in the Southeast Europe and the Commonwealth of Independent States – have faced investment treaty arbitration.

(...)

The growing use of investor-State arbitration is evidence of the attractiveness to investors of this system of "direct claims". Some of the 226 cases that have been presented to ICSID thus far arise from concession contracts with State entities, which provide recourse to ICSID for breach of contract, and a few invoke host State investment legislation that consents to investor submission of claims to ICSID. But the vast majority of claims before ICSID concern challenges to regulatory or administrative acts independent of contractual relations, such as revocation of permits or imposition of onerous operating conditions that are inconsistent with local law or due process requirements, or are targeted specifically at disproportionately impact, one or more foreign investor.

According to the data available at ICSID's website the ICSID's arbitration caseload is as follows:



Particular apprehension resulted, mainly, from the cases emerged in the ambit of NAFTA, as well as the abundant claims formalized at ICSID against Argentina, due to the financial crisis in 1991/1992.

In the first case, Kalicki & Medeiros (*idem*, p.64) pointed out that Chapter 11 of the Agreement has generated 27 disputes so far, of which 9 cases against the United States (4 concluded and 5 pending), 8 cases against Canada (3 concluded and 5 pending) and 10 cases against Mexico (6 concluded and 4 pending).

Notably with regard to the cases involving compensation caused by expropriation due to regulatory measures by NAFTA, it is very appropriate to point out some examples offered by Hallward-Driemeier (*op.cit.*, p.26-27), to justify such apprehension, as follows:

Most of the recent publicized cases have arisen under NAFTA's Chapter 11. While not strictly a bilateral agreement, the terms are the same as those used in many BITs. And the cases below illustrate the types of obligations other signatory host countries could face. While cases like these have been brought by OECD multinationals in developing countries before, these are some of the first cases where MNCs have sued rich OECD host governments. The outcomes add insight into why OECD governments have refused to enter into other agreements that would give such rights to foreign companies operating in their borders, at the same time as wanting such rights for their own MNCs overseas. It should be noted that these cases have not all been settled and the prospect of expansive regulatory takings claims may not be upheld. Even so, the size of the suits and the potential constraints on policy choices should give host country signatories pause over the precise nature of the terms they agree to.

Concerned about the possible health risks associated with a gasoline additive, MMT, Canada considered banning it (it was already effectively banned in the US). Ethyl Corporation, an American company and the sole supplier of MMT in Canada, filed the first Chapter Eleven case. After instating a ban, Canada's parliament then reversed course, lifting the ban and paying Ethyl \$13 million for damages incurred during the time the ban was in place. Avoiding the \$200 million suit was not the only consideration, but it was widely discussed in the deliberations of the issue.

The threat of another lawsuit also served to thwart a proposed health reform bill in Canada. Canada was proposing to increase the warnings on cigarette packaging. RJReynolds and other tobacco firms threatened a lawsuit and the reform measure was dropped. Since the signing of NAFTA, only two new environmental regulations have been considered in Canada – and both have been challenged under Chapter Eleven.

In the US, there is a case pending that will be extremely influential in determining the scope of such claims. The case regards another gasoline additive, MTBE. Originally hailed as a means of improving air quality by enabling gas to burn more cleanly, it has since been discovered to have tainted the water supply and has been linked to cancer in laboratory animals. California decided in 1999 to ban the additive. Its maker, Methanex, a Canadian corporation is suing for \$970 million in lost profits.

(...)

Another case that generated a lot of attention in the press is that of Metalclad, a US waste disposal company that attempted to set up facilities in Mexico. Despite federal government assurances, local officials denied a building permit due to failures to clean up waste that was entering the water table and due to intense protest from local residents. Metalclad sued and was awarded \$16 million – a sum that had been reduced from the original amount sought due to the determination that expected profits would not have been that high.

With regard to the Argentine case, Jean & Kalicki (*op.cit.*,p.65) recorded that 42 claims were formalized against that country through ICSID, most of which were related to the financial crisis of 2001/2002.

To evidence the existing apprehension resulting from that overwhelming quantity of demands, it is suitable to mention the article entitled “ICSID bleeds Argentina” (CIBILS, 2005), in which the Argentine economist Alan Cibils reports the emblematic case *CMS Gas Transmission Company vs. Argentina*, in which Argentina was condemned to pay the company a compensation of \$133 million for the loss of profits resulting from the freezing of rates for public services carried out by the Economic Emergency Law, as per the arbitral award issued by CSID’S arbitral panel in May 2005.

With regard to this, Alan Cibils wrote (*idem*, p.1):

CMS argued, and the ICSID panel agreed, that Argentina violated its privatization arrangement with the company when, in early 2002, amidst an economic crisis that was worse than the U.S. Great Depression, it froze utility rates. That rate freeze kept utility rates constant in peso terms. For Argentine consumers, this meant their utility bills would stay the same. But during this period, the international value of the peso, which previously had been pegged to the U.S. dollar at a rate of one-peso-to-one-dollar, plunged by 70 percent.

Finally, the Argentine economist recorded that, out of 36 pending cases against Argentina at ICSID, 19 were formalized by companies that supply public services related to energy (gas and electricity), 7 by investors related to the provision of water, 5 by investors in communication and the 5 remaining ones by other kinds of investors, estimating a potential total of compensation of around \$30 million. In this sense, he pointed out that what was at stake for Argentina was not only what they would have to pay to CMS, but also the amount that the country could be condemned to pay concerning other pending cases at ICSID.

Concerning this problem a study by the OECD entitled “Indirect Expropriation’ and the ‘Right to Regulate in International Investment Law” (OECD, 2003, p.3) recorded it as follows:

International Law has long protected foreign property in case of expropriation by giving the owner of the property right to a compensation for its value. In recent times, foreign property owners have increasingly made claims for compensation based on governmental regulations, such as placing restrictions on the legal use of property that do not actually remove the owner’s title to the property but nevertheless substantially affect its value. As the doctrine of “indirect expropriation” has developed, governments have maintained on a

number of occasions that the concept of “indirect takings”, for which there is an obligation to compensate, does not include the normal exercise of government right to regulate for a legitimate public purpose. This is also supported by some scholars. However, arbitral tribunals have not always drawn the same distinction.

Based on the premise that few legal texts have a criterion to distinguish between the acts of the regulatory power of the State that result in compensation for the damages suffered by the investor and those that do not authorize it, in the referred study, OECD carried out a legal analysis of international courts case law, with the objective to identify the criteria used by those courts in practice. Thus, after a thorough exam, the following criteria were identified overall: a) degree of interference in the right of property; b) character of the governmental measure; c) interference of the governmental measure in reasonable expectation with regard to the investment.

With regard to the degree of interference in the right to property, it was confirmed that several international courts have frequently refused to recognize the right to compensation when there is no severe economic impact, i.e., when the governmental measure does not substantially remove all or most of the economic value of the property²⁵. Besides, the admission of the duration of the regulatory measure was also identified as criterion to gauge the severity of the impact on the property.

The study of OECD points out that there is no doubt that the severity of the impact in the property right constitutes a determining criterion to confirm whether the governmental measure has to pay or not a compensation. Nevertheless, it is controversial whether such criterion should be the only one to be considered²⁶ or if the purpose and context of the governmental measure should also be considered.

25 Among the cases in which this guidance was adopted, the *paper* of OCDE includes the *Pope & Talbot versus Canada* case, *S.D.Myers Inc. versus Canada* and *Marvin Roy Feldman (CEMSA) versus Mexico*, all in the ambit of NAFTA, and the *Sporrong and Lönnroth case versus Sweden*, judged by the European Court of Human Rights.

26 See the *Metalclad versus Mexico* case, within NAFTA.

With regard to this, it was pointed out that, both in the doctrine and in the case studies, the balanced exam of the two criteria prevailed, stressing that, in all cases analyzed by the referred study, it was determined that the investor be compensated for the damages suffered, despite the State's legitimate interest to promote a certain measure.

The second criterion identified refers to the character of the governmental measure, by which it is understood that the State has the right to promote the public interest through regulatory measures. In this sense, as long as measures related to the consumer's protection, environmental protection, agrarian reform etc, are non-discriminatory, they would not result in compensation, keeping in mind that they are considered essential for the functioning of the State.

This orientation is adopted by the European Court of Human Rights, which has granted the States a wide margin of assessment related to the measures adopted for public interest. In this sense, the understanding of the Court is that such assessment must be accepted, unless it is exercised in a plainly unreasonable manner²⁷.

With regard to the last criterion (interference of the state measure in reasonable expectation by the investor regarding the investment carried out), the study records that the investor, to have the right to some compensation, will have to prove that his demand is reasonable, that it is not only based on his subjective expectations and he is not challenging the regulatory regime of the State.

With regard to this theme, it is also convenient to register the declaration of Jan Paulsson, President of the International Court of Arbitration of London (2005, p.1), as follows:

In 1962, Professor Christie's influential article in the British Yearbook of International Law entitled "What Constitutes a Taking under International Law" concluded that the question **does governmental interference with the economic activity of a foreigner constitute a taking for which compensation should be paid?** can be determined only on a case-by-

27 According to DOLZER (2002), the European Court of Human Rights has developed its law related to the powers of a member-State, both with regard to general issues and to protection of property, through the concept of "margin of appreciation", thus echoing the classical interpretive emphasis on state sovereignty.

case basis. In 2004, Zachary Douglas (now a scholar of University College London) and I revisited this topic and wrote that Professor Christie's conclusion remained valid, observing that "the fact that we are no closer to a precise definition of indirect expropriation some forty years after Professor Christie's study only reinforces this insight."

Finally, Giusti and Trindade (2005, p.70) inform that, taking into consideration the threat placed to the sovereignty of the States, there is already a new generation of bilateral investment agreements, trying to give a greater balance to the investor-State relations, as follows:

The critiques that are usually made to the adoption of a too wide concept of violation to investments and expropriation by the courts of ICSID is that, for being such ample concepts, they end up by unduly limiting a sovereign government of exercising abilities that are inherent to it and whose purpose, without further appeal, would be the creation of public policies to provide the well-being of its population. Under the argument of protecting themselves, the investors must not apply a too wide investment concept (and that has hardly been desired by the Party States the treaty at the moment of its negotiation) to try to diminish a risk that is naturally inherent in the business, ending up by transferring that same risk to the investment host State.

On the other hand, there is already news of a new generation of international investment treaties that try to reach a balance between a comprehensive definition, but not too ample in investment, and themes that must not be embraced by that same investment definition. This new wave of treaties points out that adverse economic effects happening on a particular investment, alone, do not induce the occurrence of indirect expropriation. Besides, regulation measures by investment host States that are not discriminating and destined to protection of the common good of its population, such as measures affecting public health, environment and security, would not constitute indirect expropriation either. In short, the fundamental note is that the protection of foreign investments cannot be aimed at in detriment of objectives of legitimate public policies. It is precisely up to the arbitration tribunals constituted to analyze the controversies related to investments, and, if it were applicable, arbitration tribunals constituted under the auspices of ICSID, to determine if this balance so desired was achieved in concrete cases.

2. PROTECTION OF FOREIGN INVESTMENT IN BRAZIL

2.1 INTERNATIONAL COMMITMENTS OF BRAZIL RELATED TO THE PROTECTION TO FOREIGN INVESTMENT

Between the years of 1994 and 1999, Brazil signed 14 Bilateral Agreements for Promotion and Protection to Investments (BITs), besides 2 (two) Protocols on the Promotion and Protection to Investments, in the ambit of Mercosul.

In effect, BITs were signed with the following countries: Portugal (02.09.1994), Chile (03.22.1994), United Kingdom (07.19.1994), Switzerland (11.11.1994), France (03.21.1995), Finland (03.28.1995), Italy (04.03.1995), Denmark (05.04.1995), Venezuela (07.04.1995), Republic of Korea (09.01.1995), Germany (09.21.1995), Cuba (06.26.1997), Netherlands (11.25.1998), Belgium-Luxemburg (01.06.1999).

Concerning the object of this work, the referred BITs provide for the protection of foreign investments in face of nationalizations, expropriations and measures of similar effect – the so-called ‘indirect expropriation’ – promoted by one of the signing States.

Explaining such protection more clearly, the referred Agreements establish that the signing countries, with regard to foreign investments, can only nationalize them, expropriate them or take some measure of effect similar to these, when the public interest for such exists, when such measures are not discriminatory and upon compensation.

With regard to the requirement of public interest, the agreements use varied expressions to describe it, as, for example, ‘public utility’, ‘public need’, ‘national interest’, ‘social interest’ and, even, ‘national security’.

It is also appropriate to mention that the majority of these agreements mention the need that measures taken by a Party State must follow the due process of law. For this, expressions are used such as ‘through the due process of

law’, ‘according to the legal provisions of the Contracting Party’, ‘according to the due procedures of law’, ‘based on the fair process of law’.

Finally, with regard to the issue of compensation, nearly all the agreements adopt, with small terminology variety, the **Hull formula** of the ‘*prompt, effective and appropriate*’ compensation.

With reference to Mercosul, two protocols on investments were signed: the “Colonia Protocol for the Reciprocal Promotion and Protection of Investments within MERCOSUL” (protection to the intra-block investments) – of 01.17.1994 – and the “Protocol on the Promotion and Protection of Investments by Non-Member States of MERCOSUL” (Buenos Aires Protocol) (protection to the extra-Block investments) – of 08.05.1994.

Both provide for the granting a fair and balanced treatment to the investments of a foreign investor and the guarantee against unjustifiable and discriminatory measures by the investment host State, besides including the most favored nation clause.

With regard to expropriations and nationalizations, the protocols provide for that these will only be carried out by *public interest, on non-discriminatory bases* and *according to the due process of law*, being able to consider that both protocols have the same compensation standard, even under slightly different nomenclatures, that is: *previous, appropriate and effective compensation* (Colonia Protocol), and *fair, appropriate, immediate or opportune compensation* (Buenos Aires Protocol). Of the agreements signed, the BITS signed with Chile, United Kingdom, Portugal, Switzerland, France and Germany, as well as the Buenos Aires Protocol²⁸, were sent to the National Congress for ratification.

These agreements faced strong resistance for approval by the Congress, under the terms they were signed. This is why the Executive Power considered it

²⁸ The BITS were submitted to the National Congress, according to the following messages : Chile (Message no. 1,159/94), United Kingdom (Message no. 08/95) Portugal (Message no. 09/95), Switzerland (Message no. 10/95), France (Message no. 652/97) and Germany (Message no. 755/98).

convenient to require the withdrawal of the submission for approval until the treatment to be given to this issue were better defined²⁹.

One of the main objections made by the National Congress refers to the previous commitment of Brazil to be submitted, at the exclusive discretion of the foreign investor, to the settlement of disputes by international arbitration.

In effect, the following motivations contrary to the provision of investor-State international arbitration were listed by the National Congress: opposition to the legal principle of exhaustion of internal resources to repair the damage, establishment of equal conditions between two absolutely different subjects (The Brazilian State and the foreign investor), launching of vexatious and unfounded suspicions on the Brazilian Judicial Power, creation of a privilege to the foreign investor in detriment to the national investor (violation of the principle of national treatment), violation of article 5, XXXV, of the Constitution, that determines that 'the law will not exclude any injury or threat to a right from the consideration of the Judicial Power and incompatibility with the principle of the reciprocal agreement of the parties in the sense that the dispute be settled by arbitration.

Likewise, with regard to the issue of expropriation, it was argued that when the referred agreements provide for immediate payment of compensation, in convertible and easily transferable currency, they would go against articles 182, § 4, item III and art. 184 of the Federal Constitution, which establish payment in public debt bonds issue by the local government, redeemable within up to 10 (ten) years, and in agrarian debt bonds issued by the Federal Government, redeemable within up to 20 (twenty) years, for the cases, respectively, of expropriation of urban property, for not fulfilling their social function, and expropriation of rural properties, for social interest, for agrarian reform purposes.

With regard to the prevision of investor-State arbitration, it is important to point out that Brazil had already refused to admit it decades earlier, more precisely in 1964, when consultations had been made by the World Bank to create the

²⁹ See Presidential Message no. 1,080/2002, related to the BITs and Presidential Message no. 162/2004, related to the Protocol of Buenos Aires.

International Center for Settlement of Investment Disputes (ICSID), and for the same reasons that made it object to it in the context of BITs. That is the reason Brazil did not sign the Washington Convention. In effect, Giusti and Trindade (2005, p.49-78) register it as follows:

The Brazilian position in face of the types of settlement of international conflicts and to arbitration itself was, in general, historically well known and – why not? – conservative. Perhaps still as an inheritance of the Calvo Doctrine, the ideals of the New International Economic Order internationally defended in the 1960's and 1970's by Brazil, which was one of most eloquent members of the so-called Group of the 77 in the United Nations, presented a reaction even in the 1990's. The concept of national sovereignty is still found today fairly rooted in the legal culture and Brazilian governments, in spite of the movements of regional integration and the economic prevalence of the market based on the movement of capitals.

With this said, except for the commitments taken on by Brazil with the World Trade Organization (WTO), notably by the General Agreement on Trade in Services (GATS) and by the Agreement on Trade Related Investment Measures (TRIMs), the legal regime applicable to foreign investment in Brazil is circumscribed to the Brazilian national legislation, and the settlement of Investor-State disputes – except specific legal exceptions in the case of state entities, as we will discuss later – must be submitted to the Brazilian national jurisdiction.

2.2 THE LEGAL REGIME APPLICABLE TO FOREIGN INVESTMENT IN BRAZIL AND THE FLOW OF DIRECT FOREIGN INVESTMENT RECEIVED

According to Veiga, the legal regime of foreign investment in Brazil was relatively liberal (with few horizontal reserves and sectarian restrictions agreed on)³⁰ during the period in which the import substitution regime (60's to 80's) was in

³⁰ The restrictions to the entry of investments involved specific sectors of the industry (such as mining), but they were specifically relevant and lasting in the service area. In the case of the manufactured products, there was hardly any limitation, and in certain sectors that the government considered strategic, the movement of foreign investments was conditioned to certain requisitions, such as the association with Brazilian companies or transfer of technology.

effect, and noteworthy for its stability, considering that, from the beginning of the 60's, it was basically regulated by constitutional rules and by Law no. 4,131/62³¹

Veiga adds that the Federal Constitution of 1988 reinforced the restrictions to foreign investment made until then by the introduction of the distinction between Brazilian enterprises with national capital and Brazilian companies with foreign capital, which enabled the law to establish discriminations of treatment. Besides this, he adds that the Constitution maintained the state monopolies of the gas and oil sectors, reserved the exploitation of mineral and water resources, coastal navigation, domestic air transport, and media activity to the Brazilian companies with national capital, as well as maintained the restrictions in financial services, securities and above all, hardware production to foreign companies.

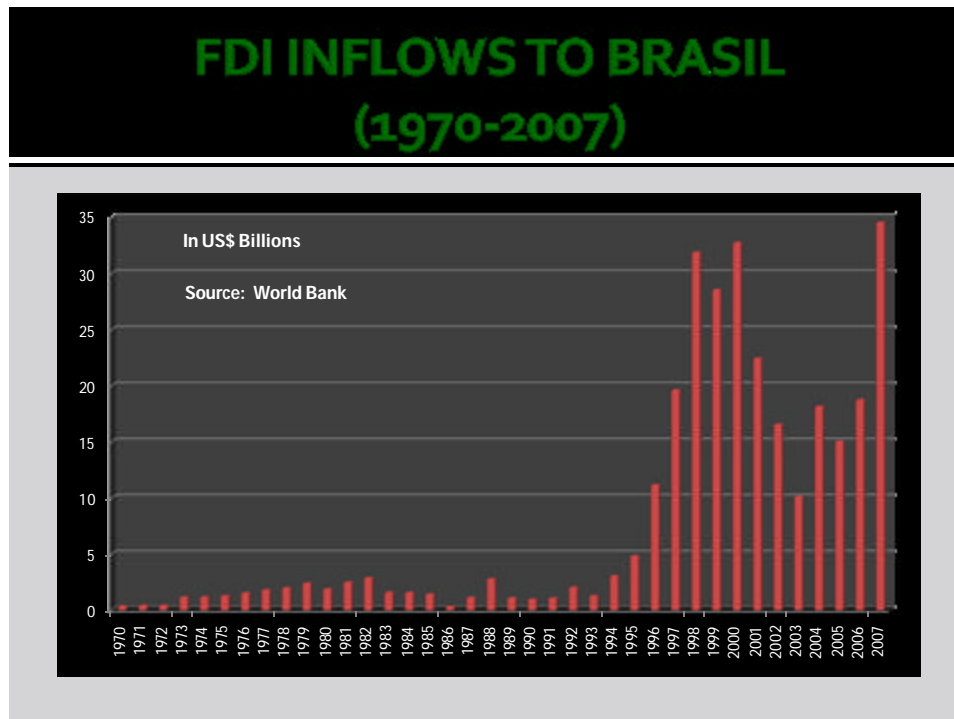
Finally, he mentions that this situation began to be reversed at the beginning of the 90's, when Brazil underwent a strong process of deregulation of the economy, above all with regard to the issue of a series of constitutional amendments between 1995 and 1996³².

With regard to the flow of direct foreign investment in Brazil, the UNCTAD 2005 Investment Policy Review Brazil (p.5) points out that Brazil has been, since the Second World War, and except in the 80's, one of the major host countries of direct foreign investments among the developing countries due to the size of its domestic market.

31 According to Laplaine & Sarti (LAPLANE & SARTI, 1999, *apud* VEIGA 2004), Law no. 4,131, of September 3, 1962, disciplined the application of foreign capital and the remittances of values abroad. Its principal objective was the discouraging of exit of foreign capitals already invested in the Country and stimulus to its reinvestment.

32 Besides eliminating the distinction between Brazilian companies with national capital and Brazilian companies with foreign capital, the changes that had happened did not actually take place in the regime applicable to direct foreign investment, but to the general regime of investments. In effect, in general, such changes implied in the opening of sectors belonging to private initiative, previously reserved to the state monopoly.

To give a picture of the Brazil Foreign Direct Inflows, see graphs below which illustrate FDI inflows from 1970 to 2007:



Besides this, he records that beginning with the approval of the 'Real' Plan, followed by privatizations, elimination of distinction between Brazilian companies with national capital and foreign capital, opening of several sectors of the economy to private investment (such as telecommunications and energy) and trade opening (elimination of most of the non-tariff barriers), direct foreign investment had an immense increase in Brazil. Finally, in spite of the 1998-1999 crises, the energy crisis of 2001 and the world economic relenting beginning in 2000, the study shows that direct foreign investment in Brazil is still significantly higher than at any period prior to 1996.

3. THE LEGAL SYSTEM OF EXPROPRIATION IN BRAZIL

3.1 DIRECT EXPROPRIATION

The Brazilian legal order provides for five modalities of expropriation: expropriation for public purposes, expropriation for social interest, dispossession for failure to carry out the social function of urban or rural property (the former aiming at land reform), not to mention the expropriation of land in which cultivation of illegal psychotropic plants is found (the last 3 modalities have a sanctioning character).

In Brazil, expropriation is an administrative proceeding initiated ordinarily by an executive branch declaration of public utility or social interest, culminating with the loss of property in exchange for an indemnity. In the case that the government and the dispossessed owner do not reach an agreement concerning the price of the property, the case will be taken up in a judicial court.

3.2 THE TERM “INDIRECT EXPROPRIATION” IN BRAZIL

Contrary to what occurs at the international level, the term indirect expropriation has a different meaning in Brazil. As a matter of fact, in international law, the referred term is employed to designate the damages caused to the property in its overall sense (that is to say the material and non-material property), by the exertion of the State's regulatory power. As examples, it can be mentioned the damages suffered by an individual as a result of the regulatory measures of the State concerning public health, consumer's protection, protection to the environment, sanitary measures etc.

On the other hand, in Brazil, the term indirect expropriation refers as much to the act of appropriation as to the interference by the State to the physical property, without the observance of due process of law; that is to say, without following the ordinary expropriation proceeding in its different modalities.

In this sense, indirect expropriation in Brazil consists of a factual action taken by the State, regardless of the rules of law.

It is important to underline that under Brazilian legislation, the referred term is used only for the expropriation of the physical property, whether it is total or partial. Thus, in its capacity of exercising the policy power over private property, the State can impose a series of restrictions on it on behalf of the public interest and the well being of the community. The different modalities of restriction vary as to their function and as to their level of interference in private property.

The Brazilian civil procedure law provides for a legal action called “*ação de desapropriação indireta*” (“indirect expropriation action”), that is applied specifically to legal actions of indemnity concerning cases in which the physical private properties bear restrictions imposed by the State. When it comes to damages caused to non-physical property, an ordinary indemnity legal action would be applicable.

4. STATE REGULATORY POWER IN BRAZIL

According to Caio Tácito (*apud* Medauar, 1998, p.349) (free translation), the state regulatory power (“*poder de policia*”) is “*a collection of attributions granted to the Administration to discipline and restrain rights and individual freedom on behalf of an adequate public interest.*”

In this sense, although a legal system grants protection to the exertion of rights and liberties by those who are subordinated to that system, for the most part under the Rule of Law, such rights and liberties shall not be exerted in an absolute manner, since such would lead to constant conflicts in society.

It is precisely for this reason that the state is endowed with regulatory power, which allows it to control the exertion of rights and freedoms so as to avoid such conflicts and to conform such exertion to the public interest.

On the other hand, it is of paramount importance to emphasize that the state regulatory power has limits in its exertion. As a matter of fact, consistent with the principle of proportionality, the exertion of regulatory power by the State cannot annihilate a right or individual freedom but only restrain them insofar as necessary for the preservation of public interest.

4.1 CONCEPT OF STATE REGULATORY POWER

The doctrine usually mentions the existence of a classic concept of state regulatory power with a liberal feature, and a modern one with a social-economic feature. Such concepts are linked to the different behaviors adopted by the State since the beginning of the Rule of Law.

According to the classic concept, the regulatory power of State confines itself to the limitation of rights and individual freedom in order to maintain security and public order. On the other hand, according to the modern concept, it assumes an interventionist connotation in a variety of social sectors, allowing the State to interfere in rights and individual freedoms through restrictions and impositions on behalf of the public interest.

In the tax area, the state regulatory power receives special attention by having its concept defined by the Brazilian Tax Code. It owes its *ratio essendi* to the fact that state regulatory powers is one of the tax bases for collection of taxes in Brazil (Federal Constitution, Art.145, II). In this context, Art.78 of the Brazilian Tax Code provides as follows (free translation):

The activity of public administration is considered a regulatory power which, limiting or disciplining rights, interests or freedoms, regulates the practice or abstention of act or fact on behalf of public interest regarding security, health, order, production and market discipline, practice of economic activities contingent on granting or authorization by the State, public peace or respect for property and individual and collective rights.

In turn, the sole paragraph of the referred Article 78 sets forth the concept of regular state regulatory power as follows (free translation):

Exercise of regulatory power is considered regular when carried out by the competent department, within the limits of the applicable law, with the observance of due process and, in cases of activity which the law considers as discretionary, without abuse or deviation of power.

4.2 CHARACTERISTICS OF STATE REGULATORY POWER

According to Di Pietro (*op.cit.* p.113), it is usual to point out the discretionary, self-enforceable, and coercible attributes of state regulatory power

The margin of liberty that the administration has to act in one way or another within the limits of legality should be understood as discretionary. As to self-enforceability, it is the ability the administration has to enforce its own decisions, independent of the Judiciary Power. According to Meirelles (*apud* DI PIETRO, *op.cit.* p.115) (free translation), the “coercive imposition of the measures taken by the Administration” is its coercible attribute.

4.3 EXERCISE OF STATE REGULATORY POWER AND ITS LIMITS

Based on the lessons of Kant, Cretella Júnior (1999,p.19) teaches, as does the Natural Law, that state regulatory power will always be unchangeable and will exist regardless of the law systems and governments. On the other hand, depending on the governments, positive law shall vary and so will the application of the state regulatory power.

Thus, the state regulatory power could express itself in a variety of fields, either by the application of the State’s classic functions, which encompass aspects related to security, health and public peace, or by its modern functions, which

comprise environment preservation, the fight against the abuse of economic power, etc.

Such expressions could be formulated as much by means of general legal measures of the Legislative Branch (laws), as by general and specific legal measures issued by the Public Administration.

In Brazil, administrative regulatory power is carried out by the three governmental entities (Federal Government, States and Municipalities). According to Mello (free translation), “the competent entity for a certain administrative regulatory measure shall be the one competent to legislate about a subject”.

Concerning the limits to the exertion of state regulatory power, it should be kept in mind that such limits are expressed either horizontally or vertically. Horizontal boundaries refer to the area in which the state regulatory power can be exerted, and vertical boundaries, the depth with which such state regulatory power can be exerted to the detriment of a certain right or individual freedom.

So neither rights and individual freedoms nor state regulatory power are absolute. As to the former, although they are protected by the constitutional order, they find their limits in the need for the preservation of rights and freedom of other individuals, as well as of public interest. As to the latter (state regulatory power), although it can prevail over the rights and individual freedoms on behalf of the supremacy of public interest, such prevalence shall be exerted within the legal limits.

If the state regulatory power exceeds the limits in relation to which it must be restrained, then abuse of power appears, which can be either by deviation of power (deviation of purpose) or excess of power. In the former case, the public agency diverts from the public interest in order to search for a different objective from the one provided by the law. In the latter case, the public agency exceeds the limits of its competence.

According to Di Piero (op.cit. p.116) (free translation):

Regulatory power shall not go beyond what is necessary to satisfy the public interest it aims to protect; its purpose is not to destroy individual rights, but, on the contrary, to assure their exercise, adapting them to the social welfare; it can only restrict them when there is a conflict with the major interests of the community and to the amount strictly necessary to attain the public purposes.

Because of the concern for potential abuses exerted by the public administration, scholars advocate the use of the principle of proportionality (the vertical limit to the regulatory power) – according to which the means must fit to the purpose.

4.4 PRINCIPLE OF PROPORTIONALITY AS A LIMIT TO THE EXERCISE OF STATE REGULATORY POWER

In the context of a conflict between the state and individuals, the principle of proportionality is the tool to adjust the invasive character of the state regulatory power on the fundamental rights of individuals.

According to Stumm (1995, p.78), the referred principle would have appeared linked to the idea of power limitation in the eighteenth century and have acquired constitutional *status* and acknowledgement as a principle in the middle of the twentieth century.

Its *ratio essendi* lies in the fact that the aim pursued by public administration is to preserve public interest. On the other hand, as mentioned above, the Brazilian legal order grants protection to a multitude of rights and individual freedoms. Based on this, and keeping in mind that public interest has to prevail over a right or individual freedom, the sacrifice of such right or individual freedom shall be made to the extent required by public interest. Unless this requirement is observed by the public administration when exerting its regulatory power, the regulatory measure shall be legally flawed, exposing the public administration to legal liabilities.

According to Scaff (2001, p.235), the principle of proportionality has two dimensions: it works as a blockage to the arbitrary measures of the State and, conversely, as a protection to individual constitutional rights. Through its blockage function, public administration measures have to be exerted to the point of achieving the pursued public purpose. In its protective function, it should protect the integrity of the individual fundamental rights to the maximum, restricting them only to the point necessary to attain the public purpose.

Although the principle of proportionality is not expressly provided for in the Brazilian legal system, it is important to stress that scholars and case law acknowledge it as deriving from other principles provided for in the Brazilian Federal Constitution, in particular the one concerning the State of Law.

Finally, scholars are accustomed to dividing the principle of proportionality into three parts: a) adequacy; b) necessity; and c) the principle of proportionality *stricto sensu*. Adequacy shall be verified by the extent to which the measure taken by the State is adequate to the attainment of the pursued public purpose. Whether the public measure is effectively needed to attain the public purpose or whether there is another less severe way to do this shall determine the necessity. And as to the principle of proportionality *stricto sensu* – its core – this regards the level of the intensity of the measure taken by the State, that is, it shall sacrifice rights only to the extent necessary to satisfy public interest and protect the integrity of fundamental rights to the maximum.

5. STATE REGULATORY POWER IN THE CONTEXT OF INTERVENTION IN THE ECONOMY

As mentioned at the beginning of this study, the assessment of the State's regulatory power applied in the economic area is, for obvious reasons, extremely relevant in foreign investment protection vis-à-vis the regulatory power of the State. As a matter of fact, it is in the economic field where the regulatory power of the State shows itself much more clearly to investors in general, keeping in mind the vast repercussions which such economic measures bring about in their daily life.

5.1 DELIMITATION OF THE CONCEPT OF STATE INTERVENTION IN THE ECONOMY

According to Scaff (*op.cit.* p.82), the concept of State intervention in the economy, which is normally taught, regards the functions taken on by the State in a post-liberal era, comparing the functions exercised by the State in liberal times and the functions of economic leadership exercised by the State currently, where the latter determines the course of the economy.

Among the factors mentioned by the author resulting in the transformation of the liberal State into an Interventionist State, the need to break up economic activities must be emphasized. This is due to the disastrous social and economic consequences caused by the appearance of monopolies and oligopolies during the liberal State. Also the advent of the First World War, a period during which the State had to intervene in the market in order to direct the productive activities to the war effort.

For Scaff (*op.cit.* p.91), "state intervention in the economic domain (...) performed a role of mitigating the conflicts of the liberal State through the attenuation of its characteristics – the contractual freedom and private property of the production means..." In this sense, according to the author, a need to impose

a social function on these institutions emerged and, as a consequence, resulted in state conditioning over the contractual freedom of individuals and the social function of propriety.

By the way, Grau (1991, p.136-137) draws a distinction between intervention and state action. According to him, intervention is a more vigorous concept, referring to state action in the private sector. As for state action, it has a broader notion, encompassing economic activities as well as public services.

For Silva (2000, p.785), the term intervention in the economic domain is normally used in a broader sense, so as to include all kinds of state actions in the economy, a fact that is not denied by the Brazilian Federal Constitution. Nevertheless, the author distinguishes between participation and intervention in state action. The former regards the State as a manager of the economic activities, whereas the latter regards it as a normative and regulatory agency of economic activities.

5.2 ECONOMIC ACTIVITY *VERSUS* PUBLIC SERVICE

As did many other Brazilian constitutions that adopted the capitalist system, the Brazilian Federal Constitution, in its Article 170, specifies that the economic order be based on free enterprise and on the principles of private property and free competition.

Allowing for the private appropriation of production means and for free initiative, as a general rule, the Brazilian legal order determines that the economic activities shall be carried out by the private sector, without prejudice to the State also doing it in exceptional cases.

Therefore, when the State uses its regulatory power to intervene in economic activities, it invades a private sector domain, where private law rules are applicable.

Such a notion is important in order to keep in mind that, theoretically, it is not suitable to refer to State intervention in an activity which constitutes a public service since, although conferred to the private sector through concession or permission, it maintains public ownership in addition to being subject to a system of public law.

For Grau (*op.cit.* p.136), “the State does not carry out an intervention when it renders a public service or regulates the rendering of a public service. In this case, it acts in a domain of its own ownership, that is the public domain.” That is why it is important to distinguish economic activity from public service.

Nevertheless, it is interesting to point out that the Brazilian Tax Code, when defining regulatory power in its Article 78, stretches its field of action to also include the economic activities contingent on concession or authorization by the Public Power, which, as a consequence, includes the regulatory intervention of the State over the economy. Besides, Brazilian Jurisprudence does not follow the strictness of the doctrinal definition of intervention of the State over the economic domain, as it makes reference to it even when it concerns contractual relations between the State and a public utility concession.

For Grau (*op.cit.* p.138-139), there is no distinction in essence between an economic activity and a public service. The author notes that public service is nothing more than “a kind of economic activity whose performance is preferably the responsibility of the public sector.”

In its Article 175, the Brazilian Federal Constitution states “*It is incumbent upon the Government, as set forth by law, to provide public utility services, either directly or by concession or permission, which will always be subject to public bidding.*”

By the way, the same Brazilian Federal Constitution establishes the activities which are subject to public services, as can be verified in Article 21, XI³³ and XII³⁴, where the public services included in the Federal Government's competence are listed, as well as in Article 25, Paragraph 2³⁵, where the public services conferred to the Federal States are listed.

5.3 MODALITIES OF STATE INTERVENTION IN THE ECONOMY

For Grau, State intervention in the economic domain can be carried out in two ways: **intervention in the economic domain** and **intervention over the economic domain**. The former “occurs when the State acts as an economic agent, assuming and participating in the management or in the control of the voting shares of an economic unity...” As to the latter, “it occurs when the State acts as an issuer of rules with the function to regulate the productive process, but not to participate in it” (GRAU, 1998 *apud* SCAFF, *op.cit*, p.104-110).

33 Article 21. The Union shall have the power to: XI - operate, directly or through authorization, concession or permission, the telecommunication services, as set forth by law, which law shall provide for the organization of the services, the establishment of a regulatory agency and other institutional issues; (*Clause XI added by Constitutional Amendment No. 15, August 15, 1995*);

34 Article 21, XII- operate, directly or through authorization, concession or permission:
 a) the services of sound broadcasting and of sound and image broadcasting;
 b) the electric power services and facilities and the energetic exploitation of watercourses, jointly with the states wherein those hydro-energetic potentials are located;
 c) air and aerospace navigation and airport infrastructure;
 d) railway and waterway services between seaports and national borders or which cross the boundary of a state or territory;
 e) interstate and international highway passenger transportation services;
 f) sea, river and lake ports;
 (*Clause XII added by Constitutional Amendment No. 15, August 15, 1995*)

35 Article 25. The States are organized and governed by the Constitutions and laws they may adopt, in accordance with the principles of this Constitution. Paragraph 2 - The states shall have the power to operate, directly or by means of concession, the local services of piped gas, as provided for by law, it being forbidden to issue any provisional measure for its regulation.
 (*Paragraph 2 amended by CA 5, August 15, 1998. The original text determined that the concession should be granted to State companies only. The amendment allowed privatization of the gas companies.*)

Intervention in the public domain, according to the author, can be divided into **intervention by absorption**, where there is no permission by the State for an identical activity to be carried out, and **intervention by participation**, where the State acts in a specified field together with other economic agents.

Intervention over the economic domain can be done by **rules of direction**, which do “not allow behavior other than the ones provided for in the rules” and by **rules of induction**, by which “the State does not determine coercive proceedings to be adopted by the economic agents,” [but simply] “(...) license certain activities to the detriment of others, guiding the economic agents to follow the options which are economically more advantageous.”

5.4 ECONOMIC INTERVENTION IN THE BRAZILIAN FEDERAL CONSTITUTION

According to Silva, “the economic order has acquired a legal dimension since constitutions began to discipline it systematically, which started with the Mexican Constitution of 1917.” In Brazil, he explains that “the Constitution of 1934 was the first one to provide for principles and rules concerning the economic order,” influenced by the Weimar Constitution (SILVA, *op.cit.* p.764).

For the jurist “State action, among others, aims at trying to organize social and economic life, mending the disorder caused by Liberalism (*idem*, p.764).

As a consequence, economic rights shall be exercised, limited by the same principles that grant them protection (the ones provided for in Article 170 of the Brazilian Federal Constitution), in order to prevent abuses in such exercise, either in face of someone else’s economic rights or in face of public interest.

This means that while economic free enterprise is a basis of the Brazilian economic order and has its exercise constitutionally assured, it has also to be limited by the State when it tends toward the concentration of the economic power due to someone else’s economic free enterprise as well as to the public interest in

the maintenance of the constitutional economic principles of free enterprise and consumer protection³⁶.

As seen above, the modalities of State action towards the economic domain can be divided, according to Silva, into *participation* and *intervention*. This corresponds to what Grau calls, respectively, *intervention in the economic domain* and *intervention over the economic domain*.

Intervention in the economic domain in Brazil is based on articles 173³⁷ and 177³⁸ of the Brazilian Federal Constitution. Under these regulations, the State is entitled to directly carry out an economic activity. However, concerning the activities listed in Article 177, the State, through the Federal Government exclusively, has a monopoly on the economic activities, but may hire state or private enterprises to carry out the activities listed in nºs. I to IV of Article 177³⁹.

36 Article 173, Paragraph 4 - The law shall suppress the abuse of economic power that aims at the domination of markets, the elimination of competition and the arbitrary increase of profits.

37 Article 173. With the exception of the cases set forth in this Constitution, the direct exploitation of an economic activity by the State shall only be allowed whenever needed for the imperative necessities of national security or to a relevant collective interest, as defined by law.

38 Article 177. The following are the monopoly of the Union:

- I - prospecting and exploitation of deposits of petroleum and natural gas and of other fluid hydrocarbons;
- II - refining of domestic or foreign petroleum;
- III - import and export of the products and basic by-products resulting from the activities set forth in the preceding items;
- IV - ocean transportation of crude petroleum of domestic origin or of basic petroleum by-products produced in the country, as well as pipeline transportation of crude petroleum, its by-products and natural gas of any origin;
- V - prospecting, mining, enrichment, reprocessing, industrialization and trading of nuclear mineral ores and minerals and their by-products.

39 Article 177, Paragraph 1 - The Union may contract with state-owned or private enterprises for the execution of the activities provided for in items I through IV of this article, with due regard for the conditions set forth by law.

(Paragraph 1 amended by Constitutional Amendment (CA) 9, November 9, 1995. Original text read: "Paragraph 1. The monopoly set forth by this article includes the risks and results derived from the activities mentioned, the Union being forbidden to grant or charter any kind of participation, in cash or valuables, in the exploration of reservoirs of oil or natural gas, excepting the provisions of article 20, paragraph 1." This CA ended the monopoly of Petrobrás. This CA passed in the first year of the first term of President Fernando Henrique Cardoso; the same year, the CA was passed ending the monopoly of the Telecommunication companies. Nationalists accused FHC of "selling the assets of the Brazilian society").

In the case of article 173 of the Brazilian Federal Constitution, the State can directly carry out an economic activity through mixed capital or public companies. Such enterprises shall have their creation authorized and scope of action defined by complementary law, according to Article 37, XIX of the Federal Constitution⁴⁰. In addition, because they carry out activities in the private domain, they shall have to subject themselves to private law, except for some deviations of public law such as observing the Public Administration principles in regard to bidding and contracting of buildings, services, purchases and sales⁴¹.

As to the intervention over the economic domain, it is done through State regulation and is provided for in Article 174 of the Brazilian Federal Constitution, as follows:

Article 174. As the normative and regulating agent of economic activity, the State shall, in the manner set forth by law, perform the functions of control, incentive and planning, the latter being binding for the public sector and indicative for the private sector.

As Silva explains (*ibidem*, p.785), regulation of economic activity aimed in the beginning at bringing the economy back to its track, where the system of free competition was effective. Nevertheless, it has evolved nowadays to encompass also other objectives such as price regulation, consumption, savings, investment etc.

⁴⁰ Article 37, XIX - only by means of a specific law shall an autarchy be created and shall a public company, a mixed capital company and a foundation have their creation authorized, it being necessary, in the latter case, to enact a complementary law to define the scope of action;
Constitutional Amendment No. 19, June 4, 1998

⁴¹ Article 173, Paragraph 1 - The law shall establish the juridical statute of the public company, the mixed capital company and their subsidiaries which explore economic activity of production or trading of goods or rendering of services, with provisions for:

III - bidding and contracting of buildings, services, purchases and sales, with observance to the principles of public administration;

[Paragraph 1 amended by Constitutional Amendment (CA) No. 19, June 4, 1998. The original text read: "Paragraph 1 - The public company, the mixed-capital company and other entities engaged in economic activities are subject to the specific legal system governing private companies, including labor and tax liabilities." The aim of this CA was twofold: to give more freedom to State companies to compete with private companies (previous to the CA, State companies and the direct public administration were subject to the same bidding and contracting laws), and to bring accountability to the administration of the State companies].

Among the functions performed by the State, as a normative and regulating agency of economic activity, Article 174 lists inspection, incentive and planning. According to Silva, inspection aims at controlling the attainment of the regulations issued by the State. As to the incentive, it concerns State action as a promoter of economic development. Finally, the planning consists of a technical process for the organization of the economic activities in order to reach the desired results (*ibidem*, p.786).

6. STATE TORT LIABILITY FOR DAMAGES CAUSED BY THE APPLICATION OF GOVERNMENT REGULATORY POWER IN BRAZIL

6.1 EVOLUTION OF THEORIES CONCERNING STATE LIABILITY

According to Di Pietro (*op.cit.* p.524), the subject of civil liability of the State has been treated diversely over time and space, with various existing theories. The scholar says that, in some legal systems like the Anglo-Saxon, the principles of private law prevail, while a public system is adopted in European-Continental law.

Regarding State liability over time, she explains that, at the time of absolutist States, the theory of State irresponsibility was in force, fundamentally based on the idea of sovereignty. Then, in the nineteenth century, the State became subject to liability based on the principles of civil law, which demanded the existence of fault. Later, State liability evolved to an objective liability approach, resulting from the development of the publicist theories concerning liability in the case law of the French State Council.

From an objective point of view, Di Pietro (*idem*, p.524) stated that publicist theories at first produced the concept of fault of service (*faute du service*), or administrative fault. Thus, the individual civil servant's fault was detached from the anonymous fault of service, which occurred when the latter didn't work, worked with delay or badly, in which case there was State liability, independent of the civil servant's fault.

Secondly, Di Pietro (*op.cit.* p.526) added that for certain hypotheses, the French State Council began to adopt the theory of risk, which serves as a ground for objective State liability, thus named because there is no need of fault for its configuration.

According to this theory, based on the equal distribution of the social burden, the person who endures a burden greater than the one endured by the community, is entitled to receive indemnity from the Public Power, with the aim of reestablishing the balance among the society (MEDAUAR, *op.cit.* p.285). For this, it suffices to prove the link of causality between the damage suffered and the behavior of the State.

For Meirelles (*apud* DI PIETRO, *op.cit.*, p.527), “the theory of risk encompasses two modalities: the one of administrative risk and the one of whole risk; the first admits (the second does not) the excluding clauses of State indemnity: the victim’s fault, fault of third parties and *force majeure*.”

6.2 LIABILITY IN STATE TORT ACCORDING TO THE DOCTRINE IN BRAZIL

For the present study, it will be important to analyze the liability in State tort in the Brazilian context. Although such can result from the behavior of the Legislative and Judiciary Departments – an exceptional case – it originates in general from the behavior of the Public Administration. Informatively, the contractual State liability, which is ruled by its own principles, will not be analyzed here.

According to Mello (*op.cit.* p.781), “*the idea of State indemnity is an inevitable logical consequence of the notion of State of Law, since it is a simple result of the submission of the Public Power to the Law*.” In this sense, he states that, from the logical point of view, such indemnity does not require any specific rule.

However, the current Federal Constitution of 1988, in its Article 37, paragraph 6, provides that “*when rendering public services, both public and private legal entities shall be liable for damages that any of their agents, acting as such,*

*cause to third parties, ensuring the right of recourse against the liable agent in cases of malice or fault.”*⁴²

Brazilian scholars agree that the rule of objective State indemnity has been incorporated in the Brazilian constitutional context since the Brazilian Federal Constitution of 1946, as well as the rule of subjective indemnity regarding public agents.

According to the theory of the objective indemnity, it shall be sufficient to prove the causal nexus between the damage suffered by the private party and the behavior of the State for the objective indemnity to be illustrated. The existence or not of *lato sensu* fault is irrelevant, in reference to faults involving the modalities of imprudence, negligence and malpractice, or of malice.

Concerning the objective indemnity of the State in Brazil, Brazilian scholars do not agree as to the theory on which it is based. Regarding this point, Scaff (*op.cit.* p.142-146) says that, although the scholars adopt doctrines with different nomenclatures, what really matters is that their opinions substantially agree that the theory adopted is one of “whole risk”, in the terms expressed by Cretella Júnior, with the excluding cause “*fault of the victim.*”

For Scaff (*idem*, p.137), according to this theory, “*the determinant point is the damage caused by the State, independent of the identification of who has caused it, or even of the agent’s intention in doing so* (free translation).” He also declares that there is no need to search for the fault of the State, only requiring that the causal link between the State behavior and the damage incurred be shown.

Relevant to the present study, it is important to mention the lesson of Cretella Júnior (*op.cit.* p.80) for whom the whole risk theory “*recommends*

⁴² The new Civil Code of 2002 – in force since Jan 1, 2003 – has dealt with the indemnity of Public Power in the following terms: “Art.43. *The internal public legal entities shall be civilly liable for the acts of their agents, when acting as such, they cause damages to third parties, reserved the regressive right against them, if there exists fault or malice by these.*”

indemnity for the damages suffered, even when the actions practiced by the public agents are normal in the exercise of their functions (free translation)."

Despite the divergence as to the terminology, Mello (*op.cit.*, p.774) says that (free translation):

"Patrimonial State liability refers to the obligation of the State to economically repair the damages caused to legally protected third parties and which are imputable to the State due to unilateral behavior, licit or illicit, comissive or omissive, material or juridical."

For Di Pietro (*op.cit.* p.523), contrary to private law where civil liability is always caused by an illicit act (against the law), in administrative law, State liability also includes the damages that, although licit, cause a heavier burden to certain people than the one imposed on other members of society.

In the first case, the liability is based on the principle of legality, while, in the latter, it is sufficient to invoke, as Mello (*op.cit.*, p.793) teaches, the principle of isonomy, i.e., equal law or right. In effect, the State shall be liable when, performing certain acts entitled by law, it indirectly sacrifices a right of third parties as a by-product of its action,

6.3. INJURIOUS STATE BEHAVIOR

As seen above, from the point of view of State behavior, the State can be liable for damages caused by positive actions (comissive acts) as well as by absence of actions (omissive acts).

6.3.1 STATE LIABILITY FOR COMISSIVE ACTS

When performing its functions, the State is always obliged to search for benefits to the community. However, it can cause members of this community to endure a burden heavier than others in the name of a common benefit. In these

cases, there is damage to an asset legally protected by a basic element of the State of Law, which is the principle of equality.

For Mello (*idem*, p.793), the reparation for a burden specially suffered by some members of the community for the attainment of the public interest is a logical consequence of the principle of isonomy; that if the community gets the benefits of the State act on the one hand, it shall endure the economic burden of it on the other hand.

It is paramount to emphasize that it is irrelevant to verify whether the State act was or was not legitimate, because both legal and non-legal acts, carried out by means of legal or material acts, shall entail the objective liability of State. It is sufficient for the causal link between the behavior and the damage⁴³ to be proved.

As a matter of fact, the State can also be found liable by the so-called “facts of Administration”, about which Meirelles (1997, p.568) says, *verbis* (free translation):

The damage caused by a public work brings to the Administration the same objective liability established for the public services, because, although the work is an administrative fact, it always results from an administrative act which orders its execution. (...)

6.3.2 STATE LIABILITY FOR OMISSIVE ACTS

State liability for omission only happens when there is illegality. This means that if there is damage arising out of a State omission, it can only be obliged to indemnify if it was obliged to avoid the damage. In this sense, the theory of subjective liability shall be applicable and, therefore, the *lato sensu* fault of the State shall be proved.

⁴³ See Federal Court of Appeals of 4th Region, 3^a Panel, Civil Appeal n° 217447/RS, Reporter Federal Judge Paulo Afonso Brum, judgment on 10.26.2000, published in DJU of 1.20.2001, p.159: “*Dealing with a committed act carried out by an agent of the Administration, it is not necessary to prove the lato sensu fault due for the incidence of the objective State liability.*”

6.4 EXCLUDING AND MITIGATING CLAUSES OF STATE LIABILITY

Objective State liability is based on the existence of a causal nexus between the behavior and the damage incurred. In this case there is neither a link nor is the State behavior decisive for the happening of the damage. There shall be a hypothesis of non-liability for the State or such liability shall become mitigated.

The causes generally cited as excluded from State liability include *force majeure* and *fault of the victim*. **Force majeure** is an unpredictable, inevitable happening which has nothing to do with the compliance of the parties and, in principle, constitutes an excluding clause of liability. However, it can involve a liability if combined with a State omission regarding the performance of a public service. Concerning the **fault of victim**, if exclusive, this shall not involve State liability and, in the cases it coincides with State liability, it shall act as a mitigating cause⁴⁴.

As for an act of God, it does not avoid State liability, because it constitutes, as mentioned by Mello (*op.cit.* p.806), an accident whose root is technically unknown, and therefore does not overturn the causal link between defective State behavior and the damage.

Regarding this point, Cahali (*op.cit.* p.55) says:

Although the indiscriminate acknowledgement of the excluding cause of Public Administration liability in cases of force majeure as well in acts of God is intended, it is certain that only in cases of damage arising out of force majeure, is the exclusion of the duty to indemnify legitimate (...).

In effect, if in private law, the act of God and the force majeure are confused as to their consequences, to exclude the liability of State, the treatment regarding both institutions shall be different in the scope of State liability.

⁴⁴ See Federal Court of Appeals of 1st Region, 5th Panel, Civil Appeal n° 200134000136839/DF, Reporter Federal Judge Fagundes de Jesus, judgment on 5.09.2003, published in DJ of 6.30.2003, p.116: *"The Brazilian legal order adopted the theory of administrative risk as to the civil State liability. So, for the public body to be objectively liable, the proof of the damage suffered and the link of causality between the omission/conduct of the Administration and the referred damage are sufficient. The mitigation or the exclusion of the referred state liability in such circumstances can only happen if the fault (total or partial) of the victim or the existence of force majeure or act of God is proved by the Administration."*

Here – as Themistocles Cavalcanti warns – the distinction between an act of God and force majeure is imposed, because, if the force majeure comes from an external fact, not belonging to the service, the act of God comes from the malfunction, from an internal cause inherent to the service itself; therefore the exclusion of liability is admissible in cases of force majeure. However, it remains in cases of an act of God, because this is included in the risk of service; in force majeure, human will does not interfere, neither closely nor remotely, while, in an act of God, the will would appear in the organization and in the functioning of service.

6.5 DAMAGE SUBJECT TO INDEMNITY

6.5.1 CHARACTERIZATION

Mello (*op.cit.* p.794) teaches that (free translation):

In matters of State liability for damages caused by the State, Sotto Kloss is right when he states that the problem shall be examined and decided in view of the situation of the passive party – which is the one damaged in his legally protected sphere – and not in view of the characteristics of the behavior of the active party.

Therefore, in the first situation, it is necessary to say that the nature of the damage can be patrimonial as well as extra-patrimonial. In effect, the Brazilian Federal Constitution provides, in its Article 5, number X that the privacy, private life, honor and image of persons are inviolable, and the right to compensation for property or moral damages resulting from their violation is ensured.

Incidentally, according to Arnold Wald (1989) (free translation):

Damage is the injury suffered by a person in his assets or in his physical integrity, thereby constituting an injury caused to a legal asset, which can be material or immaterial. Moral damage is the one caused to someone in his personality rights, with the possibility to accumulate liabilities for material and for moral damage.

For Cretella Júnior (*op.cit.* p.729), the determining factor for the distinction between material and moral damage is the effect of the injury produced and not the injury in itself, as follows (free translation):

When the damage does not correspond to characteristics of patrimonial damage, it is said we are in the presence of moral damage. The distinction, contrary to what it seems, does not come from the nature of the right, asset or injured interest, but from the effect of the

injury, from the feature of its consequences to the victim. Thus, patrimonial damage can possibly occur in consequence of an injury to a non-patrimonial asset as well as a moral damage resulting from an offense to a material asset.⁴⁵

It is interesting to note that moral damage – formerly supported only by the case law – was ultimately embraced in the Brazilian legal system as from the Federal Constitution of 1988 – the Constitution that granted autonomy to moral damage in relation to material damage. Accordingly, the Superior Court of Justice, through the **Law Abstracts Nos. 37 and 227**, settled the understanding, respectively, that “***the indemnities for material and moral damages arising out of the same fact are cumulative***” and “***the legal entity can suffer moral damage.***”

Despite the wide range of damages subject to indemnity, not all damages caused by the State are cumulative, whether they arise out of omissive or active behavior.

Mello (*op.cit.* p.802) teaches that two characteristics are necessary for a damage to be subject to indemnity: the existence of an injury to a right and the certitude of the damage. According to the author, the existence of an injury to a right means there shall be an encumbrance of a right; that is, it is not enough for an economic injury to exist, but an injurious event that results in a legal injury. Concerning the need to certify the damage, Mello (*op.cit.* p.804) points out that the damage cannot be only possible or potential, but must be certain, whether present or future.

Regarding the characterization of moral damage, two perceptions address this problem: the first one maintains that to prove the moral damage, it is not

⁴⁵ Concerning this subject, see: Superior Court of Justice, 2nd Panel, Special Appeal n° 642.008/RS, Reporter Justice Castro Meira, judgment on 6.10.2004, published in DJ of 2.14.2005, p.180: “*The liability arises from the conjunction of three elements: the omissive or committed act illegally or abusively practiced, the damage and the link of causality between both. The damage experienced by the victim can be of material or moral nature, depending on the legal objectivity violated*”; Superior Court of Justice, 3rd Panel, Special Appeal n° 410.734/SP, Reporter Justice Carlos Alberto Menezes, judgment on 12.06.2002, published in DJ of 3.10.2003, p.190: “*The violation of copyrights can reach the patrimonial and moral rights, these exclusively*”.

enough to report the facts but must demonstrate the extent of the pain suffered; according to the second one, it is understood that the characterization of the moral damage takes place when the causal link between the injurious act and the damage suffered is proved, which, in turn, is presumed *ipso facto*⁴⁶.

6.5.2 DAMAGE SUBJECT TO INDEMNITY IN CASES OF LAWFUL STATE BEHAVIOR

This is the kind of damage that needs to be analyzed thoroughly, because damage arising out of normal activities of the regulating power of State is what constitutes the object of the present study. The basis of the indemnity arising out of this type of damage is the unequal distribution of the public obligations that exceed the norm, where it is unfair for someone to endure a burden greater than the other members of the society in order to further the public interest.

Mello (*op.cit.* p.804) teaches that the configuration of the damage subject to indemnity in the cases of lawful State behavior, beyond the certitude of damage and the injury to a right, requires two other characteristics: specialty and abnormality.

According to the author (*op.cit.* p.804-805) (free translation):

⁴⁶ The Brazilian Superior Court of Justice follows this trend. See Superior Court of Justice, 3rd Panel, Special Appeal n° 611.973/PB, Reporter Justice Asfor Rocha, judgment on 3.23.2004, published in DJ of 9.13.2004, p.261: *"The jurisprudence in this Court is appeased in the sense that, in the modern conception of compensation for moral damage, the liability of the agent prevails by force of the simple fact of violation in a way that proof of the damage in concrete is unnecessary, contrary to what happens to the material damage."* Superior Tribunal de Justiça, 3^a Panel, Special Appeal n° 608.918/RS, Reporter Justice José Delgado, judgment on 5.20.2004, published in DJ of 6.21.2004, p.124: *"As it deals with something immaterial or ideal, the proof of moral damage cannot be made through the same means used to prove the material damage. In other words, the moral damage is inserted in the illegality of the practiced act, arising from the gravity of the illegal act itself, its effective proof being unnecessary; this means, as already underlined: the moral damage exists in re ipsa. Ruggiero states: "For the damage to be subject to indemnity, 'it is sufficient for the perturbation caused by the illegal act to create a reduction in the fruition of the respective right in the psychic relations, in the tranquility, in the feelings, in the affections of a person."*

Special damage is one that burdens a particular situation of one or more individuals, not being a generic loss distributed over the society. It corresponds to a patrimonial burden that falls specifically upon a certain individual or individuals and not upon the community or a generic and abstract category of people.

Abnormal damage is one that exceeds the mere patrimonial injuries, small and inherent to the conditions of social coexistence. Life in society implies the acceptance of certain risks of subjection to moderate economic burdens to which everybody is subject, occasionally or transitorily, although in a variable degree and contingent on circumstantial factors. These are the small burdens which do not represent abnormal damage.

Along the same line of thought, Figueiredo (*op.cit.* p.264) adds (free translation):

In line with the theory risk-benefit, developed by Oswaldo Aranha Bandeira de Mello and followed by Celso Antônio, certain, abnormal and special damages are indemnified where lawful activities are involved.

This is so because, if unlawful, it would be enough for the damages to be correct and amount to constituted legal situations.

However, the illegal damages (in the language of the emeritus Enterría) ought to be abnormal, i.e., they have to transcend the normal inconveniences to which anyone should be subjected on account of living in society. Besides, they should be appropriate, that is to say quantifiable - and special, for not affecting everybody, but only one or some.

6.5.3 AMOUNT SUBJECT TO INDEMNITY

In civil indemnity, the function of the indemnity is to reestablish, as much as possible the *status quo ante* through the restoration of the asset damaged. In this sense, Meirelles (*op.cit.*p.570) says (free translation):

The indemnity of damage has to encompass what the victim effectively lost, spent or did not earn as a direct and immediate consequence of the injurious act of the Administration; i.e., in civil language, *damnum emergens* and *lost profits*, as well as legal fees, indexation and late interest, if there is delay in payment.

In the practice of Brazilian judicial courts, the determination of the amount to be indemnified shall depend on the factual circumstances of each case regarding those of material damage as well as those of moral damage.

As to the cases of material damage, such determination does not, in principle, entail major inquiries, whereas the verification of the extent of the damage depends essentially on the evidence.

Regarding the moral damage, according to the jurisprudence of the Superior Court of Justice, it has a redressing purpose, as well as the aim of discouraging potential repetitions of the act. In this sense, it is understood that the repairing quantum has to be arbitrated with reason and cannot entail enrichment without cause⁴⁷.

6.6 BRAZILIAN JUDICIAL COURTS STANDARDS FOR STATE LIABILITY REGARDING MEASURES OF STATE REGULATORY POWER

Regarding the State liability arising from damages caused by the intervention in the economic domain (see definition of Grau *ut supra*), we are dealing with damages coming from abusive acts of regulatory power (that is to say, ones which fall outside the legal limits and are therefore considered illegal) and with acts of regulatory power which, although legitimate, entail a heavier burden on an individual in relation to the rest of the society.

As seen above, the State can be subject to indemnity for comissive as well as for omissive acts. In the former case, the liability shall be objective, being enough to prove the causal nexus the damage suffered and the active State behavior. In the latter case – of liability for omission – the basis for the liability is, in principle, subjective, based on *lato sensu* fault; that is to say, it is necessary to prove that the State was obliged to avoid the damage, not having done this by imprudence, negligence, malpractice or malice, cases in which the omission will be alleged illegal, entailing liability⁴⁸.

⁴⁷ See Superior Court of Justice, 4th Panel, Special Appeal n° 348.388/RJ, Reporter Justice Fernando Gonçalves, judgment on 10.7.2004, published in DJ of 11.8.2004: “*The indemnity has, beyond the purpose of compensation, the objective of discouraging the offender to repeat the act. However, it has to be guided by proportionality, taking into account the peculiarities of the claim and the parts involved, avoiding illegal enrichment*”; Superior Court of Justice, 2nd Panel, Special Appeal n° 658.547/RJ, Reporter Justice Eliana Calmon, judgment on 4.18.2005, published in DJ of 4.18.2005, p.266: “*The amount of the moral damage has been dealt with in the Superior Court of Justice with the aim to attend to its double function: repair the damage in an effort to minimize the victim’s pain and punish the offender so that this is not repeated.*”

⁴⁸ See Superior Court of Justice, 1st Panel, Special Appeal n° 472.735/DF, Reporter Justice Luiz Fux, judgment on 8.25.2003, published in DJU of 8.25.2003, p.264: “*There is a civil State liability for omission whenever a facere is consecrated as a duty and the Public Administration infringes it... Interpretation of the paragraph 6 of*

As a matter of fact, analysis of the liability arising out of abusive acts of intervention is not important for this study, because in relation to these, and except for the concurrence of excluding and mitigating clauses, there will be no major inquiries as to State indemnity.

Thus, what is really important to be analyzed is the State liability for damages arising out of lawful acts of intervention in the economic domain, which have as basis the unequal distribution of the public obligations.

So, in the first instance, it is necessary to identify when an act of intervention will be considered legal, legitimate. Such analysis undergoes two steps: the first one – which is basic – concerns the question of the legality and the second is the contrast between the act and individual rights.

As to the legality, it represents the principle that gives basis to the State of Law and, as such, is a fundamental requirement for the application of a regulatory measure⁴⁹.

Regarding the analysis of the clash between an intervention with an individual right, what matters is to verify whether the principle of proportionality was

Article 37 of the CF/88”; Federal Court of Appeals of 4th Region, 3th Panel, Civil Appeal n° 9104191285/PR, Reporter Judge Gilson Dipp, judgment in 07.10.1992, published in DJ of 6.16.1992, p.31.573: “*Liability of the autarchy is dismissed because proof of the causal link between the lack of success of the financial institution and the alleged inadequacy or omissions of the inspection is nonexistent. It is unacceptable that the mere subjection of a person to the regulatory power can create, to the state body, a risk which gives place to liability, a case in which neither fault nor the risk to the parastate entity are present.*”

⁴⁹ See Federal Court of Appeals of 2nd Region, 2^a Panel, Civil Appeal n° 138.006/RJ, Reporter Federal Judge Castro Aguiar, judgment on 5.16.2001, published in DJU of 6.07.2001: “*The jurisprudence is pacific in the sense of proclaiming that, although issued at the time of the Federal Constitution of 1946, the current legal order received the former legislation which represses the economic Power, including the Delegate Laws Nos. 04/62 and 05/62, in face of the coherence of their provisions with the current constitutional texts. Of absolute constitutionality, therefore, is the intervention in the economic domain by the State, through the inspection carried out by SUNAB.*” Federal Court of Appeals of 2nd Region, 3rd Panel, Regimental Appeal in Interlocutory Appeal (Agravo Regimental em Agravo de Instrumento) n° 66.284/RJ, Reporter Judge Francisco Pizzolante, judgment on 12.12.2000, published in DJU of 6.19.2001: “*The National Oil Agency has the power to intervene in the economic domain, according to Article 174 of the Republic Constitution and its purpose is to regulate and inspect the economic activities of the oil industry.*”

accomplished, that is to say whether the act was adequate, necessary and that the individual right has been sacrificed only to the extent sufficient to reach the aim intended by the State. If the intervention does not meet the principle of proportionality, it shall be considered abusive, entailing the State liability based on the illegality⁵⁰.

It is of paramount importance to stress that, even being lawful and proportional, an intervening state act can entail the State liability on account of the damage caused to someone, as long as the burden borne by him is heavier in relation to the rest of the community⁵¹.

It is also important to remember, according to the teaching of Mello, *ut supra*, the inquiry concerning the existence of State liability has to begin with the analysis of the damage. The damage – for most cases arising out of legal and illegal acts - requires two characteristics: the first one is that the damage cannot be limited to an economic damage, but needs to represent a damage to a subjective right, and the second one concerns the need for the injury to be right (present or future), not only potential⁵².

⁵⁰ See Superior Tribunal de Justiça, 2^a Panel, Special Appeal n^o 79.937/DF, Reporter Justice Fátima Andrighi, judgment on 2.06.2001, published in DJ of 9.10.2001, p.366: “Price control is not to be confused with price freezing, which constitutes a convenience policy of State, while it intervenes in the economic domain as a normative and market regulating body, not breaking the proportionality principle as the sector as a whole suffered the consequences of an economic policy in a wide and generic manner”; Superior Court of Justice, 1st Panel, Special Appeal 443.310/RS, Reporter Justice Luiz Fux, judged on 10.21.2003, published in DJ of 11.03.2003: “The performance of the Public Administration ought to follow the parameters of reasonability and proportionality which condemn the administrative act which does not consider the adequate proportion between the means the Administration employs and the objective the law intends to reach. The reasonability finds resonance in the adjustability of the administrative providence according to the social consensus over what is usual and judicious. Reasonable is a concept which is deducible *contrario sensu*; this means, it escapes from the reasonability ‘what can not be’. The proportionality, as one of the facets of reasonability, reveals that not all means justify the ends. The means leading to the achievement of the aims, when exorbitant, overcome the proportionality, because of the immoderate measures in face of intended results.”

⁵¹ See Federal Court of Appeals of 3rd Region, 3rd Panel, Civil Appeal n^o 585026/SP, Reporter Judge Nery Júnior, judgement on 04.25.2001, published in DJU of 10.10.2001, p.652: “Even though it can be admitted the legitimacy of the ‘temporary retention’ of coffee stocks, the administrative act of the Coffee Brazilian Institute, which has determined the retention, intervening in the private economic domain, has caused damages to producers and exporters, who have to be compensated in homage to the administrative risk theory and state objective liability theory, as these ones do not depend on the illegality of the act that caused the damage”.

⁵² See Superior Court of Justice, 1st Panel, Special Appeal n^o 549.873/SC, Reporter Justice Luiz Fux, judgment on 8.10.2004, published in DJ of 10.25.2004, p.224: “With the aim to regulate foreign trade and maintain the

Concerning the damages arising out of legal acts, and beyond the characteristics mentioned above, two others have to be added: the specialty and the abnormality. In this sense, it is necessary for the victim to have experienced a particular injury arising out of an act of intervention and that such injury exceeds the burden that would be reasonable and sociably accepted independent of indemnity.

It has to be noted that the demonstration of the damage lies necessarily in the proof of the damage, which is normally produced through expert evidence before the judicial court. It is precisely the expert evidence that provides the dimension of the indemnity corresponding to the damage, the indemnity for material and moral damage⁵³ being admitted in the *Brazilian* case law. As to the material damages, they encompass *damnum emergens* as well as *loss of profits*. Finally, regarding future profits, they are only admitted if there is certainty⁵⁴.

balance of payments, the Sovereign State can decree the exchange parity, predictably subject as to its stability, to foreign trade and to the international policy, facts which are not imputable to the National State, whether in the light of objective liability or the subjective liability, inherent to the hypothesis of the omissive acts, in which it is mandatory to detect that the public entity had the duty to avoid the unpredictable fact which caused damages to third parties"; Federal Court of Appeals of 1st Region, 2^a Panel, Civil Appeal in *Writ of Mandamus* n^o 1999.34.00034153-6, judgment on 9.29.2003, published in DJ of 10.16.2003, p.47: *"The performance of CONAB in the carrying out of the national agriculture policy, more precisely in the segment of food supply, is one of the ways of State intervention in the economy that ought to be oriented by the observance of the general principles of economic activity, which enlighten the financial and economic order, according to Article 170 of the Federal Constitution."*

⁵³ See Federal Court of Appeals of 1st Region, 5^a Panel, Civil Appeal n^o 2002.01.00007832-1/DF, Reporter Federal Judge João Batista Moreira, judgement in 23.04.2004, published in DJ of 18.06.2004, p.37: *"The liability in the tort of State, although predominantly of objective character, does not exempt the proof of the damage and its respective cause, whose burden is upon the person who is seeking for the indemnity";* Federal Court of Appeals of 1st Region, 3rd Panel, Civil Appeal n^o 96.0149869-9, Reporter Federal Judge Cândido Ribeiro, judgement in 25.11.1997, published in DJ of 13.02.1998, p.319: *"The expert evidence produced well demonstrated the existence of the damage caused, as well as the own causal link arising out of the conduct of the public agents of the Federal Government who imposed on the claimant prices for its product which were below those that effectively he had a right to charge."*

⁵⁴ See Federal Court of Appeals of 3rd Region, 4th Panel, Civil Appeal n^o 89030368371/SP, Reporter Federal Judge Sérgio Lazzarini, judgement in 9.30.1992, published in DOE of 3.15.1993, p.154: *"Future and uncertain damages which constitute mere rights of expectation are not subject to indemnity."*

7. THE LOW EFFECTIVENESS OF THE BRAZILIAN JUDICIAL SYSTEM

Here lies one of the main concerns regarding the Brazilian judiciary system, which is the need of more effective judgements in order to allow the ones who present their claims before the courts the possibility of profiting fully and timely the rights to which they are entitled according to the Brazilian legal system.

Regarding this point, in the Study entitled “Diagnóstico do Poder Judiciário” (*“Diagnosis of the Judiciary Power”*) (BRASIL, MINISTÉRIO DA JUSTIÇA, 2005, P.6), of August 2004, the Secretary of Judicial Reform of the Brazilian Ministry of Justice registers as follows:

The Judiciary Power needs to modernize in order to render more and better services to the Brazilian population. The inefficiency of the public administration put at service of the Justice brings huge losses to the country: it renders the judgements inaccessible to the most part of the population; it renders the life of those who have access to the Judiciary Power in an endless struggle for the acknowledgment of rights; it makes difficult the professional exercise of lawyers, prosecuting attorneys; public attorneys and Judiciary civil servants; it penalizes unfairly the judges in their mission of making justice and, yet, inflates the Brazil cost. The ill-functioning of the Judiciary Power interests those who take refuge in its inefficiency in order not to pay, not to perform obligation, to procrastinate, to buy time – but does not interest the country.

Such manifest is confirmed by the argentinian Leandro Despouy, author of the *“Report of the Special Rapporteur on the independence of judges and lawyers – Mission to Brazil”* (UNITED NATIONS, 2005, p. 9), of February 22th, 2005, made for the Human Rights Commission of the United Nations Economic and Social Council, during his mission to Brazil from October 13th to 25th, 2004, according to the following:

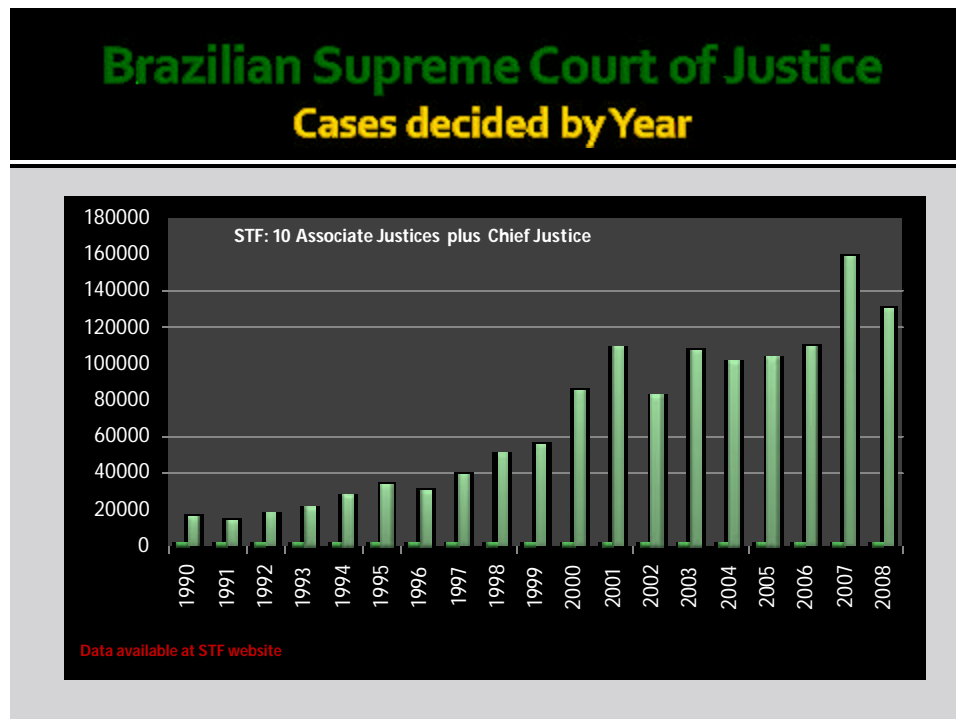
21. The first general analysis of the judiciary, which was carried out in 2003, revealed that 17.3 million cases had been initiated and allocated to a judge - the equivalent of one case for every 10 inhabitants. This extraordinary figure shows how severely congested the system of justice is. According to the Movimento Nacional de Direitos Humanos (National Human Rights Movement), 80 per cent of

the cases under way are before higher courts ruling on matters connected with the State. Paradoxically, the public authorities are more involved than any other party in court cases and are thus one of the main causes of litigation. Civil society accuses the judiciary of giving priority to individual actions dealing with money matters rather than to collective actions. In the Rio de Janeiro Court of Justice, 16 firms account for 44.9 per cent of the legal actions initiated. In the Court of Justice, actions related to the financial market account for over 60 per cent of the proceedings under way.

22. The Brazilian legal system relies heavily on constitutional guarantees and therefore provides for many remedies, which ultimately delay court decisions. The President of the Recife Court of Justice cited a case in which 34 remedies had been invoked, not to mention a large number of procedural objections. Another difficulty is the excessive number of cases that reach the Federal Supreme Court.

23. The problem of delays is worse in some parts of the country than in others. In the State of São Paulo, where about 13 million cases are under way, there is one judge for every 24,000 inhabitants, leaving each judge with an average of 8,000 to 10,000 cases. By contrast, in Rio Grande do Sul, which has a more up-to-date judicial system, there are less delays, the courts have been equipped with information technology and different forms of virtual proceedings are being tested.

In order to give a picture of the congestion faced by the Brazilian Judiciary System, find below two graphs with the yearly number of cases judged by the Brazilian Supreme Court of Justice and by the Brazilian Federal Court of Justice (data available at Courts respective websites) :





Concerning the Judiciary Power reform process under way in Brazil, the referred Report (*idem*, p.16) states that:

66. On 17 November 2004, after 12 years of discussion, the Brazilian Senate adopted the first chapter of the judicial reform. This reform, which has been criticized from some quarters as being too timid and from others as being too radical, should be seen as an important, though not the last, step towards improving the functioning of the system of justice. (...)

Notwithstanding the first step in the Reform of the Judiciary Power has been taken with the issuance of the Constitutional Amendment nº 45, of December 8, 2004, there is still too much to be done to render the judgements more effective in Brazil, as was highlighted by the Secretary of Judicial Reform of the Brazilian Ministry of Justice in the abovementioned “Diagnóstico do Poder Judiciário” (*op.cit.*, p.6-7), *verbis*:

In the conception of the Government, the very reform of the Judiciary Power passes through the development of actions which can be grouped in three fundamental axes: the modernization in the Judiciary Power management, the modification of the legislation (Code of Civil Procedure and Penal Code) and the constitutional reform of the Judiciary Power.

Finally, as to the arduous effectiveness of the rights through the current procedure legislation, it has to be underlined that such arduousness gets more severe when it comes to guaranteeing a right in face of the Public Treasury, because this one, besides having innumerable privileges, such as the presumption of legality of its acts, extended terms to contest and appeal, and restriction of subjection to preliminary injunctions, counts yet on a particular enforcement process, which culminates in a request for payment denominated "precatório", as will be seen below.

8. THE SYSTEM OF PAYMENTS CONCERNING THE JUDICIAL PAYMENTS OWED BY THE BRAZILIAN STATE

In Brazil, payments owed by the Federal, State or Municipal treasuries by virtue of a court decision shall be made through a legal request called ‘**precatório**’. This consists of a letter issued by the courts of decision enforcement to the President of the Court of Appeals to which they are subordinated so that the referred President issues requirements of payment to the competent Treasury.

It is important to underline that the system of ‘precatório’ is typically Brazilian and was introduced in the context of the Brazilian Federal Constitution of 1937, aimed at normalizing the process of payment made by the State, and has been adopted by the Brazilian State ever since. As a matter of fact, one has tried to establish an order of preference for such payments to avoid their becoming subordinated to the discretion of the public administrator.

Moreover, such a system was adopted, keeping in mind two fundamental characteristics present in the Brazilian system, which are the impossibility to pawn public assets (and thus the necessity that the payments owed by the Treasury be included in the budget) and the separation and interdependence among the Powers of State.

As for the current Brazilian Federal Constitution of 1988, the system of ‘precatório’ was provided for in Article 100, whose reading had three modifications by virtue of the Constitutional Amendments Nos. 20/1998, 30/2000 and 37/2002, as seen below:

Article 100. With the exception of alimony credits, payments owed by the Federal, state or municipal treasuries, by virtue of a court decision, shall be made exclusively in chronological order of presentation of judicial requests and charged to the respective credits. It is forbidden to designate cases or persons in the budgetary appropriations and in the additional credits opened for such purpose.

Paragraph 1 - It is mandatory for the budgets of public entities to include the funds required for the payment of debts shown in the judicial requests presented up to or on July 1. The payment shall also be made before the end of the following fiscal year, with the amounts being adjusted until the date of payment. *(text underlined amended by*

Constitutional Amendment No. 30, September 13th 2000. Before the CA, adjustment was made only until the date that the requests were presented).

Paragraph 2 - The budgetary allocations and the credits opened shall be assigned directly to the Judicial Power, being within the competence of the President of the Court which rendered the decision of execution to determine payment, according to the possibilities of the deposit, and to authorize, upon petition of a creditor and exclusively in the event that his right of precedence is not respected, seizure of the amount required to satisfy the debt. *(Text underlined amended by Constitutional Amendment No. 30, September 13th, 2000).*

Paragraph 3. Provisions of the present article, relative to the issuance of judicial requests, shall not be applicable to values defined by law as small amounts that the Treasuries of the Union, States, Federal District of Municipalities are obliged to pay by virtue of judicial sentence with no appeal. *(added by Constitutional Amendment Nb. 30, September 13th 2000. The CA 37, June 12, 2002, defined as small amounts: 40 minimum wages for Federal, State and Federal District payments, and 30 minimum wages for municipality payments).*

Paragraph 4. Issuance of a complementary judicial request, or of a supplementary judicial request of a paid value, as well as fractioning or partitioning of the due amounts, in order to have payments made on basis of the provisions of paragraph 3 of present article, is forbidden. *(added by Constitutional Amendment No. 37, June 12, 2002).*

Paragraph 5. The law may establish distinct amounts for the purposes of paragraph 3 of the present article, in accordance with the different financial capabilities of the public entities. *(added by Constitutional Amendment No. 37, June12, 2002)*

Paragraph 6. The President of the competent court who, by action or omission, delays or tries to frustrate the regular liquidation of judicial requests shall incur a liability in crime. *(added by Constitutional Amendment No. 37, June 12, 2002).*

Once the Executive Branch receives the requirement of the President of the competent Court of Appeals, it shall include in the budgetary bill for the following year, according to Article 100, Paragraph 1 of the Brazilian Federal Constitution, the funds necessary to honor the 'precatório' issued by virtue of a judicial decision with no appeal presented up to or on July 1.

Notwithstanding the constitutional provision, in practice, the failure to carry out the judicial orders to allocate funds in the State budget is rampant. This is deemed to happen because there is no deadline to the accomplishment of such orders, besides the fact that there are no efficient sanctions for disobedience. As a consequence, the jurisdictional efficiency remains compromised.

Regarding the point, the Center for Judicial Studies of the Brazilian National Council of Justice, concerned with the erosion which the image of the Judicial Power of State has been suffering due to the delay regarding the payment of 'precatórios', has produced a study entitled "Enforcement against the Public Treasury – Political Reasons for the Failure to Carry Out Judicial Orders", aiming at identifying the real reasons for this phenomenon. Such research was based on the data analysis collected in the press, in the Federal Justice and in the actual Public Administrations, during the period from January 1, 1998 to April 30, 2000.

Among the reasons identified by the study for the failure to carry out the judicial orders of payment, are fraud, overestimation of 'precatórios' value (the most frequent cause in cases of dispossession), lack of funds, procedural circumstances and accumulation of 'precatórios' (NATIONAL COUNCIL OF JUSTICE, 2001, P.28).

As for the main reasons for such failures, the study confirmed that the most common one was the simple omission by the Public Administration, followed by the interruption in the order of payment preference, deviation of funds, procrastination and partial payment (*idem*, p.31-32).

As regards particularly to the 'precatórios' derived from expropriations, the mentioned study shows the failure to fulfill resulted from reasons of omission in 49% of the cases, from interruptions in the preference order in 17%, from deviation of funds in 17%, and from procrastination in other 17% (*ibidem*, p.54).

Concerning this situation, the Judicial Power has reacted in several ways, chiefly by the following: a) by processes of intervention, when the Public Power does not include the funds necessary in the budget or includes them but does not make the payment⁵⁵; b) by the seizure of assets, when there is an interruption in the preference order of the 'precatórios'; c) by the contemplation of charges

⁵⁵ The study states that such processes are always under way, waiting for decisions by the courts to grant or not the intervention request.

against public administrators on account of crimes of liability from the non-payment of 'precatórios'.

While solutions have not been found to such problems, which are quite complex, some initiatives have been undertaken to mitigate them: for instance, the modification made by the Constitutional Amendment No.20, of December 15, 1998, to Article 100, Paragraph 3, of the Brazilian Federal Constitution, which established that payments of small amounts, as defined by the law, owed by the Treasury of the Federal Government, States, or Municipalities, by virtue of judicial decision with no appeal shall not follow the system of 'precatório'⁵⁶.

Incidentally, aimed at implementing this constitutional provision, Law No.10.259 was enacted on July 12, 2001, providing for Federal Civil Special Courts and for their competence to process, conciliate and judge cases within the competence of the Federal Justice for amounts up to sixty minimum wages, as well as to enforce their decisions. Also, Article 17, Paragraph 1, of Law 10.259/2001, provided for that, for the purposes of Article 100, Paragraph 3 of the Federal Constitution, amounts defined therein as being small amounts, to be paid independently of the system of 'precatório', shall have the same value established in Law 10,259/2001 for the competence of the *Federal Civil Special Court* as their limit.

⁵⁶ To such provision, Constitutional Amendment No.30, dated September 13, 2000, added the Federal District Treasury.

9. BRAZILIAN ARBITRATION AND EXECUTION OF FOREIGN ARBITRAL AWARDS

According to Magalhães (2006:165-172), in Brazil as in much of the rest of the world, arbitration was scarcely used during the 19th and 20th centuries on account of the prevalence of the State as the only one entitled to have jurisdiction.

This reality has changed at the international level after the 1950s when, coincidentally, the States began to intervene more actively in the private economic process and international investments speeded up due to the participation of private enterprises. Since then, many countries have begun to adapt their national legislations on arbitration to adjust to the new reality in order to take away the privilege of jurisdiction from the State. This was so in France, Spain, Greece, United States, United Kingdom, Switzerland, Canada and Italy.

In the case of Brazil, according to the author, although the institution of arbitration was provided for a long time ago, Brazil only recently adhered to the world tendency of making arbitration a more effective instrument for the resolution of disputes⁵⁷. It was done by the enactment of the Arbitration Law No. 9,307/1996, strongly inspired by the UNCITRAL Model Law on International Commercial Arbitration and the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.

As a matter of fact, it was only since Law No. 9,307/1996 that the arbitration clause has become binding and, therefore, subject to specific enforcement. Before then, the case law deemed such clause as an obligation of doing which, in case of controversy, did not compel the recalcitrant part to sign the agreement to settle the arbitral proceeding, leaving room to only seek compensation for damages⁵⁸.

57 Regulation 737 of 1850 provided for a mandatory arbitration for the resolution of disputes among merchants, and the Brazilian Civil Code of 1916 provided for the institution of arbitration by arbitral agreement

58 As to commercial arbitration, Magalhães remembers that, although Brazil signed the Geneva Convention on Arbitral Clauses of 1923, this hasn't had application in Brazil, except for a Superior Court of Justice decision rendered before the Brazilian Arbitration Act was enacted, in which the Court, for international agreements subject to that Convention, deemed the arbitration clause is *per se* able to settle an arbitration proceeding and

Besides this, other important innovations introduced by the Brazilian Arbitration Act included equalization of the arbitral award to the decisions rendered by the Judicial Power, the dispensation of recognizing the arbitral award before a judicial court before enforcing it, and the elimination of the double *exequatur* in case of recognition of foreign arbitral awards.

It is important to stress that the Law No. 9,307/1996 had little effect until the year 2001, when the Plenary of the Federal Supreme Court considered a case involving the recognition of a Spanish arbitral award, where the Court examined the constitutionality of the arbitral proceedings and the binding nature of the arbitration clause vis-à-vis the constitutional provision (Article 5, XXXV) which sets forth that “the law shall not exclude any injury or threat to a right from the consideration of the Judicial Power.”⁵⁹

In the above-mentioned case, the Federal Supreme Court decided that the Brazilian Arbitration Act does not repeal *per se* the State jurisdiction, once the parties, in the exercise of their freedom of choice, decide to resolve the disputes resulting from an agreement by means of arbitration. And so the Court declared the law to be constitutional, providing the necessary legal safety for the development of the new institution.

As for the recognition and enforcement of foreign arbitral awards in Brazil, the Brazilian Arbitration Act, in its Article 34, provides that these shall be implemented efficiently in conformity with international treaties in the Brazilian legal order and, in its absence, strictly according to the terms of that Law.

In this instance, it has to be emphasized that Brazil, which had already adhered to the Inter-American Convention on International Commercial Arbitration

does not require any subsequent arbitration agreement for that purpose (see Special Appeal n.616/RJ, Reporter Justice Gueiros Leite, judged on April 24, 1990)

⁵⁹ See Regimental Appeal in the Foreign Sentence No.5,206.

(Panama Convention) in 1996⁶⁰, as well as to the Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards in 1997⁶¹, has ratified the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards in 2002⁶².

Concerning the Mercosur, the signature of the Brasília Protocol to the Settlement of Disputes and its Regulation of 1991⁶³, aimed at resolving the disputes among the States-Part (specifically designated the Olivos Protocol of 2002)⁶⁴, as well as the Cooperation and Jurisdictional Assistance Protocol in Civil, Commercial, Labor and Administrative Matters (Las Lenas Protocol) of 1992⁶⁵, and the Agreement on International Commercial Arbitration of Mercosur of 1998⁶⁶ should be mentioned.

The Brazilian Federal Constitution of 1988 conferred to the Federal Supreme Court the competence for recognition of foreign arbitral decisions (including foreign arbitral awards), as did previous Brazilian Constitutions. Later, by virtue of the enactment of the Constitutional Amendment No.45, of December 8, 2004⁶⁷, such competence was transferred to the Superior Court of Justice, which

60 The Panama Convention, of 1975 was approved in Brazil by Legislative-Decree No.90, of June 6, 1995, and executed by Decree No.1.902 of May 9, 1996.

61 The Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitral Awards, signed in Montevideo in 1979, was approved in Brazil by Legislative-Decree No.93, of June 20, 1995, and executed by Decree No.2.411, of December 2, 1997.

62 The New York Convention of 1958 was approved in Brazil by Legislative-Decree No.52, of May 25, 1992, and executed by Decree No.4.311, of July 23, 2002. Although such approval did not introduce big changes in the Brazilian legislative reality (as the Brazilian Arbitration Act of 1996 had already done), its psychological effect was quite important in order to send a message of greater reliance to the foreign investors.

63 The Brasilia Protocol was approved in Brazil by Legislative-Decree No.88, of December 1, 1992, and executed by Decree No.922, of September 10, 1993.

64 The Olivos Protocol was approved in Brazil by Legislative-Decree No.712, of October 14, 2003, and executed by Decree No. 4.982, of February 9, 2004. Article 55, 2, of the Olivos Protocol provides that the Brasilia Protocol and its Regulation shall remain effective, while the controversies initiated under its validity are not completely concluded and until the proceedings set forth in Article 49 of the referred Protocol are completed.

65 The Las Lenas Protocol was approved in Brazil by Legislative-Decree No.55, of April 19, 1995, and executed by Decree No.2.067, of November 12, 1996.

66 The Agreement on International Commercial Arbitration of Mercosur of 1998, was approved in Brazil by Legislative-Decree No.265, of December 29, 2000, and executed by Decree No.7,719, of June 4, 2003.

67 Article 105. The Superior Court of Justice has the competence to:
i) ratify foreigner sentences and grant *exequatur* to letters of appeal;

issued the Resolution No.9, of May 4, 2005, provisionally controlling its proceedings.

Regarding the investor-State arbitration, Kalicki and Medeiros (2007, p.71-77) emphasize that, although this is not admitted in Brazil, important steps were taken in order to allow the submission of the state entities to arbitration.

In this sense, the authors mention the growing number of legislative authorizations for the use of arbitration by the state entities in specific circumstances, the consensus of the Brazilian doctrine in favor of the submission of the state entities to arbitrations, and the recent judicial decisions recognizing the validity of the arbitration clause provided for in agreements signed by state entities.

Accordingly, they remember the well-known decision rendered by the Superior Court of Justice in 2005, in which that Court, considering a case involving *Companhia Estadual de Energia Elétrica – CEEE* (a Brazilian mixed capital company) and *AES Uruguiana Empreendimentos*, reversed the decision of a lower court and recognized the validity of an arbitration clause providing for the resolution of disputes by the International Chamber of Commerce (ICC).

In relation to the laws passed in the 1990's, authorizing the submission of the state entities to arbitration, Kalicki and Medeiros (*idem*, p.74-75) write as follows:

(...) the Brazilian Congress has approved several laws (particularly during the 1990s, following the wave of privatization and opening of the Brazilian market) granting State entities authorization to submit to arbitration in specific circumstances, particularly in situations where it is necessary to attract private investments. Submission to arbitration is authorized for international banking, transactions, for example, by Law No. 5,662 of 1971 (BNDES), Article 5; for international financial transactions, by Decree-Law No.1,312 of 1974, Article 11; for concession contracts, by Law No. 8,987 of 1995, Article 23; for the telecommunications sector, by Law No. 9,472 of 1997, Article 93; for petroleum, by Law No. 9,478 of 1997, Article 43; and for electricity, by Law No. 10,848 of 2004, Article 4. Furthermore, three legislative events reinforced Brazil's pro-arbitration attitude regarding

(Letter i added by CA 45, September 8, 2004).

State contracts. The first was Congress' rejection, in the course of approving a Constitutional Amendment in 2004, of Constitutional Amendment No. 45, a proposed provision expressly prohibiting State entities' submission to arbitration. The second event was enactment of the Public-Private Partnership Law (PPP Law – Law No. 11,079 of 2004) for the purpose of attracting private investments to infrastructure projects in Brazil, with an express provision allowing the use of arbitration in these PPP contracts (Article 11(III)). The last event was approval of an amendment to the Concession Contracts Law in order to explicitly allow the inclusion of arbitration clauses into concessions (Article 23-A). Both the PPP Law and the amended Concession Contracts Law require, however, that arbitration take place in Brazil and proceedings be conducted in Portuguese and pursuant to the procedural rules set forth in the Brazilian Arbitration Act (Law No.9,307 of 1996), In other words, the progress made by Brazil in enacting these two new provisions expressly contemplating arbitration for concessions and PPP contracts was limited by the fact that the laws (at least apparently) provide only for domestic arbitration, rather than international arbitration as would be preferred by international investors.

Having said this, the perception is that, although Brazil has been reluctant to admitting the investors-State resolution of disputes by arbitration, either by refusing to sign the Washington Convention, or by not ratifying the bilateral investment agreements signed in the 1990s, which provided for arbitration clauses, legislation in the arbitration domain has taken large steps since the 1990s. Today, especially after the trial of the constitutionality of the Brazilian Arbitration Act by the Federal Supreme Court, there is an exceptional pro-arbitration atmosphere – of paramount importance when talking about the risk perception of the foreign investor towards Brazil.

CONCLUSION

One of the big concerns of investors has been the search for protection to investments made in foreign lands, mainly because of the history of nationalizations, expropriations and interventions carried out by foreign States.

This concern is not only to look for guarantees from the substantive law, but also to find an efficient way to settle disputes outside the jurisdiction of the investment host State, particularly the arbitration.

With regard to the foreign investor's protection against the sovereign right of the country to nationalize or expropriate foreign properties, in the current International Law, the adoption of such measures by the State is perfectly legal, as long as it is not discriminatory and performed for a public purpose, not however being exempt from the corresponding compensation.

Nevertheless, the developed countries (traditional exporters of capital) and the developing countries (traditional importers of capital) argue about the definition of a *forum* for the solution of controversies, the law to be applied and the compensation standard in such situations.

Historically, the developed countries have advocated that the resolution of disputes be settled in neutral forums, through arbitral procedures, adopting the rules of the International Law. Furthermore, they sustain that a standard compensation be applied following the Hull formula of "ready, effective and appropriate".

On the other hand, the developing countries, under the influence of the Calvo doctrine, understand that controversies should be determined under the national jurisdiction of each country and according to its corresponding national legislation. Besides, they uphold the position that the compensation must be given appropriately, according to the rules in effect in the expropriating State.

To this context, it was added an effort by the developed countries to extend the protection of foreign investments, so that the protection prevails also against actions of the regulating power of the State that causes damages to them.

This effort is due because the demands of modern society imposed a more active role to the State, implying a more frequent intervention by the State on the market. These interventions often cause damages to foreign investors – damages that although do not mean expropriation as such, are totally or partially equivalent to it, being therefore known in international literature as *indirect expropriation*.

The attempt to regulate the protection to foreign investments against expropriation, particularly “indirect expropriation”, in the multilateral *fora*, found great resistance from developing countries, which caused the developed countries to resort to bilateral agreements as a way of imposing their position.

This new attempt of the developed countries found fertile ground in the change of posture of the developing countries, which, eager to attract investments, signed a great number of bilateral agreements for promotion and protection to investments (BITs) as from the 80’s, believing that it depended on them to attract foreign investments.

In spite of this belief, it is fitting to observe that studies carried out on this issue, from the economic point of view, show that there are no evidences that BITs contribute to attract direct foreign investments, except in countries with a low risk institutional environment.

Besides this, the increase of BITs, together with the provision of resolution of the investor-State controversies through arbitration - normally included in these agreements – ended up by bringing about a proliferation of international arbitration demands, giving opportunity to contrast the sovereign power of the State to regulate its economy with the protection to foreign investment against *indirect expropriation*.

The result of this was that the States began to be condemned to pay enormous compensations to foreign investors for damages caused to these as a

result of the exercise of their regulating power, even though such power was being carried out within legal limits. These occurrences produced great concern, mainly in the developing countries (major hosts of foreign investment), which began consider the situation as a threat to their sovereignty to dictate public policies.

With regard to Brazil, perhaps still influenced by the Calvo doctrine, it has maintained a more conservative position in granting protection to foreign investments at international level, as well as in relation to admitting resolution of investor-State disputes through arbitration.

This position became evident in the objections raised by the National Congress (by the time some of the international agreements of protection to investments signed by Brazil in the nineties were submitted to congressional approval), especially referring to investor-State arbitration, reaffirming the historic position contrary to the institute, according to what had already been expressed then Brazil refused to sign the Washington Convention. In this sense, Brazil does not have international agreements on foreign investment protection in force, with the exception of the commitments taken on in the ambit of the World Trade Organization (WTO), through Trade Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS).

Nevertheless, Brazil has been a great host for direct foreign investment since the Second World War (with the exception of the eighties -crisis period of the external debt) due to the size of its market and, mainly as from the nineties, due to the economic stability resulting from the 'Real' Plan, opening of several sectors of the economy to private capital, privatization program, elimination of the distinction between Brazilian companies with national capital and with foreign capital, besides the elimination of most of the non-tariff barriers.

Besides the facts mentioned, it can also be said that the authorization for the state entities to be able to submit to arbitration, according to the specific legislations approved in the nineties, in the economic sectors open to private capital, as well as the pro-arbitration environment in effect in the country today,

also contributed to the feeling of less risks and to greater attraction for direct foreign investments.

With regard to this matter, since Brazil has not granted protection to foreign investment at the International Law level, the resolution of investor-State disputes is ruled by the Brazilian national legislation and must be submitted to the national state jurisdiction, except cases in which arbitration is admitted. When weighing the consequences of this option, the exam of the Brazilian legislation (therein included the internalized treaties), doctrine and case law shows that protection to foreign investment against damages resulting from regulating measures by the State is the same as that granted to national investors. Therefore, protection to foreign investment is fairly generous in Brazil, both concerning the applicable hypotheses and the extent of the damage repair.

In effect, the Brazilian State can be hold liable for material and moral damages to the foreign investor, be they a result of legal or material acts, licit or illicit acts, acts of commission or omission.

In the case of acts of commission, liability of the State is *objective*, which means it is sufficient that the causal nexus is proved between the injurious act and the damage produced, whereas in the acts of omission, in principle, proof of the *lato sensu* fault (imprudence, negligence and malpractice, or malice) will be necessary, since there has to be evident opposition to the law.

When it comes to illicit acts, confirmation of the State's responsibility does not require major investigation since it results from an infringement to the principle of legality.

On the other hand, in the case of licit acts, the scrutiny of the State liability demands a deeper exam where not only the legality of the act will be checked out, but also its proportionality, given that the principle of legality is merely the guarantee in name, whereas the principle of proportionality plays the role of guarantor of content, avoiding the discretion from being disguised as legality.

According to the principle of proportionality, a state licit measure will only be proportional if it meets the following three requirements: a) the measure must be adequate to obtain the desired public purpose; b) the measure must be effectively necessary to obtain the desired goal, not having another less oppressive manner to achieve this end; c) by the principle of proportionality in its strict sense, the measure must imply a sacrifice of law or of freedom only in the proportion that it is sufficient to achieve public interest, trying to preserve, at the most, the integrity of the right or liberty.

As a result of the application of the principle of proportionality, the intervening state measures that do not fulfill the conditions mentioned above will be considered disproportionate, leaving room for the State liability on account of an illicit act.

Nevertheless, even though the requirements of proportionality are met, the State can be held liable for damages caused to third parties, once the fundamentals for the compensation for damages resulting from licit acts are met, which means there is a breach of the principle of isonomy in the distribution of public responsibilities.

In this respect it is noteworthy that for the damages resulting from licit acts, as well as from illicit acts, the responsibility of the State must be verified from the point of view of the person affected, having to examine whether the damage deserves compensation.

A common characteristic of the damages subject to compensation of both licit and illicit acts is the fact that such damages should not only represent an economic loss, but also a violation of a right or interest legally protected. Besides this, the damage must be certain, either current (*damnum emergens*) or future (loss of profits), not being admitted damages merely possible, potential.

For damages caused by licit acts, they must be added by the characteristics of the specialty and of the abnormality. Special damage means patrimonial offence to one or more individuals, or groups, in particular, and not the one which

generically affect the society. Abnormal damage is the one that surpasses patrimonial offences that would be reasonable to bear because of living in society.

As to moral damages, these are extra-patrimonial damages which result from the illicit act itself, the simple proof of illicit conduct being sufficient to characterize them.

With regard to the compensation *quantum*, this will depend on the proof of the extension of the damage, when it deals with material damages. Concerning the moral damages, the judge will have to establish, taking into consideration the factual circumstances of each case, a reasonable sum, so as to represent a repair to the person offended, as well as a lack of stimulus for the repetition of the act by the offender.

Having said all this, regarding the regulatory power legitimately applied, in Brazil the State can be hold liable for damages caused to the foreign investors even if the state measure is legal and proportional, as long as such damages are special and abnormal, which means there is an unequal distribution of public responsibilities.

In this context, it is reasonable to understand that the applied Brazilian national legislation plays a double role with relation to the regulating power legitimately exerted by the Brazilian State: a) on the one side, it preserves the sovereignty of the Brazilian State in leading the public policies that it considers most adequate for the development of the country, without it feeling threatened by the encumbrance of supporting repair of damages in non-reasonable manner and levels in name of public interest; b) on the other hand, it guarantees to foreign investor that, even in face of intervening licit acts by the State, he will be entitled to the repairing of damages when it is not deemed reasonable to support a greater burden than the rest of the community.

For the ample possibilities of liability by the State for the damages caused by acts resulting from its regulating power under the Brazilian legislation, two

factors strongly contribute to its discredit when the resolution of investor-State disputes is conducted under the Brazilian state jurisdiction:

a) the first of them is the low effectiveness of the jurisdictional service in the Brazilian State, resulting particularly from the large numbers of appeals provided in the Brazilian legislation, from the congestion of the Judiciary, as well as the resulting slowness in the handling of the judicial lawsuits;

b) the second refers to the payment system used by the Brazilian State for judicial decisions, which demand a budget estimate for payment in the chronological order of presentation of the requisitions; as a matter of fact, the referred system faces practical problems, such as lack of funds, breach of the order for preference, deviation of allocated amounts, postponement and partial payment, which remain due for inefficient treatment.

Nevertheless, it is important to record that the arbitration institute as a means for settlement of disputes has been consolidating in Brazil in recent years, with a real pro-arbitration environment in the Country nowadays, mainly since the Brazilian Arbitration Law was declared constitutional by the Supreme Federal Court, in 2001.

In this particular, it is important to mention the contribution resulting from the ratifications, by Brazil, of the Inter-American Convention on International Commercial Arbitration (Panama Convention), Inter-American Convention on Extraterritorial Validity of the Foreign Judgments and Awards, New York Convention for the Recognition and Enforcement of Foreign Awards, besides the Brasilia Protocol, Olivos Protocol, Las Leñas Protocol and International Commercial Arbitration Agreement of Mercosur, all in the ambit of the Mercosur.

In reference to this situation, although the Investor-State arbitration as such is not still admitted in Brazil, great advances have been made whereas laws were approved in specific areas, authorizing that state entities can be submitted to arbitration, as happens in concession contracts in telecommunication, oil and energy, sectors that were opened to private capital in the nineties.

Consequently, it is possible to conclude that the Brazilian market attracts the direct foreign investor not only because of its size, but also because of the economic stability and environment of low institutional risk offered by the Brazilian State. The benefits that the eventual approval and ratification of international agreements for investments can bring to the Country with regard to the attraction of major investments are questionable.

Besides this, the Brazilian legal system, from the point of view of the national legislation, doctrine and case law, preserves the sovereignty of the Brazilian State on the guidance of the public policies considered more adequate to the development of the Country, at the same time as offering a wide protection to foreign investors because of the damages caused to them by acts of the regulatory power of the State, even though they may be licit.

Finally, although this wide protection may be partially committed when the settlement of disputes is performed through the Brazilian state jurisdiction, the effectiveness of the jurisdictional service in the Brazilian State is low, as well as the inefficiency of the payment system of legal compensation adopted by it, Brazil has made enormous progress in the arbitration field, being fairly reasonable to admit that the investor-State arbitration may be incorporated to the Brazilian reality in a not distant future.

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