Investment Treaties: What Every Emerging Market Investor Needs to Know

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One of the most important changes in the legal landscape of cross-border investment in the last several decades has been the emergence of international investment treaties. Today, this patchwork of over 3,000 treaties gives investors in most emerging markets of the world basic legal protections against government interference with their investments. Equally important, these treaties offer investors a forum to litigate their disputes with the host State before a neutral panel of arbitrators, who can award financial compensation to the investor in a binding decision that can be enforced directly against the host State.

Investment treaties – what are they and how do they work?

Investment treaties are international legal agreements between States that regulate the treatment by one State of foreign investment from investors who are nationals of another State. Such agreements can take the form of (1) a bilateral agreement between two States, as in the case of a bilateral investment treaty ("BIT") or a free trade agreement ("FTA"), as well as (2) a multilateral agreement across a regional trade bloc (such as the North American Free Trade Agreement or "NAFTA") or a particular sector of the economy (such as the Energy Charter Treaty). Although the specific provisions will vary from treaty to treaty, their general structure is quite similar and will typically include provisions that define:

1. the "investors" who qualify for protection under the treaty,
2. the "investment" which is protected by the treaty, and
3. the substantive protections which the host State commits to provide to qualified "investors" with qualified "investments" in that State.
4. the terms on which the investor can enforce those protections through international arbitration with the host State.

"Investor"

The first basic element of an investment treaty is its definition of a covered "investor". This is important, as the investor has to show that it qualifies as a covered "investor" in order to benefit from the treaty's protections. The "investor" definition in most treaties is very broad, and typically includes (1) natural persons who are citizens of one of the contracting States, and (2) companies who are nationals of one of the Contracting States. Since most private equity investors will make their investments through a company or some other form of legal entity, the analysis tends to focus on the second prong of the definition. The nationality of a company may be defined by reference to several criteria, including the place of incorporation, the place of effective control, or the place of management (seat) of the company. Depending on the criteria to be applied, it may be possible to meet the definition of an "investor" simply by having the entity's place of incorporation in one of the contracting States that is a party to the treaty, even if effective management or control of the entity is exercised from another jurisdiction. This is an important factor to consider when evaluating which treaties may be used to gain protection for the investment.

"Investment"

In addition to defining who is a covered "investor," an investment treaty will also define what constitutes a covered "investment". This definition is important as the investor has to show that it has made an "investment" within the meaning of the treaty in order to gain treaty protection. Most treaties define "investment" broadly to include virtually every kind of asset such as property and property rights; shares in companies or other forms of equity participation; claims to money or to contractual performance having an economic value; intellectual property rights; good will; as well as business concessions given by law or under contract, such as concessions to extract or exploit natural resources. As such, the definition of a covered "investment" will almost invariably encompass most types of private equity investment, including various forms of equity participation as well as debt instruments such as corporate bonds or loans provided to the underlying business.

Substantive treaty protections

Having defined what constitutes a covered "investor" and a covered "investment", an investment treaty will then define the substantive protections that the host State commits to provide to such covered foreign investment. Although the specific provisions vary from treaty to treaty, investment treaties generally create several distinct protections which may include the following:

Non-contingent protections. Many investment treaties create minimum standards of treatment which the host State receiving the investment must respect. These protections are considered "non-contingent" in the sense that their scope and content are based on developed principles of public international law that apply universally to all States, and are not defined relative to the treatment which the host State gives to investors from its own home jurisdiction or from other jurisdictions. Such protections typically include: (i) the right to fair and equitable treatment of the investment by the host State, (ii) the right to receive full protection and security of the investment by the host State, and (iii) the right to have the investment not subjected to unreasonable or discriminatory behavior by the host State that would impair the reasonable use, enjoyment or disposal of the investment.

Contingent protections. Most investment treaties also create contingent protections in the sense that they are defined relative to the protections which the host State affords to other investors. These protections typically include: (i) national treatment, which obligates the host State to treat the investment no less favorably than investments owned by the State's own nationals, and (ii) most-favored nation or "MFN" treatment, which obligates the host State to treat the investment no less favorably than investment made by nationals of any third State. MFN treatment can be particularly valuable as it allows the investor to benefit from any stronger protections which other States have negotiated for their investors under other investment treaties with the host State.

Protection against expropriation. Virtually all investment treaties also protect against the host State's expropriation of the investment without prompt, adequate and effective compensation. The term "expropriation" is usually defined to include not only an outright taking of the investment by the host State, but also any measures that interfere with the investor's use and economic enjoyment of the investment to such an extent that they should be viewed as equivalent to an expropriation. Protection against "indirect" expropriation is an important feature of many investment treaties, as States often do not openly characterize the measures which they take as expropriatory, even if the measures do have such an effect.

"Umbrella clause" protection. Finally, some investment treaties contain provisions which oblige the host State to observe all commitments it has entered into with respect to the investments of the other State's investors. Such "umbrella clauses" have been read to trigger liability for the host State for any breach (however serious) of its obligations under any investment contract or other agreement entered into directly with the foreign investor in connection with the investment. This can be particularly useful for emerging market investors who invest in companies that do business directly with the host State.

Investor-state arbitration

Perhaps the most important feature of an international investment treaty is the ability to enforce the treaty's substantive protections directly against the host State through an international arbitration with the host State. This legal mechanism will be set out in an investor-State dispute resolution clause in the treaty itself. The clause typically provides for the investor to submit a written notice of dispute setting out its claims against the host State under the treaty. The submission of this formal notice will then trigger a "cooling off period" under the treaty (usually three to six months) during which the investor and the host State are to engage each other in an effort to settle their dispute amicably. If no such settlement is reached, the investor can refer the dispute to arbitration. Many investment treaties will give the investor a "menu" of arbitral fora to choose from. These may include: (i) arbitration under the auspices of the International Centre for the Settlement of Investment Disputes ("ICSID"), an arm of the World Bank based in Washington, DC; (ii) arbitration under the auspices of another established institution such as the International Chamber of Commerce based in Paris, or the Stockholm Chamber of Commerce; or (iii) ad hoc arbitration pursuant to arbitration rules promulgated by the United Nations Commission on International Trade Law ("UNCITRAL"). Each forum differs in terms of the costs involved, and the steps in the process including the scope of the parties' ability to appeal the arbitrators' decision.

Some investment treaties also contain "fork in the road" clauses. Such clauses will state that a choice of dispute resolution procedure, once taken, forecloses the possibility of electing any other dispute resolution procedure potentially available. If a "fork in the road" clause exists in the treaty, seeking a remedy before a domestic court can cause the investor to lose its right to arbitrate under the treaty. It is therefore critical to consider the presence of such a clause and its effect on future claims under the treaty before taking any steps to prosecute legal claims in relation to the investment, whether in the host State's home jurisdiction or elsewhere.

Once arbitration is initiated by the investor, the arbitration will proceed in accordance with the rules of the arbitral forum which the investor has chosen. If the host State asserts a jurisdictional objection – for example to contest whether the investor is a qualified investor with a qualified investor under the treaty – then that issue will usually be decided in an initial phase of the arbitration. If the arbitrators decide that they have jurisdiction over the dispute, or if no jurisdictional objection is posed by the State, then the arbitrators will proceed to decide the merits of the case. This typically involves at least two rounds of written submissions to the arbitrators, followed by a live hearing during which both sides' witnesses will be made available for cross-examination by opposing counsel on the issues in dispute. The arbitrators will then deliberate and issue their decision in the form of a written award, which will decide what (if any) breaches of the treaty were committed by the host State, and the damages (if any) to be awarded to the investor for those breaches.

Unlike domestic court judgments, international arbitral awards are subject to recognition and enforcement pursuant to international treaties which have been made part of the law of most jurisdictions around the world. As such, an international arbitral award can be brought into national courts and enforced directly against the host State by converting it into a judgment, which can then be used to collect upon the host State's assets in accordance with the laws of the forum where recognition and enforcement of the award is sought. Enforcement can also take the form of "diplomatic protection" by the home government of the investor, should the host State refuse to abide by the award. Investors can urge their home State to engage in direct government advocacy, terminate government support in international organizations, restrict bilateral cooperation efforts, and the like.

The United States Investment Protection Network

U.S.-based private equity investors in emerging markets can benefit from the extensive network of treaties which the United States has negotiated with developing countries around the world. These existing treaties as well as the United States' current ongoing treaty negotiations are discussed below. In addition, U.S.-based private equity firms may also benefit from the network of investment treaties entered into by other major capital-exporting States besides the U.S., such as the U.K., if the investment is made through a company that is registered in that State. Given that many private equity firms will make their investments through a fund that is set up in an offshore jurisdiction or through some other special purpose vehicle, it is important to keep these non-U.S. investment treaties in mind as well.

Existing U.S. BITs and FTAs

The United States has negotiated BITs with numerous countries around the world in order to protect U.S. investment interests overseas and to promote market-oriented policies abroad. The United States currently negotiates BITs based on a model text, most recently updated by the U.S. Department of State and the Office of the United States Trade Representative ("USTR"), in conjunction with other U.S. government agencies. The U.S. Department of State and USTR share primary responsibility for U.S. BIT policy and negotiations. The United States has forty-two BITs that are currently in force. Most major foreign investment countries have also signed BITs with their other trading partners. They include: Germany (127), Switzerland (112), China (106), United Kingdom (95), France (92), and the Netherlands (91).

The United States also currently has fourteen FTAs in force with twenty countries. Many of these FTAs include investment chapters that outline protections for investors that mirror the key obligations found in the U.S. BITs.

Current ongoing negotiations

The United States is also currently engaged in negotiations for a BIT with China. Significantly, China has agreed to negotiate the BIT using a "negative list" approach where countries specifically carve out sectors that they do not want to open up to foreign firms. A negative list is different from a "positive list" approach where countries list only those specific sectors for which they are willing to make commitments. In addition, China is willing to grant national treatment during the "pre-establishment phase", which covers investment activities prior to a firm actually making an investment. The United States and India have also recently begun assessing ways to move forward with their BIT discussions.

In addition, the United States is engaged in negotiations for the regional Trans-Pacific Partnership ("TPP") Agreement with Australia, New Zealand, Japan, Singapore, Malaysia, Vietnam, Brunei, Canada, Mexico, Peru and Chile; as well as the Transatlantic Trade and Investment Partnership ("TTIP") with the Member States of the European Union. While both agreements will likely include protections for investors, the investor-state dispute settlement mechanisms to be incorporated have come under criticism by public interest organizations and certain U.S. lawmakers for encroaching on sovereignty and restricting future regulatory powers. However, these are concerns that have been raised in the past, yet BITs and investment chapters in the FTA continue to proliferate as countries ultimately concede the importance of these instruments for purposes of encouraging foreign investment into their territories.

So what?

For emerging market private equity investors, political or regulatory risk in the jurisdiction of the target investment is a significant factor that can drastically affect the value and even the survival of that investment. Investment treaties can provide a powerful tool to emerging market investors to combat that risk. Such treaties give qualified investors with qualified investments a range of basic protections against government action that interferes with the investor's ownership, use, and enjoyment of the investment. Just as critically, such treaties also give the investor the ability to

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enforce those treaty protections in an international arbitration directly with the host State before a neutral panel of adjudicators, whose decision can then be enforced against the host State in national courts around the world or through "diplomatic protection". Emerging market investors will do well to keep them in mind when problems with their host governments arise.

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