

Legal Protection to Foreign Investors

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Governments have the ability to affect the return of foreign investments. The typical expropriation is one in which a government unilaterally transfers the property right of a firm without compensating the previous owners. However, governments can also expropriate through discriminatory taxation or regulation. For instance, governments can impose a high differential tax rate on a firm's benefits, limit the prices or locations at which a firm may sell its products, limit royalty payments, etc. Chifor (2002) notes that indirect expropriation through taxation and regulation has supplanted direct takings as the most common type of expropriation. Governments can also expropriate by defaulting on their debt. Borensztein and Panizza (2008) report 114 default episodes during the last 30 years. Sovereign defaults have been common in developing countries, though we have observed in 2010 and 2011 a significant increase in the perceived probability of a sovereign default in some European countries.

Governments could resort to expropriations to increase current fiscal resources or as a way to avoid implementing unpopular policies that could, for example, avert a sovereign default. However, expropriations can be costly in the long run. For instance, expropriations may be followed by lower capital inflows, expropriated firms may be run less efficiently, or expropriations may distort the behavior of firms that were not directly affected but fear being so in the future. When the long-run benefits derived from foreign investment or from better borrowing terms in international capital markets offset the potential short-run gains from expropriation, the welfare of domestic households could be increased by limiting the government's ability to expropriate foreign

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investors.¹ One mechanism that could be used to limit expropriation risk is to pass national laws that explicitly grant protection to investors. Yet, the fact that the authorities in charge of enforcing the law are the same ones that may violate investors' property rights casts doubt about the degree of protection that can be offered by local legal systems. Instead, one mechanism that is used to discipline current and future governments is to reduce the degree of sovereignty by increasing the government's exposure to foreign courts. This second mechanism is the focus of the present article.

One way sovereigns involve foreign courts is by signing international investment agreements that grant foreign investors the right to settle a dispute in international arbitration tribunals. Governments have also ratified international conventions that bind them to recognize arbitration tribunals' decisions concerning investment—and commercial—disputes. As far as the success of litigating investors is concerned, several authors (see, for example, Dolzer and Stevens [1995]; Reed, Paulsson, and Blackaby [2004]; and Baldwin, Kantor, and Nolan [2006]) argue that governments have tended to comply with unfavorable rulings in international tribunals. This has been so despite investors' limited legal means available to enforce reparation payments. The fact that governments have complied with unfavorable rulings suggests the presence of other types of costs. For example, ignoring unfavorable rulings may send a negative signal about the government's commitment to respect investors' property rights, which may have adverse aggregate consequences on capital inflows. But the apparent success could also be contaminated by the presence of sample bias in the set of cases that has been submitted to international tribunals. Investors who expected difficulties in collecting compensation payments may have decided not to bear the costs of litigation.² Note also that investors' past success in litigations may not be a good predictor of future success.

International investment agreements were originally designed with the intent to promote foreign direct investment, but they have gradually adjusted to extend protection to other types of investment. In part, this may explain the fact that not all investment agreements explicitly protect holders of sovereign debt.

In order to protect foreign lenders, governments have increasingly chosen to issue debt in international financial centers such as New York. This practice exposes defaulting governments to litigations in foreign national courts.

¹ Some authors have argued that the risk of losing political support could serve as an enforcement mechanism that protects domestic residents. Hatchondo and Martinez (2010) present a survey on the politics of sovereign defaults.

² A country that anticipates an unfavorable tribunal decision could also withdraw from an international investment agreement. Bolivia did so in 2007, shortly after a Dutch-based subsidiary of Telecom Italia filed a claim seeking arbitration in an alleged case of expropriation of a telecommunications investment.

Holders of bonds in default that were issued in foreign countries can enforce repayment in courts by diverting some type of sovereign assets located outside the defaulting country. However, defaulting governments have, in general, succeeded in locating those assets outside the reach of creditors. It should be mentioned that even when holders of debt in default do not succeed in collecting payments, they may be imposing a cost to the defaulting sovereign. This occurs because, in order to keep their assets outside the reach of creditors, governments in default may not be able to issue debt in international financial markets.

The rest of the article is organized as follows. Section 1 discusses international investment agreements. Section 2 discusses the protection granted to lenders by the issuance of sovereign debt in international financial centers. Section 3 concludes.

1. INTERNATIONAL INVESTMENT AGREEMENTS

This section discusses the legal protection that international investment agreements grant to a broad class of foreign investments. The typical investment agreement takes the form of a reciprocal bilateral investment treaty in which two countries agree on a set of conditions under which the nationals of one country may seek compensation if their investments in the other country are affected. There are also a few multilateral investment agreements, like Chapter 11 of the North American Free Trade Agreement between Canada, Mexico, and the United States.

It should be mentioned that international investment agreements do allow for states to expropriate foreign investors under certain circumstances, namely that the expropriation is done for a public purpose, in accordance with the law, in a nondiscriminatory manner, and after paying a prompt and adequate compensation to the property owner (see Dolzer and Stevens [1995] and Organization for Economic Cooperation and Development [2004]). The exact description of the conditions under which investors are granted the right to request compensation varies across treaties.

International investment agreements specify the arbitration rules that investors and governments can follow to settle disputes. The most common arbitration rules are specified by the International Center for the Settlement of Investment Disputes (ICSID) and the United Nations Commission on International Trade Law (UNCITRAL).³ In what follows, we describe how these arbitration rules work and the enforcement mechanisms available to investors.

³ According to the United Nations Conference on Trade and Development (UNCTAD 2009), of the 317 investor-state disputes outstanding in international tribunals, 201 had been filed under the ICSID arbitration rules and 83 under UNCITRAL arbitration rules.

Arbitration under ICSID Rules

The ICSID was established in 1965 under the ICSID Convention.⁴ The ICSID Convention was sponsored by the World Bank with the objective of promoting the flow of foreign direct investments; by the end of 2010, it had been ratified by 157 countries. Countries that ratify the Convention agree to abide by the ICSID arbitration rules, including the enforcement of the decisions of its tribunals. Reed, Paulsson, and Blackaby (2004) and the United Nations Conference on Trade and Development (UNCTAD 2009) have noted that the increase in the number of bilateral investment agreements observed in the last two decades has been accompanied by a parallel increase in the number of arbitrations conducted under ICSID rules.

The ICSID, which is one of the five organizations that make up the World Bank group, provides facilities for the resolution of investment disputes through conciliation or arbitration. For instance, it assists in the constitution of tribunals, it administers the funds necessary to cover the costs of the proceedings, it produces publications to contribute to the understanding of international investment laws, etc. The ICSID is not in charge of conducting arbitration proceedings.

With respect to the enforcement of arbitration tribunals' decisions, Article 54 of the ICSID Convention states that final decisions of ICSID tribunals must be considered equivalent to "final judgments" of local courts in countries that have signed the ICSID Convention.⁵ Baldwin, Kantor, and Nolan (2006) point out that this clause may not necessarily imply that final decisions of ICSID tribunals cannot be challenged in local courts because in some countries the legal system allows, under some circumstances, for challenges to local equivalents of final judgments. In fact, Baldwin, Kantor, and Nolan (2006) review four cases in which ICSID rulings were challenged in local courts. Even though some received favorable judgments in lower courts, eventually all challenges were unsuccessful. Another important implication of Article 54 of the ICSID Convention is that final decisions of ICSID tribunals not only bind in the country that hosted the expropriated investment, but also in all countries that have signed the Convention.⁶ This implies that investors could seek reparation in any country that has signed the Convention and not only

⁴ Convention refers to an agreement among countries that establishes obligations to the countries that ratify it.

⁵ Article 54(1) of the Convention states that: "[e]ach Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State. A Contracting State with a federal constitution may enforce such an award in or through its federal courts and may provide that such courts shall treat the award as if it were a final judgment of the courts of a constituent state."

⁶ As a clarification, Reed, Paulsson, and Blackaby (2004) point out that "...[i]n the context of ICSID arbitration, enforcement is generally indistinguishable from recognition. The two terms are used in a single phrase—recognition and enforcement—that broadly refers to all steps leading

in the country where the expropriation took place. However, Reed, Paulsson, and Blackaby (2004) and Baldwin, Kantor, and Nolan (2006) note that it is assumed that under the ICSID Convention, signatory states shall enforce the judgments according to their own national law, which has two implications. First, sovereign immunity laws protect (some) government assets from foreign investors when investors attempt to seize government assets in jurisdictions different from the one in which the expropriation took place.⁷ Second, the Convention does not obligate a signatory country to enforce the compensation of investors after a favorable arbitration decision if the local law does not allow enforcement of compensation of equivalent local court judgments.

Baldwin, Kantor, and Nolan (2006) discuss that if a government refuses to honor a tribunal's decision, the affected investor could resort to the International Court of Justice (the primary judicial body of the United Nations). But this alternative also presents its own difficulties. First, the International Court of Justice only accepts disputes between two states, which means that the affected investor should request its government to sponsor such a claim. There are political and economic reasons why government authorities may decide not to sponsor claims of individual investors against another state. Second, it is unclear that the International Court of Justice will accept jurisdiction over the dispute without a consent of the government that refused to honor the arbitration tribunal's decision. Third, even in the case of a favorable decision in the International Court of Justice, the means to collect the payments are limited. Potentially, a state could take the issue before the Security Council, but it is highly unlikely that the Security Council would decide to enforce the claims.

The previous discussion suggests that the actual legal protection enjoyed by investors is somewhat limited. Despite that, Dolzer and Stevens (1995); Reed, Paulsson, and Blackaby (2004); and Baldwin, Kantor, and Nolan (2006) state that, with a few exceptions, governments have complied with ICSID tribunals' decisions. Besides, on some occasions, the parties reached a settlement before a final decision was made and, on other occasions, before a case was submitted for arbitration. The authors above argue that there may be various reasons why governments comply. First, it could be that countries that have ratified the Convention are the ones that try to attract foreign investments and backing out of honoring the decisions of arbitration tribunals may discourage future investors. That said, the tradeoffs or preferences of government

up to, but stopping short of, actual execution of an award." This meaning is different from the meaning that the term enforcement is typically assigned in economics.

⁷For instance, the French company Liberian Easter Timber Corporation (LETCO) obtained in 1986 an arbitration against Liberia for breach of a forestry concession. LETCO first tried in a New York court to obtain the right to seize registration fees and taxes owed to the government of Liberia, but the court ruled against LETCO based on the U.S. Foreign Sovereign Immunities Act. Later LETCO tried in a court in Washington, D.C., to obtain the right to seize bank accounts of the Liberian Embassy in the United States and the court also ruled against LETCO.

authorities that were in office when the country ratified the Convention may differ from the ones of government authorities that are supposed to enforce an unfavorable arbitration decision, and from the ones of future governments. Second, given that the ICSID is part of the World Bank, it may be expected that the World Bank could withhold benefits—like extending new loans—to countries that refuse to comply.

Arbitration under UNCITRAL Rules

The UNCITRAL was established in 1966 by the United Nations with the objective to help harmonize and unify the law of international trade. Since then, the UNCITRAL has prepared several conventions, model laws, and other instruments related to laws of trade transactions. Among the contributions that UNCITRAL has developed are rules for arbitration of commercial disputes (see UNCTAD [2003]), which were designed to offer a well-specified international arbitration procedure that could be used in a variety of disputes, including disputes concerning the expropriation of foreign investments.

The enforcement of an arbitration tribunal decision that acted according to the UNCITRAL rules depends on the conventions ratified by the countries of the parties in dispute. The most common instrument governing the enforcement of international arbitrations is the United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards of 1958, also known as the New York Convention. The New York Convention, which had been ratified by 145 countries by the end of 2010, requires that the states that have ratified it recognize and enforce international arbitration agreements and foreign arbitral decisions issued in other contracting states, subject to certain exceptions. This means that two parties can decide to locate their disputes in a third, neutral country, knowing that the tribunal's decision can be enforced in any country that has adhered to the Convention. There are also regional conventions, like the Inter-American Convention on International Commercial Arbitration, that can be invoked to pursue the enforcement of international arbitration decisions. Reed, Paulsson, and Blackaby (2004) argue that tribunals' decisions enforced under the ICSID Convention are more favorable to recognition than the ones enforced under the New York Convention or regional conventions, as the latter allow for challenges in local courts under more circumstances than do the former. The enforcement limitations described for the case of the ICSID Convention also apply to the New York Convention and other regional conventions.

2. SOVEREIGN DEBT

This section reviews the legal protection enjoyed by holders of debt in default.⁸ Holders of sovereign bonds issued in New York, London, or other financial centers can resort to courts in those jurisdictions in order to enforce repayment (subject to certain conditions such as the majority enforcement provision in collective action clauses). That said, the bondholders' ability to enforce courts' rulings is uncertain and the absence of a well-specified international bankruptcy procedure and successive law changes have generated a significant degree of heterogeneity in the success of litigations of holders of defaulted sovereign bonds (see Panizza, Sturzenegger, and Zettelmeyer [2009] and the references therein). The discussion below describes that, *de facto*, bondholders' ability to enforce debt repayment through the judicial system has been quite limited.

Buchheit (1995) explains that, until the first half of the twentieth century, most countries (including the United States) recognized an "absolute" theory of sovereign immunity, which implied that sovereigns could not be sued in foreign courts without their consent. The United States began to recognize a "restrictive" theory of sovereign immunity in 1952, which limited sovereigns' immunity for commercial activities carried on outside sovereigns' territories. This principle turned into law in 1976 with the approval of the Foreign Sovereign Immunities Act. That law specifies that sovereigns can be judged in U.S. courts for their commercial contracts signed with foreign counterparties, and several court decisions have confirmed that bond issuances in U.S. markets are to be considered commercial activities. A similar law was approved in the United Kingdom in 1978 (the State Immunity Act), and most countries now have similar laws (see Buchheit [1995]).⁹

In spite of the more limited sovereign immunity, creditors who tried to collect sovereign debt through judicial systems experienced mixed results (see Sturzenegger and Zettelmeyer [2006] and Panizza, Sturzenegger, and Zettelmeyer [2009]). This casts doubt on the degree of protection granted by issuing debt in developed countries. The challenge that litigators face is not so much to obtain judgments against a sovereign debtor but to enforce that judgment. For instance, the Foreign Sovereign Immunities Act grants creditors the right to seize sovereigns' property in the United States though litigators

⁸ The anonymity of bondholders limits governments' ability to default only on foreigners. In contrast, it may be easier for governments to target foreign firms for expropriation, especially in developing countries with underdeveloped stock markets.

⁹ The legal protection granted to debtors was raised by Bulow and Rogoff (1990) as a potential source of the excessive borrowing that led to the debt crisis of the 1980s. As a result, Bulow and Rogoff (1990) propose to augment sovereign immunity for debt liabilities. This would also induce governments in developing countries to improve domestic institutions that determine the enforceability of contracts or the accountability of government authorities. They argue that those reforms would enable developing countries to attract foreign capital flows while also helping incoming capital flows to be allocated to better projects.

can only seize property that “is or was used for the commercial activity upon which the claim is based” (Foreign Sovereign Immunities Act 1976). Given that sovereigns usually do not need to use any of their property located in the United States to issue debt, and that the financial assets obtained at the time of the bond issuances are no longer located in the United States, the repayment that creditors may expect to obtain through that route is minimal. Creditors have also tried to attach international reserves of the country in default but with limited success (see Panizza, Sturzenegger, and Zettelmeyer [2009]). Of course, a sovereign would only choose to default when there are no significant assets investors could attach.

One of the most prominent cases in which creditors were able to induce repayment was that of *Elliott Associates, L.P., v. Banco de la Nacion and the Republic of Peru*.¹⁰ In 1996 the “vulture fund” Elliott purchased, in the secondary market, loans that had been extended to Banco de la Nacion and Banco Popular del Peru and that had been guaranteed by the Peruvian government.¹¹ The loans were bought for \$11.4 million and had a face value of \$20.7 million. Those bonds were part of government debt that was scheduled to be included in the Brady Plan restructuring. The Brady restructuring agreement was finalized in March 1997, and was accompanied by a promise not to provide any preferential treatment to creditors who had not participated in the agreement. For that reason, Peruvian authorities refused Elliott’s demands for full repayment. Elliott started litigations in a New York court. In 2000, it obtained authorization to recover \$55.7 million from the government of Peru for the principal and past due interests up to such date and post-judgment interest. Even though Elliott did not manage to confiscate property belonging to Peru’s government, it obtained a court authorization to intercept and attach the first payment that Peru’s government was about to make through the Chase Manhattan Bank in New York to creditors who had participated in the Brady restructuring agreement. Elliott was also able to obtain enforcement orders from courts in Luxembourg, the United Kingdom, Germany, and Canada. In response to that, Peru’s government decided to channel the Brady bonds payment through Euroclear: a financial company that operates in Brussels and that provides domestic and international securities services. Elliott succeeded in convincing the Brussels Court of Appeals to suspend those payments. After that, Peru’s government decided to settle by paying Elliott \$58.4 million and not risk defaulting on its new debt by not being able to pay on time creditors who had participated in the restructuring agreement. Defaulting on Brady

¹⁰ See Gulati and Klee (2001), Nolan (2001), and Singh (2003).

¹¹ A vulture fund typically refers to an investment company that purchases debt claims in secondary markets at a relatively large discount because the debtor has defaulted or there is a high chance of default. In the event of a default, these investors have the legal expertise to litigate and are willing to hold those debt claims for many years until they reach a settlement with the debtor.

bonds would have triggered the right of all Brady bondholders to demand full repayment of their securities at that time. Ex-post, Elliott made a return of around 400 percent in four years for that investment (without including legal fees).

Panizza, Sturzenegger, and Zettelmeyer (2009) note that, for several reasons, the success of Elliott's strategy proved to be more of an exception than a rule. First, the legal argument used by Elliott was weak and relied on a controversial interpretation of the *pari passu* clause (see Gulati and Klee [2001]).¹² The argument presented by Elliott at the Brussels Court of Appeals was that Peru's government was trying to use Euroclear to violate the right of equal treatment of creditors, and that right was entitled to Elliott since the loans it owned contained the *pari passu* clause. That interpretation of the *pari passu* clause was rejected in courts in several subsequent litigations. Second, the law changed to avoid other cases like *Elliott v. Peru*. For instance, Belgium passed a law that tries to prevent creditors from obtaining court orders that could intercept payments from a sovereign to its bondholders. Third, sovereigns could move preemptively by settling payments within their legal jurisdiction or by using the Bank of International Settlements, which would prevent litigators from intercepting those payments.

One notorious case in which holders of debt in default have not been able to induce repayment through the judicial system is the 2001 Argentine default. For bonds issued in Argentina, the government decided in 2002 to change the currency of denomination (from U.S. dollars to Argentine pesos). The pesification of government debt was done using an exchange rate below its market value and Sturzenegger and Zettelmeyer (2006) estimate a mean recovery rate of 64 percent across bonds. For debt issued in foreign countries, the Argentine government proposed in 2004 to exchange those bonds with three new securities from which bondholders could choose. The exchange took place in 2005 with a participation rate of 76 percent and with a recovery rate ranging between 25 percent and 29 percent, according to Sturzenegger and Zettelmeyer (2005). In addition, the Argentine government passed a law that forbids the executive branch from negotiating with creditors who do not participate in the exchange and from incurring in transactions with bondholders arising from any court order. In spite of that, some creditors who did not participate in the exchange (holdouts) litigated in the United States and other developed countries' courts. They managed to obtain judgment orders against Argentina's assets but they have not succeeded in confiscating assets. It must be said that the limited success of bondholders does not necessarily mean that the litigation process has been costless for Argentina. Holdouts may have

¹² Many sovereign bonds include a *pari passu* clause that states that bondholders rank equally in priority of payments. The clause limits the ability of sovereigns to dilute past claims by issuing new debt that ranks senior to previous bond issuances.

barred Argentina from international capital markets because the government may be unable to receive the proceeds of bond issuances before holdouts are paid off. That may have motivated Argentine authorities to open up negotiations with holdouts in 2010, after Congress passed a law interrupting, for one year, the ban to negotiate with holdouts.

In terms of the implications for the future, Buchheit and Gulati (2010) and others note that there has been an increased use of collective action clauses in sovereign bond contracts in recent years.¹³ This may curb the ability of bondholders to hold out and not accept the terms of restructuring agreements with the hope that they may obtain a better deal after litigating. In addition to that, Buchheit and Gulati (2010) mention that legislative initiatives have been considered in the United States, United Kingdom, and other developed countries to reduce “vulture creditor activity.” These developments may facilitate debt restructuring processes, but if that makes defaults and subsequent renegotiations less costly, it may deteriorate the terms at which sovereigns can borrow.

International Arbitration and Sovereign Debt

Are holders of sovereign debt in default entitled to seek reparation in arbitration tribunals? Griffin and Farren (2005) and Cross (2006) argue that a higher recovery may be expected after arbitration in an ICSID tribunal than after litigation in a national court located in the country where the bonds were originally issued. This statement is partially based on the fact that countries have complied with ICSID rulings. In addition, resorting to the ICSID may be more efficient given that its decisions are equivalent to final judgments in all ICSID member states, whereas national court judgments must be validated in other countries.

In line with this reasoning, in 2006 a group of 170,000 Italian holders of Argentine defaulted debt requested arbitration under the ICSID Convention, invoking the bilateral investment agreement between Italy and Argentina. This request was followed by similar requests of two other groups of Italian bondholders. These cases are still pending and some experts believe that it is unlikely that the arbitration tribunal will accept jurisdiction (see Waibel [2007]). Litigations in ICSID tribunals might become a more widespread strategy in coming years if ICSID tribunals' rulings enable bondholders to recover a higher fraction of their claims.

¹³ Collective action clauses specify that if a certain percentage of bondholders agree on a debt restructuring plan, that plan binds for all bondholders, including those who opposed it.

3. CONCLUSIONS

This article illustrates that foreign investors enjoy legal protection, but this protection is imperfect. Several analysts argue that governments have tended to comply with unfavorable rulings of international arbitration courts. This may also be consistent with the fact that sovereign default episodes observed in recent years were followed by relatively friendly debt restructuring agreements (see Sturzenegger and Zettelmeyer [2005]). The case of Argentina has been more exceptional and illustrates the limited legal protection available when a sovereign debtor decides not to repay bondholders who did not participate in the debt restructuring agreement.¹⁴

The fact that expropriated investors may have difficulties in being repaired does not mean that there are no costs associated with ignoring foreign court or tribunal decisions. For instance, the absence of Argentine sovereign debt issuances in financial centers—because of the risk that bondholders of Argentine debt in default may divert the receipts from those issuances—may have imposed a cost to the Argentine government. However, it is unclear how significant that cost may be. In the case of investment disputes, a potential cost of not complying with unfavorable rulings is that it may send a negative signal about the government's commitment to respect investors' property rights, which may have aggregate negative effects on capital inflows.

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¹⁴ UNCTAD (2011) reports that Argentina is the country with the largest number of current pending investment disputes in international arbitration tribunals. As discussed in this article, eventual rulings favorable to creditors would not guarantee full repayment.

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