Overview

1. Introduction

1.1 Foreign investors invest in projects in host States in the hope and expectation of success and a reasonable return on their investment. However, it is unfortunately a relatively common occurrence for foreign investments to be damaged or completely destroyed by measures taken by the host State into which the investment was made. These measures range from outright expropriation of the investment to a unilateral change in the regulatory, royalty, pricing and tax regimes, which undermine the economic basis on which the investment was made. In such cases the investor's losses may not be recoverable because the investor is limited to bringing an action in the domestic courts of the host State, or instituting a domestic arbitration, where obtaining a fair hearing against the government of the host State is often not possible. Further, often there will not be a contract between the foreign investor and the host State and therefore the foreign investor will not have a contractual claim against the host State.

1.2 However, there is a solution to this problem, which is to structure the investment such that there is an investment treaty containing an arbitration clause (most commonly a bilateral investment treaty, or “BIT”) in place between the investor’s home State and the host State. Foreign investors are increasingly looking to structure their investments to take advantage of investment treaty protections.

1.3 This advisory considers the basics of investment treaties, and explains how investors can structure their investments so as to ensure that they are protected by such a treaty.

2. Our experience

2.1 Steptoe has an extensive history of representing both States and investors in investor-State arbitrations and other international law disputes. The Global Arbitration Review awarded Steptoe one of its top prizes at the 2016 GAR Awards, where we won in the category “International arbitration practice that impressed in the past year.” In addition, our arbitration team in 2016 received The American Lawyer’s award for “Global Dispute of the Year: Investment Arbitration (Africa).” These awards were primarily in recognition of our work on recent ICSID arbitrations against Zimbabwe, in which our clients were awarded restitution and damages (alternatively $196 million in damages) plus their full legal costs and interest.

3. Investment treaties – an overview
3.1 Investment treaties are agreements between States governed by public international law, which provide that nationals (companies or individuals) of each State when investing in the other State, will, together with their investments, be accorded certain rights and protections. In general, investment treaties only bind States once they have entered into force (as opposed to merely upon signature). Conduct deemed to be that of a State includes the conduct of all of the organs of the State (the Executive, the Legislature and the Judiciary), together with the conduct of all persons and entities empowered to exercise elements of governmental authority; the latter group, depending on the circumstances, may include State companies and their officers. Therefore the State conduct covered by investment treaties is very wide.

3.2 The most common protections that host States promise under investment treaties include: (i) a standing offer by the host State to submit disputes between it and the investor to binding international arbitration, which may be commenced by the investor; (ii) fair and equitable treatment; (iii) full security and protection; (iv) treatment at least as good as that provided by the host State to its own nationals (national treatment); (v) treatment at least as good as that provided by the host State to nationals of third States (most favoured nation treatment); (vi) repatriation of investments and returns; (vii) no expropriation unless against prompt, adequate and effective compensation; and (viii) a promise to observe obligations with regard to investments (known as "umbrella clauses"). These protections are outlined in further detail in section 7 below. A breach of an investment treaty entitles the investor to damages to a level that would wipe out the consequences of the breach.

3.3 Investment treaties are unique in that they are international agreements between States that give enforceable rights to companies and individuals. Furthermore, they generally provide protection to covered investors, whether or not the investor has a contractual relationship with the host State.

4. There must be an “investor”

4.1 In order to be an “investor” covered by an investment treaty, the investor usually needs to be a national of one of the contracting States to the treaty on which it seeks to rely. Many treaties provide that a company will qualify as a national if it is incorporated in the State of which it asserts nationality.

5. Treaty shopping

5.1 In many instances there may not be an investment treaty in force between the home State of the investor and the host State into which it wishes to make, or has made, the investment. However, this problem can often be solved easily. Take for example the situation where a British investor wishes to invest in Zimbabwe. At the time of publication, there is no BIT in force between the United Kingdom and Zimbabwe. However, there is such a treaty in force between the Netherlands and Zimbabwe. In order to obtain the protection of the BIT between the Netherlands and Zimbabwe, the British investor need only incorporate a subsidiary company in the Netherlands and ensure that the Dutch company owns (directly or indirectly) the investment in Zimbabwe. Such a structure will entitle the Dutch company to bring a claim under the BIT in the event that a measure is taken by the Zimbabwean Government which damages the investment.

5.2 However, a word of warning: consider the tax position that may be created by adding the newly incorporated company to the structure.

5.3 Furthermore, it is essential that any structuring of this kind is done before the dispute arises, otherwise such arrangements are likely to be characterised as “forum shopping,” which arguably is not permitted. It is also important to ensure that the newly incorporated subsidiary falls within the scope of the relevant treaty’s protections, particularly in terms of its definition of the term “investor.”

6. There must be an “investment”

6.1 Furthermore, an investment treaty only applies to “investments” made by foreign investors into the host State. The term “investment” is defined very widely in most treaties to cover “every kind of asset” including shares, concessions, debt instruments, land and moveable property. Very wide interpretations have been given to these definitions by arbitration tribunals. However, a one-off sale agreement is less likely to be deemed to be an “investment.” In addition, arguably, a broad view should be taken as to the location of the investment. For example, a loan from A to B (located in State 1), which is then passed on to C in State 2 for use in State 2 is arguably an investment by A in State 2.

7. Protections offered to investors under investment treaties

7.1 This section sets out the key protections typically offered to investors under investment treaties.
7.2 Access to international arbitration: Most investment treaties provide that a foreign investor may refer disputes between it and the host State, arising out of an investment, to international arbitration. This is a fundamental right, because without it all of the other rights cannot be enforced effectively by the investor. Most investment treaties provide for arbitration at the International Centre for Settlement of Investment Disputes (ICSID) (a World Bank arbitration forum), ad hoc arbitration under the UNCITRAL Arbitration Rules, or a choice between them. However, some treaties also have provision for other arbitration forums or rules, such as the International Chamber of Commerce (ICC), the Stockholm Chamber of Commerce (SCC) and the Permanent Court of Arbitration (PCA).

7.3 Many investment treaties expressly take account of rights of subrogation. In any event, it is permissible for insurers to bring a treaty claim in the name of the insured.

7.4 Monetary arbitration awards rendered by tribunals constituted pursuant to the ICSID Convention are enforceable in each of the 154 States that have ratified the Convention (as of publication) as if they were a final judgment of a court of the State in which they are to be enforced – there are no grounds for refusing to enforce the award for public policy reasons or otherwise. If the arbitration tribunal was constituted other than under the ICSID Convention, then enforcement will usually be through the New York Convention. In any event, enforcement will be subject to the laws of sovereign immunity, which will generally mean that it will need to be against assets in use (or intended for use) for commercial purposes.

7.5 Fair and equitable treatment is a very wide protection. An exhaustive definition of this standard is outside the scope of the present advisory and will depend on the particular wording of the treaty relied on. However, in broad terms, the standard generally requires a host State’s conduct toward a covered investment to be transparent, non-arbitrary, non-discriminatory, fulfill the investor’s legitimate expectations, follow due process, not amount to a denial of justice, and not be abusive (i.e. be free from coercion, duress and harassment). The most common situation in which States are found to have breached the fair and equitable treatment standard is where the implementation and maintenance of a particular regulatory regime (e.g., relating to royalties, pricing, and taxes) is promised to the investor by the host State before the investment is made, but is subsequently unilaterally changed by the host State after the investment has been made.

7.6 The right to full protection and security places an obligation on the host State to act diligently so that the investor’s investments are not damaged.

7.7 National treatment is the right of a foreign investor to be treated at least as favourably as nationals of the host State. This limits the State’s ability to favour its “national champions.”

7.8 Most favoured nation treatment, or MFN, is the right of a foreign investor to be treated at least as favourably as nationals of a third State. MFN clauses are a way of ensuring that the host State does not have distorting investment policies toward foreign investors of different nationalities. They are often relied on as a means to “import” more favourable standards of treatment from investment treaties that the host State has entered into with a third State, in circumstances where such standards would not otherwise be applicable to the investor.

7.9 Repatriation of investments and returns is the right of a foreign investor to freely transfer out of the host State, without delay, the investment, and any returns on the investment (such as dividends), in a convertible currency.

7.10 Expropriation or measures having effect equivalent to expropriation: Investment treaties usually contain a right stating that the foreign investor’s investment will not be subject to expropriation, or measures having an effect equivalent to expropriation, unless the expropriation is for a public purpose, is on a non-discriminatory basis, follows due process, and is against “prompt, adequate and effective compensation.” In this context “prompt” means soon after the expropriation; “adequate” refers to the quantity of compensation and is generally regarded as meaning the fair market value of the investment; and “effective” means compensation paid in a convertible currency, usually the currency in which the investment was made.

7.11 Umbrella clauses vary in their wording, but a typical umbrella clause states: “[The host State] shall observe any other obligation it has assumed with regard to investments in its territory by [foreign investors].” Some cases have held that umbrella clauses elevate pure breaches of contract into breaches of the investment treaty, thereby enabling the investor to utilise the treaty’s dispute resolution clause.

8. Third party funding of arbitration claims

8.1 Increasingly, international arbitration claims are funded by third party funders, thereby giving clients more options as to how they finance their disputes. The clients utilising third party funding range from blue chip companies through to individuals. We can assist clients with obtaining third party funding.

9. Treaty changes and the importance of ongoing due diligence
9.1 A final note of caution. Investor-State arbitration has come under increased scrutiny in recent years. Some States have taken steps to withdraw from their investment treaties entirely, and some have chosen to replace them with treaties that are potentially less favourable for investors. In some instances, investors that held protected investments prior to such changes will continue to benefit from the old regime for several years (so-called “sunset” clauses, with periods that typically range from 5 to 25 years). However, this is not always the case: investors may find that their protection is immediately revoked or reduced. In either scenario, investors should consider what (if any) options exist to ensure ongoing protection. As such, it is important that investors review their protection status both at the outset of their investment and on a continuing basis thereafter.

Practices
International Arbitration
Investor-State Arbitration
Public International Law