Upgrade your security

International investment agreements can provide protection from the risks of investing abroad. But make sure to review the applicability requirements and the substantive provisions

Investing abroad is a risky business. Investors face the uncertainty and unfamiliarity of the host nation's laws and regulations, changes to which can have detrimental effects on foreign investments.

The exercise of police powers by the investment host state in particular poses substantial risks that regulatory or fiscal changes could impair or even expropriate the investment. To alleviate these risks, investors should consider structuring their investments to take advantage of international investment agreements (IIAs).

Although these treaties do not prohibit countries from using their police powers, IIAs may provide investors with a forum in which to seek compensation for the harm caused to their investment by the new regulation.

Exercise of police power

Direct expropriations again seem to be on the rise. As the United Nations Conference on Trade and Development noted in its 2010 World Investment Report, expropriations "occurred in a few Latin American countries, affecting industries such as banking and electricity."

Similarly, countries have recently become more aggressive in nationalising large oil and gas projects outright. Investors therefore may have to reevaluate the consensus view, expressed as late as 2008 in a treatise on the subject, that "[t]oday direct expropriations have become rare."

But the far more prevalent risk to foreign investments comes from indirect expropriations or significant regulatory impairments. An example might be the unjustified failure by the host state government to renew necessary permits for asserted environmental reasons (see *Metalclad Corp v United Mexican States*, August 30 2000).

Similarly, a recent arbitration concerning the non-honouring of payment obligations pursuant to a joint venture agreement gave rise to a finding of expropriation (*Alpha Projektholding v Ukraine*, October 20 2010).

In cases in which the investor was not permanently deprived of the investment in its entirety, but in which regulations significantly impaired the value of the investment, tribunals have held host states liable for failure to treat investments "fairly and equitably" (*Total SA v Argentine Republic*, December 27 2010).

Regulatory risks are on the rise in the energy sector. For instance, Germany's recent decision to shut down all nuclear power plants by 2022 in response to the Fukushima disaster may be the first in a volley of similar regulations by other host states. Such decisions may significantly impair the value of investments held by foreigners in these jurisdictions – and in some instances may even amount to an outright taking.

Taxation risks are similarly on the rise. These risks include the imposition of taxes seeking to deter purportedly harmful activity, such as cigarette taxes. Investors also face a risk of the imposition of taxes allowing the host nation to participate in windfall profits.

For example, the UK recently imposed a windfall tax on the sale of oil from the North Sea, raising the levy from 20% to 32% because oil companies were making "unexpected profits." Investment structures are available to stabilise these tax risks through a combination of contractual undertakings from the government and IIA coverage.

Also, the bailout legislation adopted in response to the financial crisis may lead to actionable impairment or even expropriation. As a 2009 United Nations World Investment Report noted:

"[N]ational bailouts and rescue packages in response to the crisis have sometimes resulted in the partial or total nationalization of domestic financial institutions. If foreign investors hold shares in these companies, they may be entitled to compensation under the expropriation provisions of IIAs. In addition, foreign investors might have the possibility to challenge stricter State control over the financial sector "as regulatory takings" in the context of investor-State disputes."

Finally, and perhaps related to bailout legislation, the current sovereign debt woes in the US and Europe also create significant political risk. This risk most visibly is sovereign default.

Less obviously, Standard & Poor's downgrade of US sovereign debt by express reference to political gridlock was a manifestation of unexpected political risk. Regulatory measures and policy shifts taken by reference to sovereign debt concerns can have a significant impact on foreign investors.

Investors may be able obtain some protection against these risks as well through better political risk structuring.

Obtaining treaty protection

Careful investment structuring may protect investors against losses from even the valid exercise of police powers by host states. IIAs frequently contain the host state's consent to arbitrate disputes relating to treaty protections directly with the foreign investor.

The treaties protect qualifying investments against expropriation without compensation, as well as against unfair and inequitable treatment – such as the impairment of investments by state action despite reasonable investment-backed expectations that no such action would be taken.

But investors will not be automatically covered by IIAs in many instances. When there is no IIA between the home state of the investor and the host state of the investment, for instance, investors may have to explore alternative courses of action such as structuring an investment through a third country.

One example is the situation in *Saluka Investments v The Czech Republic*, in which a large Japanese investor, Nomura Group, incorporated in the Netherlands and for that reason was able to advantage of a bilateral investment treaty (BIT) between the Netherlands and the Czech Republic.

Japan has only 15 BITs and 11 Free Trade Agreements (FTAs), none of which is with the Czech Republic, but by structuring its investment with Dutch incorporation, Nomura Group obtained treaty investment protection in the absence of a Japanese investment treaty.

Potential structuring concerns

Investors should be aware that the mere existence of a BIT or IIA between the contracting states is not always enough to ensure investment protection. Just choosing

a treaty is not enough – an investor must comply with the definitional requirements of a BIT to be protected. The protections offered by treaties also can differ from case to case.

The requirements for presence in a home state, for instance, can differ from BIT to BIT. Some BITs have broad requirements, such as the Netherlands-Thailand treaty that defines the term "national" as a "legal person constituted in accordance with the law of either Contracting Party."

Other BITs require more, such as the Czech-Swiss BIT, stating that an investor must have a "seat" and "real economic activities" in the state in which it claims nationality. Tribunals in the past have dismissed claims when corporate formalities failed to meet treaty requirements.

Investors should also review the definition of "investment" to ensure that their transactions are covered. Most BITs have broad definitions of investment, which usually covers loans and account receivables from a trading company. BITs often protect indirect investments as well, such as minority shares in a company with foreign investments.

Nevertheless, the scope of protection may vary on a case-by-case basis. For example, although intellectual property rights are usually included in the definition of investment, the Benin-Ghana BIT stipulates that only IP rights recognised by the national laws of both contracting parties will be protected, thus limiting the scope of application of the treaty. Investors should be on the lookout for such stipulations which could considerably limit the scope of protection under the BITs.

Investors should also review the substantive protections within a treaty. For instance, the treaty between Japan and Bangladesh does not contain the typical protection against unfair and inequitable treatment that most directly protects reasonable investment-backed expectations of foreign investors.

Such a protection would have to be argued for by operation of the "most-favored nations" clause in that treaty. Some treaties require payment of compensation only for "arbitrary or discriminatory measures" although others also include "unreasonable measures" within the scope of investment protections.

Other treaties again provide for more definite treatment protections, listing specific aspects of an investment that shall not be impaired unreasonably by government action.

Finally, investors should also review the stated exceptions in a treaty, as some IIAs provide broad exclusions of liability. Article 22.2 of the US-Peru FTA, for example, includes an extremely broad exculpatory clause: "[n]othing in this agreement shall be construed ... to preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests."

The FTA further provides that if a party invokes this article in an arbitral proceeding, "the tribunal or panel hearing the matter shall find that the exception applies." Investors should carefully examine treaties in order to structure for the most desirable overall protection for their investment.

Although foreign investments are risky endeavours, IIAs can provide significant protection. When entering into IIAs, investors must be careful to review both the applicability requirements and the substantive provisions to ensure the expected protection.

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