CLIFFORD CHANCE

UK NATIONALISATION: THE LAW AND THE COST – 2019 UPDATE

– THOUGHT LEADERSHIP

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Nationalisation is on the agenda in the UK. The Labour Party says that, if it wins the next general election, it will nationalise the railways, water and energy companies, the National Grid, the Royal Mail and possibly private finance initiative (PFI) companies – and that it will pay shareholders less than the market value of their investments.

This paper considers how, as a legal matter, nationalisation would work, and the legal constraints that in practice limit a Government's ability to nationalise for less than full market value.

International law requires fair market value compensation when a business is nationalised, and we are unaware of any previous nationalisation of a solvent business, in the UK or another OECD member country, where this approach was not followed. If Labour really do depart from this international norm then that will, almost inevitably, trigger compensation claims by investors.

The investors likely to have the best chance of launching a successful claim are those based in a jurisdiction that is party to a treaty with the UK that has investor protection provisions. The UK has bilateral investment treaties with some significant investor jurisdictions, notably China, India, Hong Kong, Singapore and the UAE. The UK is also a signatory to the Energy Charter Treaty, which is only relevant to energy generation and distribution businesses, but to which there are 53 contracting parties (including France, Germany, and most other EU members). Investors who do not benefit from investment treaty protection, including UK investors, would have a potential claim under the Human Rights Act 1998 and/or the European Convention on Human Rights, but these claims are likely to face greater challenges. However, UK and other investors may benefit collaterally by virtue of another investor bringing a successful investment treaty claim.

We are doubtful that the UK Government will want to pay higher compensation to foreign investors than to UK pension funds. Hence the final result may be that there is little practical choice but to offer a fair value to all.

In recent months the Labour Party has announced that, if it forms the next UK Government, it intends to nationalise a wide range of industries, including Royal Mail, water, energy and possibly PFI companies. It's said that water will be the priority. An unprecedented programme of nationalisation is likely to form an important part of the Labour Party's manifesto for the next General Election, as it did for the last.

Labour Party 2017 manifesto excerpt:

"Across the world, countries are taking public utilities back into public ownership. Labour will learn from these experiences and bring key utilities back into public ownership to deliver lower prices, more accountability and a more sustainable economy. We will:

- Bring private rail companies back into public ownership as their franchises expire.
- Regain control of energy supply networks through the alteration of operator license conditions, and transition to a publicly owned, decentralised energy system.
- Replace our dysfunctional water system with a network of regional publicly-owned water companies.
- Reverse the privatisation of Royal Mail at the earliest opportunity."

UK Governments have nationalised businesses many times in the past, but this would be different. This would not be the emergency nationalisation of an insolvent bank (e.g. Northern Rock), an attempt to consolidate a struggling sector (British Leyland, the automotive company) or the nationalisation of infrastructure devastated by the Second World War (the railways). This would be the nationalisation of businesses that their shareholders see as successful and profitable. It would also be different in the sense that any nationalisation would be subject to legal frameworks that did not exist in the 1940s or 1970s. Legal challenges are therefore inevitable, particularly over the amount of compensation.

How would nationalisation work in practice?

The first wave of nationalisations swept across Britain soon after the Second World War, under the Attlee Government. More recent examples include Rolls-Royce in 1971, the British motor industry in 1975 (creating British Leyland), aerospace and shipbuilding industries in 1977, Johnson Matthey in 1984, Railtrack in 2002 and part of the UK banking sector following the 2008 financial crisis.

Of these, we see the Aircraft and Shipbuilding Act 1977 as the most plausible model. Unlike most of the other examples, it was (at least in part) a nationalisation of a profitable business, against the wishes of many of its shareholders.

The basic framework of this model is simple. An Act of Parliament would establish one or more new companies as holding vehicles, and provide that, on an appointed date, all equity and (perhaps) debt securities of the companies to be nationalised would vest in the new holding vehicles.

Such an approach, however, raises a number of questions.

How easily would such an Act of Parliament be passed?

There are considerable difficulties in defining the scope of the securities to be nationalised, and the terms on which they are purchased. There is additional complexity in setting out the governance arrangements for the new nationalised companies. Any nationalisation plans would take time (possibly years) to structure and would be subject to rigorous debate in Parliament.

The 1970s shipbuilding and aerospace nationalisation provides an illustration. The pledge was contained in the Labour manifesto for the first 1974 general election. It took nine months of internal deliberation before a Bill was presented to Parliament. This proved highly contentious, both in the House of Commons (where the Government had a majority of only three) and the House of Lords (which rejected the Bill three times). The Conservative opposition strongly opposed the Bill, and the support of the Labour backbenches could not be taken for granted. The Act was finally passed in 1977, after multiple amendments and significant reductions in the scope of the businesses nationalised. Very shortly afterwards, the Government lost its overall majority.

The technical and political hurdles in the way of a nationalising Act of Parliament should not be under-estimated, particularly for a Government without a clear majority. That has consequences for the legal framework of any potential Act. The longer it takes for an Act to be passed, the more difficult the valuation questions become.

Could one Act of Parliament nationalise multiple industries?

In principle, Parliament could pass one Act facilitating the nationalisation of water, energy and other industries, with Ministers able to create secondary legislation that nominates particular entities for the Government to acquire. However, as discussed further in this briefing, the more discretion is given to Ministers or administrative bodies, the greater the scope for legal challenge – and we would expect minimising the risk of legal challenge to be a key objective of a nationalising Labour Government and its civil servants. That suggests nationalisation Acts will need to be very prescriptive and detailed, and nationalising multiple industries in one Act therefore would likely be impracticable.

Labour's governance plans for water

At the Labour Party Conference in October 2018, Labour published details of its proposed approach to water nationalisation.

Labour would set up regional water authorities (RWAs) comprised of each local authority in each region. The RWAs would then acquire the nationalised water companies.

The RWAs' boards would be made up of councillors from the local authorities, three trade union representatives, a representative from Citizen's Advice (representing consumers), a representative from the Environment Agency, and a community representative.

> Discriminating against foreign investors would be problematic from both a legal and diplomatic perspective

What would be acquired?

It is clear that the equity/ordinary shares in the target companies would have to be acquired. However, it is likely that in many cases debt would also need to be acquired. Much debt may immediately fall due as a result of provisions for acceleration on change of control, nationalisation or expropriation. Debt for this purpose will include public and privately placed bonds, as well as bank loans and finance leases. Many of the target companies also have significant liabilities under swaps/hedging arrangements.

Even where that was not the case, and the debt could remain in place, that is unlikely to be regarded as attractive by Government. Labour is currently proposing to leave debt in place (and honour it in full). However, the bondholders/lenders would be gaining an (implicit) Government guarantee but receiving a yield considerably higher than on gilts (assuming gilt rates did not materially increase). An additional complexity is that many utility bonds were issued as part of whole business securitisations, which impose stringent convent packages on the businesses, and therefore restrictions which the Government may find unduly limiting on its wider plans for the sector. Hence it would be understandable if a political choice were taken to nationalise debt, even if that was not required as a legal matter.

Many utility companies have issued long-dated bonds with a fixed or RPI-linked coupon. Early redemption of the bonds typically triggers a "yield protection" or "make whole" payment, generally driven by a "Spens" formula. The price of redemption could therefore be significantly in excess of the principal and market value. Whilst an Act of Parliament could in principle override the yield protection, that would greatly heighten the risk of legal challenge.

A similar issue arises with any hedging arrangements the target companies have entered into. Utility companies often have interest rate, currency and/or RPI swaps hedging their debt, and in many cases the swaps are significantly out of the money. In circumstances where the debt is repaid, the swaps would ordinarily terminate – and where the swaps are out of the money, that would crystallise a termination payment by the utility company to its swap counterparties.

Northern Rock – a precedent for paying no compensation?

When Northern Rock was nationalised in 2008, the investors received no compensation. Labour sees this as a precedent, saying in its *Bringing Energy Home* paper:

The UK legal framework is clear that the level of compensation should be decided by Parliament. This was confirmed in 2012 by the UK Appeal Court and the European Court of Human Rights in relation to the nationalisation of Northern Rock.

One obvious response is that Northern Rock was insolvent and the subject of an emergency nationalisation to protect the financial sector as a whole from contagion should Northern Rock fail. It is no precedent for any nationalisation of the solvent (and indeed profitable) utility sector.

However in fact Labour's case is even weaker than that – the Northern Rock emergency nationalisation legislation required shareholders to be paid **market value** compensation. That valuation was required to be conducted by an independent valuer on the assumption that there would be no further Government support, and on that assumption it was plain that the market value of the shares was nil. Some shareholders subsequently sued on the basis that this critical assumption was contrary to Article 1 Protocol 1 of the European Convention on Human Rights. Both the English Courts and the European Court of Human Rights rejected this. The assumption was a policy decision which was within the wide "margin of appreciation" of Government in these circumstances; furthermore it was a reasonable assumption to prevent shareholders from benefiting from the value which had been created and maintained only through the provision of support from the state, as lender of last resort to Northern Rock.

None of this provides any support for Labour's position.

It is not clear that these costs have been factored into the various projections of nationalisation cost that have been published to date. For example, the overall £176bn figure mentioned in the widely-cited report by the Centre for Policy Studies includes the cost of nationalising the Royal Mail at £4.5bn – the company's market capitalisation. However, the Royal Mail's balance sheet also shows approximately £700m of loans, bonds and finance leases. It may therefore be that the cost of nationalising the Royal Mail would be £5.2bn, not £4.5bn – and even if the debt and other liabilities are left outstanding, they may well be consolidated into the national accounts so that the "cost" in balance sheet terms is the same, regardless of whether the liabilities are kept in place or refinanced. Many utility companies are significantly more leveraged than this, and (because of the time at which they first raised funds) have very material out-of-the-money swaps and bonds the redemption of which would be subject to large make-whole payments.

Could a 51% interest be acquired?

It has been suggested that nationalisation could be effected more modestly, by the Government acquiring a bare 50.1% of the shares in the companies in question. We query how workable that is.

First, in the context of a publicly listed company, the Takeover Code requires anyone acquiring a 30% voting interest to

How have investors historically been compensated?

We have analysed the legislation implementing each of the significant UK nationalisations of the last 70 years, and in particular the compensation provisions.

Entity/Industry	Year	Compensation
Bank of England	1946	Market value (depending upon dividend yields)
Hospitals	1946	Market value
The Coal Industry	1947	Market value
Electricity	1947	Market value
Cable & Wireless Ltd	1947	Market value
Railways	1948	Market value
Gas	1949	Market value
Iron and Steel	1951	Market value
Iron and Steel	1967	Market value
National Bus Company	1969	Market value
British Leyland	1975	Probably above market value
Rolls Royce	1971	Probably above market value
Aircraft and shipbuilding industries	1977	Market value
Johnson Matthey Bankers	1984	Market value (but was insolvent)
Railtrack	2002	Probably above market value (was in administration)
Bradford & Bingley	2008	Market value (zero, as insolvent)
Northern Rock	2008	Market value (zero, as insolvent)

Our review has confirmed that in each case, there was some form of market value compensation (with often the same statutory mechanics being used).

We have also investigated nationalisations in other OECD countries, and have been unable to find any cases of a solvent business being nationalised for less than market value. Perhaps the most ambitious nationalisation programme of an advanced economy in recent times was the French nationalisation of dozens of industrial and banking businesses in 1982. Expropriated shareholders received compensation which was said at the time to be market value (but was subsequently estimated to exceed market value by 20%). All of this reflects international norms and customary international law, as detailed further in this paper.

There have, of course, been many disputes over the years as to what precisely "market value" means in any given case. However, one has to look to countries such as Venezuela and Argentina for examples of nationalisations where the compensation was intentionally set to disregard market value entirely.

> **No one may be deprived of his or her possessions, except in the public interest and in the conditions provided for by law, subject to fair compensation being paid in good time for their loss.**

make a mandatory offer in cash (or with a cash alternative) (although in principle this could be overridden by legislation).

Second, and more fundamentally, the proponents of nationalisation do not generally argue that the purpose is for nationalised businesses to continue to be run in the interests of their shareholders (albeit with different shareholders). Rather, they suggest that the companies should be run in the wider public interest, for example by reducing utility bills. That would be problematic in a scenario where there are minority investors who are hurt financially by this course of action. Company law generally prohibits minority shareholders being unfairly prejudiced; the remaining minority shareholders may also regard their holdings as being indirectly expropriated and pursue some of the legal avenues discussed below.

It must be noted that questions of "cost" are highly politically contentious. Whilst the Government would be incurring new liabilities, it would also be acquiring an asset. Government accounting measures public sector debt and liquid financial assets on a net basis; the question is whether the securities of the nationalised businesses would be regarded as liquid financial assets – it is not enough for them merely to be *financial assets*. Historically some Government-owned businesses were regarded as liquid financial assets (e.g. Eurostar); more recently the national audit office required the Government holdings in RBS and Lloyds to be excluded from the public sector debt net calculation. This is therefore potentially an important question in economic and political terms. The essence of a liquid asset is that it is realisable at short notice without loss. That may be the case for a holding of listed shares, even a substantial one. It is much less likely to be the case for shares in a company which has been nationalised, which could not be realised without a new listing or private sale – i.e. a fairly complex privatisation process.

What compensation would shareholders receive?

The Labour Party has suggested that it would compensate investors in companies it nationalised by issuing Government bonds in exchange for their shares. That was the approach on previous nationalisations and there is little reason for any Government to depart from it. Whilst in principle there is no difference between this and paying cash, funded by the separate issue of Government bonds, it is clearly more straightforward for the Government to issue bonds directly to shareholders.

Many investors would sell any bonds soon after receiving them. For example, investors, such as pension funds and institutional investors, would wish to replace the infrastructure investments they held pre-nationalisation with other broadly equivalent infrastructure investments.

All of which begs the question: how would the Government assess the appropriate level of compensation?

Valuing listed securities

Assessing the value of listed securities is, at least at first sight, straightforward. The approach taken in the 1977 Act was to assess their value by reference to the average price for the six months prior to the first 1974 general election. The thinking was that the securities had fallen immediately following the general election, in anticipation of nationalisation, and therefore it would be manifestly unfair to assess value by reference to the market price after that date.

But this created a problem that had not been initially anticipated: many months (and, as it turned out, years) would pass between publication of the Bill and the Act receiving Royal Assent. The chosen six-month valuation period was, furthermore, a period of significant geopolitical and economic upheaval. The period included the Yom Kippur War and subsequent oil crisis, and a sustained decline of most LSE listed shares. The subsequent three years were scarcely less eventful.

Hence the price set for some companies, according to this approach, ended up looking overly generous; the price set for others, unfairly low (leading to some of the legal challenges discussed further below).

It is not clear how this difficulty can be avoided.

In principle, one could apply a statutory formula instead of simply looking at the market price. For example, utilities can be valued by reference to the regulatory asset base (RAB). However, the relationship between actual value and RAB is complex, varying both between different utility sectors and different individual businesses. Many publicly listed utilities trade at considerable premiums to RAB. Alternatively, a formula could be based upon multiples of earnings, or a discounted cashflow basis – but, again, it would be difficult for any one formula to apply effectively and equitably to different sectors and different businesses.

Hence it may be that, for listed securities, the best alternative is pricing on the basis of the market price across some reference period. The earlier the reference period is set, the fairer it will be in terms of avoiding "priced in nationalisation" effects, but the greater the risk that market movements and the differential performance of different companies combine to create pricing anomalies.

Valuing unlisted securities

Assessing the value of unlisted securities is more difficult. The 1977 Act provided that shareholders would appoint a representative who would seek to reach an agreement on valuation with the Government. If agreement could not be reached, the valuation would be determined by a specially constituted arbitration tribunal. The tribunal would apply the same basic rules as applied to listed shares, i.e. looking at the value for the six months prior to the election, with adjustments. This therefore ran into the same timing problems as discussed above in the context of listed shares.

Decisions of the valuation tribunal could be subject to appeal to the courts, but the valuation methodology set out in the Act was not susceptible to challenge.

The concept of a behind-closed-doors negotiation fits uneasily in the modern world – but there is no reason why the negotiation could not be in public (and indeed the Government might welcome that as an opportunity to put political pressure on shareholders). An alternative, and more conventional approach, would be to preserve the 1977 Act concept of valuation by a binding tribunal following pre-determined rules, but for it to apply in all cases, not merely where agreement cannot be reached.

Another approach would be a formula – but that has the difficulties identified above.

Private Finance Initiative companies

One scenario where it may be hard to avoid using a formula is for PFI companies. A number of PFI contracts recognise an expropriation of assets or shares in the private sector counterparty as an event of default, which specifies a methodology and formula for ensuring that the private sector counterparty and its financiers are fully compensated (i.e. no worse off than if the contract had proceeded as expected). Although use of this mechanism would bring the PFI contracts to an early end and bring assets back into the public sector, the price tag would no doubt seem unsatisfactory to a Labour Government if it views the contracts as a poor deal. That would suggest either nationalisation on a basis where the Government does not have to fully compensate the private sector counterparty and its financiers (for example, the Government on a project-by-project basis finding opportunities to terminate contracts for private sector default prior to a contract running its full course) or some other basis than the pre-determined methodology and formula, combined with an override of existing contractual provisions. This would create an elevated level of legal risk for the Government.

The alternative approach to nationalisation would be for a Labour Government (i) to prohibit any new PFI contracts and in parallel (ii) to simply let existing PFI contracts expire with the effluxion of time and, in doing so, make no compensation payment to the private sector. We note, however, that this is likely to be little political appetite for the Labour Party to adopt this course, as it mirrors the position taken by the current Conservative Government.

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

Labour's plan to deduct amounts from compensation

Labour's *Bringing Energy Home* and *Clear Water* papers both say that Labour proposes to deduct amounts from compensation reflecting pension fund deficits, "asset stripping" since privatisation, "stranded assets", the state of repair of assets, and state subsidies given to the energy companies since privatisation.

All of these items are problematic.

- Pension fund deficits should be priced into the market value of water company shares; hence deducting an amount for the deficit would be double-counting.
- Any assets that are "stranded" or in disrepair would also be reflected in the market value.
- It seems by "asset-stripping" Labour refers to historic dividends funded by new borrowings. This borrowing is, once more, already reflected in the market value.
- Any subsidies were approved under the regulatory and legislative framework set out by successive governments.
- More generally, making deductions for historic transactions ignores the reality that the shareholders today will, in many (and probably most) cases, be different from the shareholders who benefited from the transactions in question.

"It is surprising that the Labour Party has pointed to Northern Rock as a relevant precedent"

Price adjustments

The risk with setting a nationalisation price by reference to a past period is that companies could seek to extract value prior to nationalisation, perhaps by way of special dividends, buybacks and/or disposals or non-arm's length transactions. The 1977 Act therefore took account of and controlled dividends and other returns of value which exceeded "permitted dividends" – broadly, those representing net revenues. Dividends which were not "permitted" paid prior to the Act coming into force were to be deducted from the purchase compensation. Once the Act came into force then dividends which were not "permitted" were prohibited, and would give rise to personal liability for directors. There were similar price adjustment and prohibition provisions for disposals and onerous transactions.

Will aggrieved shareholders be able to sue?

There are important constraints on the ability of any Government to seize private property, and several approaches that aggrieved shareholders could take.

Customary international law requires prompt, adequate and effective compensation for expropriation – meaning fair market value. That much is clear – the more difficult question is what remedies an investor has if there is in principle a breach of international law. That will vary from investor to investor, and is discussed further below.

EU law

Some politicians and commentators have suggested that the principal legal impediment to nationalisation is EU law, and therefore nationalisation will become materially more straightforward after Brexit.

We doubt that this is the case.

The obvious point is that EU law did not prevent the nationalisation of Northern Rock in 2008, or the brief nationalisation of the St-Nazaire shipyard by the French Government in 2017 to prevent the shipyard falling into Italian control, among other examples. Indeed Article 345 of the Treaty on the Functioning of the European Union expressly preserves the rules in Member States governing property ownership.

In principle, EU law, and the EU state aid rules in particular, can create restrictions on how nationalisation is effected, but only if it involves the grant of government support that a private sector investor would not have secured. In other words, unless the targets of Labour's proposed nationalisation are experiencing business difficulties at the time that they are taken under public ownership (as was the case for Northern Rock), it is not obvious that the state aid rules would come into play. Even if they did, they would be unlikely to be of assistance to any shareholders seeking to prevent a nationalisation, or to increase the amount of compensation they receive. If anything, the state aid rules may effectively cap that compensation, by preventing payments to business investors that exceed the price that a private sector buyer would have paid.

Brexit is therefore unlikely to give the Government more freedom to nationalise at a price of its choice. It may impact the restrictions on businesses following nationalisation – although it is likely that the EU will insist on rules broadly equivalent to EU state aid and competition rules in any future EU-UK Free Trade Agreement (FTA).

EU Charter of Fundamental Rights

The EU Charter of Fundamental Rights was adopted by the EU in 2012. Article 17 specifically provides that:

"No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss."

It has been suggested that this creates a potential basis for a legal challenge against nationalisation if the compensation is unfair or not paid in good time.

However, in our view, this misunderstands the purpose and effect of the Charter. The Charter is binding on EU institutions, and all EU law must comply with it. It applies to Member States only when they are acting "within the scope of EU law".

Nationalisation is not "within the scope of EU law" and therefore it is unlikely that the Charter would apply to it, even if the nationalisation occurred before Brexit or during any transitional period in which EU law continues to apply to the UK

After Brexit, section 5(4) of the European Union (Withdrawal) Act 2018 explicitly provides that the Charter will not form part of retained EU law. Hence, if that section of the Act has come into force by the time of nationalisation, there would be no ability to raise any arguments based on the Charter in the UK courts.

European Convention on Human Rights

The European Convention on Human Rights (ECHR) is an international treaty, ratified by all Council of Europe states. It is not an EU treaty and will not be affected by Brexit. The ECHR was directly incorporated into UK law by the Human Rights Act 1998.

Article 1 of Protocol 1 to the ECHR guarantees the right to the peaceful enjoyment of property:

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

This right is, however, a qualified right. States may – and do – interfere with property rights, provided it is "in the public interest" to do so, and states also have a wide margin of appreciation to determine what constitutes the "public interest". Article 1, Protocol 1 requires a fair balance to be struck between the person's right to peaceful enjoyment and a state's ability to act in the public interest.

In response to various legal challenges concerning nationalisations, the European Court of Human Rights (ECtHR) has set out two basic rules which Governments must follow:

- there must be reasonable compensation for the interference with property, and
- a reasonable valuation method must be used to calculate such compensation.

"Reasonable compensation" is not necessarily the same as full market value compensation, but in our view any departure from the market value would have to be carefully justified. The Labour Party has suggested that the price could be impacted by "perceived behaviour". If that is suggesting that shareholders face a price adjustment if they publicly oppose the nationalisation, or threaten legal action, that could plausibly be challenged as "unreasonable". If, on the other hand, the "behaviour" in question was alleged to be the artificial inflation of profits at the cost of consumers then it is possible to see how an argument might be developed that reasonable compensation was less than current market value.

If Labour were to apply these deductions, Article 1, Protocol 1 could, in this context, be relied upon by individuals and companies, whether resident/established in the UK or elsewhere to argue that compensation is not reasonable.

How would the ECHR be relied upon in practice?

Before the introduction of the HRA, enforcement of rights under the ECHR could only be pursued by costly and lengthy legal proceedings, commonly requiring litigants to take their case to the ECtHR in Strasbourg (indeed, claims brought by former shareholders of aircraft and shipbuilding companies nationalised by the Labour Government in 1977 were not resolved by the ECtHR until 1986). Since then, the implementation of the HRA in 1998 has significantly changed the enforcement landscape in the UK.

There are three main pillars to the HRA, which substantively implements the ECHR into UK law:

- *First, public authorities must not act in a way that is incompatible with the ECHR.*

  This means that if an Act of Parliament gives a Minister, tribunal or other body any discretion relating to compensation, then that discretion must be exercised in accordance with Article 1, Protocol 1. Failure to do so would give shareholders a direct right of redress

> **In principle, the UK could withdraw from the ECHR – however that may not be politically feasible for a Labour Government.**

> **The Investment Treaty arbitration provisions have always been controversial. With some seeing them as placing constraints on the state's ability to introduce measures that they regard as being in the public interest.**

against the Government before the UK courts. The usual remedy in these circumstances would be an order quashing whatever had been done in breach of ECHR, requiring it to be done again in accordance with the law as laid down by the court.

- *Second, primary legislation must to the extent possible be given an interpretation which conforms with the principles of the ECHR.*

  This permits UK courts some (though not complete) latitude in the interpretation of Acts of Parliament, allowing the courts, where there is ambiguity in the language, to "read in" adequate compensation rights to ensure that the UK complies with its ECHR obligations. Again, this potentially gives shareholders a direct right of redress with respect to compensation. The more complex the nationalisation legislation, the most likely it is that ambiguities will arise, giving shareholders potential claims.

- *Third, if the primary legislation is not sufficiently ambiguous to permit a conforming interpretation, the UK courts may make a "declaration of incompatibility".*

  A declaration of incompatibility does not affect the validity or continuing operation of an Act of Parliament as a matter of domestic UK law, and does not allow the UK courts to award damages. It is merely a statement that the UK courts consider that Parliament has acted in breach of the UK's international obligations in the ECHR. The matter is then taken back to the political arena, the general expectation being that the Government and Parliament will wish to bring UK law into line with the ECHR. But whether or when this might happen in the context of a highly political nationalisation is less clear.

The most recent challenge to nationalisation by the Government through the UK courts was taken by the shareholders of Northern Rock. The shareholders launched a series of judicial reviews regarding what they saw as the inadequacy of the Government's compensation scheme (set up using a delegated power under the Banking (Special Provisions) Act 2008) when Northern Rock was nationalised. The compensation provisions, which the shareholders argued were incompatible with Article 1, Protocol 1, provided for an independent valuer to assess compensation in accordance with certain assumptions, including that Northern Rock is "unable to continue as a going concern". The shareholders ultimately received zero compensation. The court wholly rejected the shareholders' arguments: if the assumptions were appropriate, then compensation, even if zero, would be fair. The context in which the nationalisation takes places is clearly important to the issue of fairness of assumption. The context for the Labour Party's present nationalisation plans is clearly distinguishable from the context for Northern Rock's – an insolvent bank's – nationalisation. Assumptions that were deemed fair in that context could be unfair if applied in the present context. It is therefore surprising that the Labour Party has pointed to Northern Rock as a relevant precedent (see box: Labour's compensation plans).

In principle, the UK could withdraw from the ECHR – however that may not be politically feasible for a Labour Government.

Investment treaties

Whilst the ECHR may give shareholders some recourse, there is likely to be stronger substantive and procedural protection for shareholders who are able to qualify for the benefit of one of the several different types of applicable investment treaty.

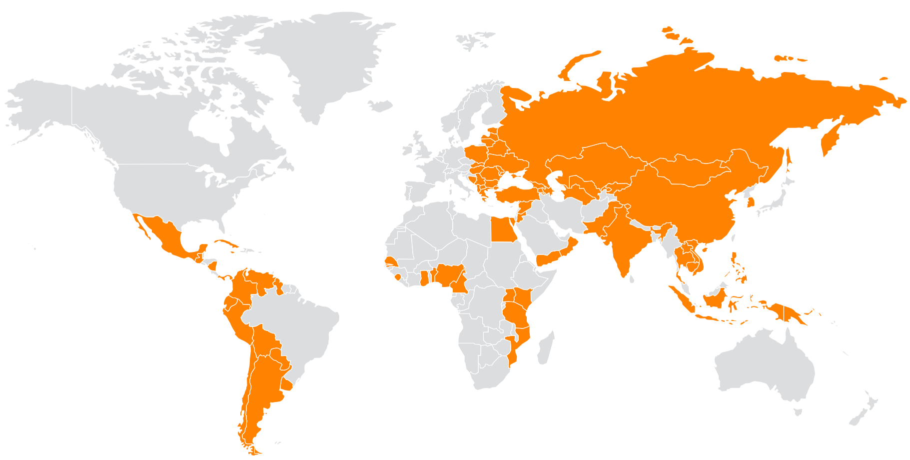
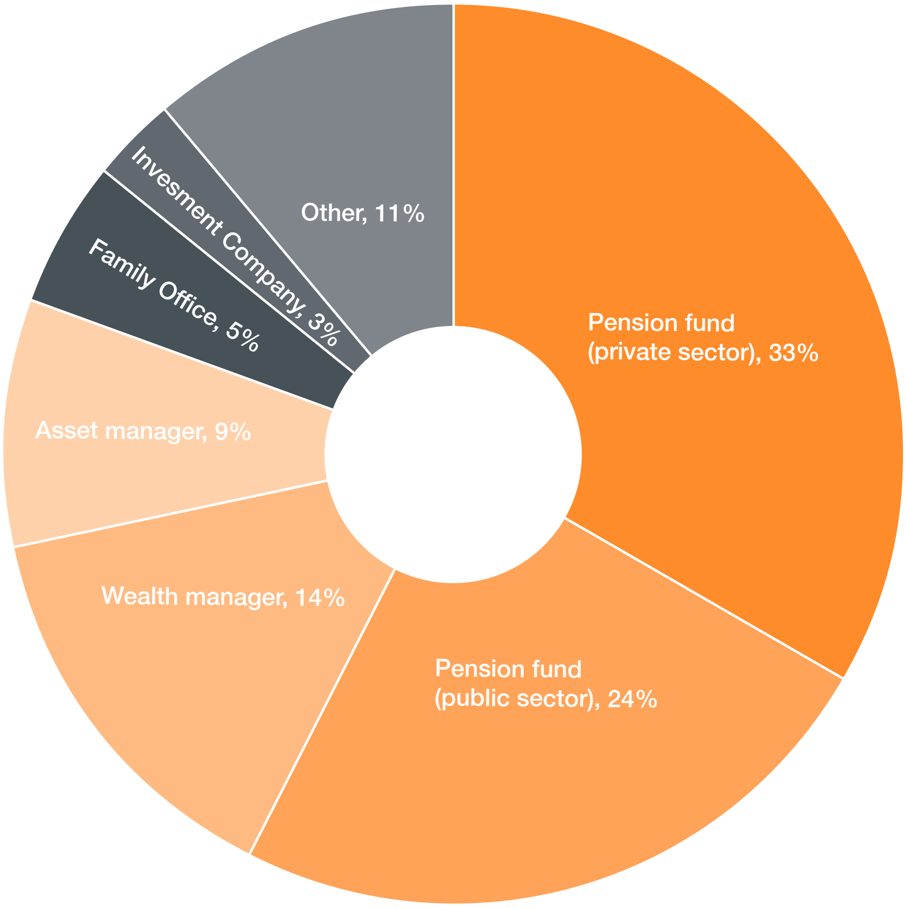


Figure 1 – UK bilateral investment treaties



Who owns UK infrastructure businesses?

The majority of UK investors in infrastructure businesses are public and private sector pension funds, according to data compiled by Preqin

It has been suggested by Labour spokespeople that UK pensioner and employee shareholders could be protected, so that nationalisation leaves them "no worse off". That implies discriminating against foreign pension fund and other investors, which would be problematic from both a legal and diplomatic perspective.

There is no public data showing the percentage of UK vs foreign investors in UK infrastructure businesses. However, ONS data shows that UK investors make up 47% of investors in UK listed shares, and we would expect the proportion of UK investors in UK infrastructure businesses to be higher.

A bilateral investment treaty (BIT) is an agreement between two states, facilitating private investment by nationals and companies of each state in the other state. It does so by acting as a tool for protecting international investment by providing investors with guarantees that they will not be discriminated against and that their investments will not be expropriated without appropriate compensation. Similar provisions can also be found in some multilateral investment treaties (such as the Energy Charter Treaty and free trade agreements that contain investor dispute mechanisms).

Traditionally BITs were signed between OECD states (such as the UK) and developing states, the theory being that fear of protectionist state measures, in particular, expropriation, was preventing external private sector investment in developing states. However BITs work in both directions. Aggrieved shareholders in a UK nationalised business, unhappy at the compensation they are receiving, could have potential redress under a BIT, if they are established in a state that is party to a BIT with the UK.

Figure 1 shows the states that are party to a BIT with the UK. They are, in the main, developing countries where there are likely to be few, if any, shareholders in industries that are the focus of the Labour Party's nationalisation plans. So there are no BITs with Western European countries (though there are BITs with some former communist states), the US, Australia, or with any of the Crown Dependencies or Overseas Territories. There are, however, some important potential shareholder jurisdictions where the UK does have BITs: Singapore, Hong Kong, China and India in particular. Significant investment into UK infrastructure has come from these jurisdictions.

Under the UK's Model BIT, which forms the basis of most of the UK's BITs, the UK may not nationalise or expropriate investments in the UK by nationals or companies of the UK's contracting state partner, except for a "public purpose related to the internal needs" of the UK, on a non-discriminatory basis and against prompt, adequate and effective compensation.

> **The majority of investors in UK infrastructure businesses are pension funds**

The protections afforded to investors covered by BITs are therefore typically somewhat broader in scope than those under the ECHR/HRA. In particular, compensation must be "prompt, adequate and effective", rather than merely reasonable.

The Model UK BIT goes on to state that

- "such compensation shall amount to the genuine value of the investment expropriated immediately before the expropriation or before the impending expropriation became public knowledge, whichever is earlier, shall include interest at a normal commercial rate until the date of payment, shall be made without delay, be effectively realizable and freely transferable."

A Government nationalising at less than genuine value could therefore find its action open to challenge if the affected investor were covered by a relevant BIT.

As well as providing substantive protections against expropriation without compensation, a BIT provides procedural safeguards. Most importantly, the UK's Model BIT provides an alternative dispute resolution procedure – the ability to bring a dispute and claim compensation before an international arbitral tribunal, rather than pursuing any claim before the UK courts.

The nature of the arbitration process means that the UK Government has very little ability to circumvent its obligations under an investment treaty – any domestic legislation which purported to override an investment treaty will not relieve the UK Government from its treaty obligations. The UK could terminate its BITs, but under the standard Model UK BIT, investor protections would remain in place for twenty years following termination.

These additional protections afforded by investment treaties produce the surprising result that, for example, a Chinese investor in a UK water company which is nationalised at below FMV could have a stronger claim, substantively and procedurally, than a British pension fund in the same position (which would likely have to rely on the ECHR/HRA).

It would therefore be unsurprising to see some investors who do not have the benefit of an investment treaty moving their investments into entities attracting investment treaty protection and there are already reports that this is being considered. Whether such an investor could take advantage of the investment treaty protections would depend on whether they qualified as an "investor" under the terms of the particular BIT. Each investment treaty is different and investors may structure their investments to take advantage of the differences in the level of investment protection in different treaties. For instance, under most of the UK's BITs, a company will qualify as an "investor" attracting protection simply because it is incorporated in a contracting state (nationality of convenience). Moving an investment holding to take advantage of an investment treaty may give rise to an objection if it is effected once nationalisation looks likely to happen.

The Investment Treaty arbitration provisions have always been controversial, with some seeing them as placing constraints on a state's ability to introduce measures that that they regard as being in the public interest (that is, of course, the point). More recently, these provisions have come under criticism from the European Commission, which views BITs between EU Member States as potentially contrary to EU law, as they may reach decisions on matters of EU law outside of the EU and national court systems. This view was on 6 March 2018 upheld by the Court of Justice of the European Union. It is therefore likely that the UK would resist any attempt by an aggrieved shareholder to obtain an arbitration award against the UK, where the BIT in question is between the UK and an EU Member State (e.g. Hungary or Poland).

Energy Charter Treaty

The Energy Charter Treaty (ECT) was created at the end of the Cold War with the aim of integrating energy markets in East and West Europe. It has 53 signatories, including France, Germany, Spain, Ireland, The Netherlands and Luxembourg and most of the EU.

Investment treaties and recent nationalisation experience

Most treaties (including the UK Model BIT and the Energy Charter Treaty) provide that, for an expropriation (or nationalisation) to be lawful, the taking must be:

(i) for a public purpose related to internal needs of the host state;

(ii) carried out in accordance with due process;

(iii) non-discriminatory; and

(iv) accompanied by prompt, adequate and effective compensation.

In practice, nationalisation only triggers BIT claims when compensation is below the fair market value (FMV) of the expropriated investment. This is illustrated by a comparison of the nationalisations conducted by Hungary with those conducted by Venezuela (two countries which have been responsible for a number of recent large nationalisations).

Since the 2010 election of Viktor Orbán, Hungary has conducted a wave of nationalisations / de privatizations, including a major part of the pension system, a major share in MOL (Hungary's multinational oil and gas company), numerous banking cooperatives, gas storage facilities and various private companies. Many of these nationalisations have been for above market value and have been labelled "sweetheart" deals, in particular those involving foreign investors (e.g. the Government's purchase of a stake in MOL from Russia's Surgutneftegaz).

So far, based on publicly available information, there have been no successful BIT claims against Hungary in relation to these nationalisations (the exception being a US$24 million award with respect to the prepaid corporate voucher industry).

By contrast, the widespread nationalisations by the Chavez administration in Venezuela have sparked dozens of treaty claims and awards against the State. Indeed, Venezuela has been the respondent state in the lion's share of reported nationalisation cases. Many of these nationalisations were effected without any compensation and arbitral tribunals were tasked with determining the FMV of the expropriated investments.

The significance for Labour's nationalisation plans is that it contains an investor protection provision which is essentially the same as that in the UK Model BIT. The ECT covers exploration, extracting, refining, production, storage, transport, transmission, distribution and sale of most forms of energy.

Hence any nationalisation of energy generation or distribution companies which does not provide fair market value compensation to investors, will potentially face international arbitration claims under the ECT by French, German etc investors, at the same time as Hong Kong, Chinese etc investors pursue BIT claims.

Free Trade Agreements

The EU has, in recent negotiations, shown an ambition to include substantive and procedural investment protections in its free trade agreements (FTAs). The UK is, at least for now, party to FTAs negotiated by the EU. Investors in a jurisdiction with an FTA with the EU that contains an investment protection chapter and provides for investor-state dispute settlement will be able to rely on those protections in the same way as a BIT.

This is a new approach for the EU, adopted since the Lisbon Treaty extended the EU's powers in respect of foreign direct investment. In recent FTAs, such as those with Canada, Singapore and Vietnam, the EU has included substantive investment protection and investor-state dispute mechanisms. The Comprehensive Economic and Trade Agreement (CETA), between the EU and Canada, includes an investment chapter and investor-state dispute settlement provisions, discussed in further detail below. The EU-Singapore FTA and the EU-Vietnam FTA also include similar provisions.

The investment chapters and investor-state dispute settlement provisions in these FTAs have not yet come into force, and will need each EU Member State's ratification to do so. With regards to CETA, while the rest of CETA applies provisionally and will enter into force when all EU Member States ratify the agreement, the EU Members States have, for now at least, carved out investment protection. Significantly, according to the Court of Justice of the European Union – in an Opinion rendered on 16 May 2017 on the competence of the EU to conclude the EU Singapore FTA – investment protection provisions that concern non-direct investors and/or investor-state dispute settlement mechanisms do not fall within the exclusive competence of the EU. All EU Member States must ratify such agreements. This is likely to lead to significant difficulties or at least delays in negotiating EU FTAs containing substantive and procedural investment protections. However, on 30 April 2019, the CJEU rendered an opinion that the investor-state dispute settlement mechanism in CETA is compatible with EU law.

Once in force, the substantive provisions will be similar to those under a BIT. For example, CETA specifies that a Party shall not nationalise/expropriate a covered investment directly or indirectly, except (a) for a public purpose; (b) under due process of law; (c) in a non-discriminatory manner; and (d) on payment of prompt, adequate and effective compensation.

CETA requires that the compensation provided shall (a) amount to the fair market value of the investment at the time immediately before the expropriation or the impending expropriation become known, whichever is earlier and (b) include interest at a normal commercial rate from the date of expropriation until the date of payment.

Once the CETA investment provisions enter into force (which, following the CJEU judgment of 30 April 2019 approving the investment court system as compliant with EU law, will occur on ratification of the treaty), affected investors will have the right to take any claim before an international investment court, rather than a traditional investor-state arbitral tribunal or domestic courts.

Even if the investment provisions in the recent EU FTAs do come into force, it is currently unclear whether the UK will remain a party to the EU's FTAs following Brexit. One possibility is that the UK and an FTA partner state both agree that the relevant FTA will continue to apply. Another is that a new FTA is negotiated (but that would take considerable time). Of course, there is also the possibility that there could be no successor FTA at all.

The other important outcome of Brexit is that there is likely to be an FTA between the UK and EU. One plausible

How is compensation determined under BITs?

Generally, in a BIT case the treaty will provide for the standard of compensation. Formulations such as "prompt, adequate and effective" and "genuine value" are widely accepted as equating to fair market value (FMV), which is generally considered the appropriate standard of compensation. FMV also reflects the compensation standard under customary international law, as per the World Bank Group, *Guidelines on the Treatment of Foreign Direct Investment* (1992).

While the precise formulation of FMV varies, a number of the Venezuelan nationalisation tribunals identified the following criteria:

- the hypothetical buyer and the hypothetical seller are interested in making the transaction, but are under no obligation to do so;
- the buyer and the seller are acting good faith and the transaction is at arm's length;
- the transaction takes place in an open market and without restrictions; and
- the buyer and the seller have a reasonable knowledge of the subject of the contract and of the market conditions.

As for the date at which the investment is valued, this will often be specified in the treaty, e.g. the UK Model BIT provides that compensation should be the genuine value immediately prior to the expropriation or the date it became public, whichever is earlier.

A right to interest may be provided for in the treaty. If not, tribunals tend to award interest compounded annually at a rate slightly above the US treasury bill rate or LIBOR from the valuation date to the date of payment.

model for such an FTA is CETA, and if such an FTA contained CETA-style investor protection provisions then EU investors would gain a very significant degree of protection against nationalisation.

International law

BITs and investment protections in FTAs represent a codification of and enhancement to the general protections for investors found in international law. Absent a BIT or FTA, an investor would have no forum to pursue an international law claim against the UK – but the investor's government might be willing to pursue diplomatic and other remedies. That is particularly the case where the investor is itself owned by, or closely associated with, the government – as would, for example, be the case for sovereign wealth funds. Particular difficulties may arise with Northern Ireland Electricity, which is owned by a company controlled by the Republic of Ireland.

Hence nationalisation for less than full market value could have consequences for the Government beyond the merely legal.

How likely is nationalisation to happen?

Our assessment is that a nationalisation Bill is very likely to be presented to Parliament if the Labour Party under its current leadership achieves a general election victory with a workable majority, or forms a Government with the support of the Scottish National Party. If that happens, the political impetus behind nationalisation should not be underestimated and, on the surface at least, it seems to have a high level of public support. What is much less clear is how the various complexities identified in this paper would be resolved and, in particular, how compensation would be addressed. These complexities mean the successful passage of nationalisation legislation through Parliament would not be guaranteed.

Furthermore, even if Labour has a secure majority, the technical challenges in preparing a nationalisation Bill of a large number of complex businesses are considerable. Nationalising two sectors in one Bill, whilst technically possible, seems impracitable (particularly if Labour wants to deliver on priority items, such as water, as soon as possible). Thus there would likely be a series of nationalisation Bills presented in different sessions, over a period of years.

One alternative to nationalisation would be an increased level of regulation. The 2017 Labour Party manifesto proposed increased regulation for a variety of businesses, from buses to electricity distribution. The emphasis since the election has been away from this and towards nationalisation, but, if nationalisation began to look overly complex or overly expensive, then the Government might view a reform of the regulatory regime as attractive, either as a short term solution or as an alternative to nationalisation.

There might even be an attempt to drive down the value of certain industries as a precursor to nationalisation – however customary international law recognises that such a "creeping expropriation" is subject to much the same constraints as a direct expropriation.

Conclusions

Any nationalisation that does not provide fair market value compensation, or is otherwise perceived as unfair will almost certainly be challenged

- through investor-state arbitration proceedings (where investors are established in a country which has an appropriate investment treaty with the UK, whether a BIT or an FTA), and/or
- in the UK courts on the basis of the HRA (by investors unable to take advantage of investment treaties, including national investors)

A case brought under an investment treaty would, in our assessment, have a stronger chance of succeeding than claims under the HRA, which face higher substantive and procedural bars. Ultimately however, the less reasonable the terms of any nationalisation, the more likely such challenges are to succeed.

This suggests that investors in with appropriate investment treaty protection could end up receiving higher compensation than others. This may mean that some investors could seek to move their investments to jurisdictions where they can take advantage of investment treaty protection.

However, UK investors, or investors that do not attract investment treaty protection, can take a degree of comfort from the political quandary the Government would find itself in if it is ordered by an international tribunal to pay increased compensation to foreign investors. How politically realistic would an outcome be that favoured foreign investors? Would a UK Government really be able to justify leaving a UK pension fund worse off than a Hong Kong investor?

Market value compensation still leaves plenty of room for unfairness – overpaying some, and underpaying others. Disputes would therefore still be likely, but they would be disputes on much more favourable ground for the Government than trying to defend nationalisation for less than market value before UK courts and international arbitration tribunals.

Further information

If you would like further details on any aspect of this paper, or how it applies to your business, please speak to your usual Clifford Chance contact or any of those listed overleaf.

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