INTERNATIONAL BUSINESS TRANSACTIONS IN A NUTSHELL

NINTH EDITION

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CHAPTER 6

PROPERTY TAKINGS AND REMEDIES

Investments in foreign nations create risks that the host governments may "take" property and refuse to provide "proper" compensation. What is a "taking" and what is "proper" compensation have long been debated. The right to take is difficult to challenge; most nations have some form of eminent domain allowing government taking for public purposes. Thus, the issue usually becomes proper compensation. It is likely to be viewed by the investor as improper unless it is (1) paid with sufficient promptness, (2) adequate in amount, and (3) paid in an effective form.

DEFINING THE TAKING

The terms most frequently used when referring to the taking of foreign property are often neither clear in meaning nor consistently applied. The least intrusive act is usually called an *intervention.* That assumes the taking is intended to be temporary, and that the investment will be returned when the problems that motivated the taking are corrected. If the property is not returned in a reasonable period of time, the taking becomes at least a *nationalization.* The words *nationalization* and *expropriation* are often used interchangeably. They are usually intended to mean a taking followed by some form of compensation. But if no payment or inadequate payment fol-

lows the taking, the act may merit the label *confiscation*. The more usual case of a taking occurs when there is a nationalization or expropriation followed by an offer of some payment, but disagreement arises about whether the payment standard should be "just", "appropriate", "prompt, adequate and effective," or paid under some other label. These payment terms have never been very clearly defined.

Government interference may alternatively involve a series of steps that amount to a disguised, constructive, defacto, or "creeping" expropriation. A taking may occur almost imperceptibly and often over a substantial period of time. It is nevertheless a taking. Reasonable taxes on an investment might be raised to become confiscatory; mandatory labor legislation might attempt to transfer the financial resources of an investment to nationals of the host country; remittances and repatriations might be blocked or delayed to where host country inflation effectively consumes them; necessary government approvals might prove unobtainable; and other regulations dealing with various aspects of the investment might become burdensome to the point of constituting an overwhelming justification for abandoning the investment.

Expropriations may take all property of all investors, or be *selective*, or *discriminatory*, or *retaliatory*. Or all three. The action may be selective by taking only one industry, or be discriminatory by taking either the property of a particular foreign investor, or all the property of all the investors of a particular

foreign nation, or be retaliatory by taking property in response to acts of the foreign investor or its government.

When governments take property of *foreign* investors it is difficult to challenge successfully the public purpose of the taking nation, even though many expropriations clearly appear to have been motivated by little more than revolutionary fervor and with no sound economic justification. National courts, however, are not anxious to rule on the validity of the taking nation's satisfaction of the public purpose mandate.

THE "IZATIONS" OF THE PAST CENTURY

Expropriation in the last century effectively began when Russia (after the 1917 revolution), and Eastern European nations (after World War II), eliminated private ownership of the means of production and distribution. Additionally, Mexico expropriated oil in 1938. Indonesia nationalized most Dutch owned property in the 1950s. Egypt expropriated the Suez Canal Company in 1956. Expropriations were frequent in the 1960s, beginning with the extensive takings by Cuba of all foreign owned properties. The most recent extensive nationalizations were those by Iran in the late 1970s when the revolutionary government also seized the U.S. embassy and its staff. This led to the creation of the Iran-United States Claims Tribunal, a nine member arbitration entity which began hearing claims in 1982. By 2012, nearly all the 4,700 private claims filed against Iran had

been resolved. More than $2.5 billion in awards were made. (www.iusct.org). The decisions add significantly to the development of expropriation law.

In the 1970s, the pace of nationalization slowed. Many developing nations turned to a new "*ization*" (*e.g.*, Mexicanization or Peruvianization) process, mandating the conversion of wholly foreign owned subsidiaries to joint ventures with majority local ownership. But that process began to diminish in the early 1980s, particularly after the debt shock in 1982 led many developing nations to encourage more foreign investment in the hope that exports would increase and generate hard currency earnings to help pay foreign debts. The next stage was *privatization*, the reduction of state ownership by the sale of state owned enterprises invariably operating with government subsidies. The most significant privatizations of the final decade of the century took place in the former nonmarket economy nations of Eastern Europe. As the new century began to evolve, some sporadic nationalizations occurred, such as in Venezuela and Bolivia, and more recently Argentina. The meaning of expropriation also was being tested in actions brought under the North American Free Trade Agreement (NAFTA), as the concept of expropriation was seemingly being expanded to include *regulatory* practices which impeded a foreign investment.

Nationalization of property has not been limited to acts by socialist or third world nations. The United Kingdom nationalized coal, steel, airline service and

production, and other industries after World War II. France nationalized nearly all banks in 1982. (Many of the U.K. and French nationalized properties were later returned to the private sector, through the process of privatization.) But in both the United Kingdom and France, the takings were of property owned nearly exclusively by nationals rather than by foreign investors. The United States is not without its government's hand in the ownership of business. Part of the nation's passenger railway service was transferred to government ownership. But that involved an industry in severe financial distress. National ownership was viewed as a means of saving a dying, vital service sector, rather than displacing ownership successfully operated by the private sector. Nationalizations as an alternative to bankruptcy are a special and separate classification of property takings.

Actions that lead a country to nationalize a foreign owned commercial enterprise are difficult to predict. A taking of property may follow a change in administration, whether that results from revolution (Cuba, Indonesia, Iran, USSR) or election (Chile, Venezuela, Bolivia). Or the taking may occur during a non-threatened administration (Mexico, Great Britain). Nationalism and a sense of exploitation by foreigners may generate a takeover. Or the taking may occur because other methods of ownership are viewed as economically unsound, or politically or socially inappropriate. Most nationalizations are politically motivated; few have occurred within a stable government where a thorough economic study was first

undertaken that concluded that certain sectors of industry ought to be state owned, or at least owned by nationals rather than foreigners.

A particular investment's susceptibility to being nationalized increases to the extent that it engages in what are viewed as essential national industries, such as extractive, export oriented natural resources, banking, insurance, international transportation (airlines, shipping), communications, national defense or agriculture. The entity is also more susceptible if it involves the use of people or processes that can be duplicated easily domestically; or if it consumes supplies that can be obtained easily from sources other than the affected investors; or if it does not have an essential value dependent upon the investor's goodwill or good name in the marketing of goods or services produced by the investment, and it has enough overall value to outweigh any bad press or other offsetting loss following a takeover.

INTERNATIONAL LAW

A nationalization may appear to be legal under domestic law, but it may not pass scrutiny under international law. What constitutes the international law of expropriation, however, is not easy to discern, particularly since the Third World in the late 1960s began to demand participation in formulating rules of international law applying to a nation's taking of property. Nations differ about what constitutes a public purpose and what is required compensation. They also differ regarding the legitimacy of discrimi-

natory nationalizations, when the property of only one nation is taken, especially when that one nation is the colonial power formerly ruling the newly independent nation. Furthermore, some nations have presented lists of deductions to be applied to a multinational's valuation of its property, such as the Chilean deduction for what Chile considered to be excess profits for many past years of operation by foreign copper companies. Finally, and quite importantly, taking nations often reject the notion that any law other than *domestic* law should apply to a sovereign act of taking property, whether the property belongs to their own nationals or to foreigners. Different attitudes are sometimes ascribed to differences in colonial/colonialist political postures over the last two centuries, era and rapidity of the country's industrial development, and differing attitudes toward public/private economic enterprise.

The right of a sovereign nation to full and permanent sovereignty over its natural resources and economic activities and the right to take privately owned property are long accepted international legal norms. That is true whether the property belongs to the country's own nationals or to foreigners. Most constitutions express that right. But the taking must be for a public purpose or in the public interest. Sovereignty nevertheless sometimes becomes a shelter for many acts defined no more specifically than "for the social welfare or economic betterment of the nation." The concept persists that a taking is improper if it cannot be justified for some public purpose. The difficulty of

measurement, as well as the doubt that such measurement may be undertaken outside the taking nation, have caused the public purpose element of expropriations to be relegated to obscurity in conflicts of the past half-dozen decades. The expropriation issues of importance have not included whether there was justification for the taking, but what is a taking and whether the question of compensation was properly addressed by the taking nation.

The U.S. government has repeatedly stated its position regarding the proper international law rule for compensation. The view stresses "prompt, adequate and effective" elements to justify a nationalization. However challenged, "prompt, adequate and effective" may express what the Department of State believes ought to be the standard. It is a view with only minimal support from other governments, and from many jurists, arbitrators and international law scholars. The more commonly used terms are "just" or "appropriate" compensation. While the United States adherence to a "prompt, adequate and effective" standard may create obstacles in the settlement of an expropriation case, that standard is applied in determining whether certain benefits of U.S. laws may be extended to countries which carry out expropriations. Ironically, when either the "just" or "appropriate" standard is applied, the measurement seems to include elements of the "prompt, adequate and effective" standard.

The conflict regarding the proper standard of compensation, and the debate whether international law or domestic law applies to a taking, has its modern roots for the United States in the 1938 Mexican expropriation of foreign owned petroleum investments. The United States recognized Mexico's sovereign right to take foreign property, but only upon payment of prompt, adequate and effective compensation according to international law. The Mexican response refuted both that alleged "prompt, adequate and effective" standard, and even the fundamental premise that international law rather than domestic law was the proper source of the applicable law. Mexico said it would pay because the Mexican constitution required payment, and it would pay according to Mexican standards of compensation. A settlement was ultimately reached regarding payment, but no settlement was reached regarding the standard under which the payment ought to be made. The next large scale nationalization of U.S. property was by Cuba in 1960. Like Mexico, Cuba refuted the prompt, adequate and effective standard. But unlike Mexico, Cuba's continued isolation from the United States more than fifty years after the Castro led revolution has prevented any settlement.

Soon after the Cuban expropriations, the U.N. General Assembly passed the Resolution on Permanent Sovereignty Over Natural Resources, affirming the right of nations to exercise permanent sovereignty over their resources and mandating the payment of "appropriate" compensation "in accordance with

the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law." Although a U.N. General Assembly Resolution does not create international law, this Resolution appeared to be expressive of the customary international law of the day. A dozen years later, during which time the United Nations had expanded with the addition of many newly independent nations, the General Assembly addressed the issue again in the Declaration on the Establishment of a New International Economic Order, passed but with reservations by Japan, West Germany, France, the United Kingdom and the United States. Their concern was the absence of any reference to the application of international law in the settlement of nationalization compensation issues. Later that same year, the General Assembly passed the Charter of Economic Rights and Duties of States, with most of the major developed nations opposed to the article that stated that nationalization compensation was a *domestic* law matter.

The view of the developing nations expressed in the U.N. resolutions was consistent with how they justified expropriations in practice. Chile expropriated the Kennecott Copper Company's holdings, offering to pay according to Chilean law, but only after deducting excess profits that Kennecott allegedly had withdrawn from its Chilean operation over a number of years. Similar refusals to compensate were expressed by other developing nations. Unfortunately, the International Court of Justice has produced no

international standard. The narrow ruling in the *Barcelona Traction* decision did not reach the issue of expropriation. The ICJ's predecessor, the Permanent Court of International Justice, held in 1928 in the often quoted *Chorzów Factory Case*, that there was a duty of "payment of fair compensation", and the *Norwegian Shipowners' Claims* arbitration in 1922 adopted a "just" standard.

Several arbitration and national court rulings have helped determine the path of development of an international rule of compensation. The *TOPCO-Libyan* arbitral award of 1977, declared the state of customary law to require "appropriate compensation". The *Banco Nacional de Cuba v. Chase Manhattan Bank*, 658 F.2d 875 (2nd Cir. 1981) decision in the United States in 1981, suggested that the consensus of nations was "appropriate compensation." The 1982 *Aminoil-Kuwait* arbitral award also approved "appropriate" as the accepted international standard. But the United States continued to argue the standard to be prompt, adequate and effective. The American Law Institute rejected that as the standard in revising the Restatement on Foreign Relations Law, adopting in the Restatement (Third) a standard of "just" compensation. That standard is believed to avoid the possible inclusion of deductions under an "appropriate" standard, but has received little support.

The Iran–United States Claims Tribunal, meeting at The Hague for more than two decades, did not ap-

ply a "prompt, adequate and effective" compensation standard in fact. Claims approved by the Tribunal, nevertheless, for the most part have been paid "promptly" from the funds established for such payment, and they have been paid in dollars, thus meeting any "effectiveness" standard. With respect to the "adequacy" element the tribunal has used various measurements of valuation that seem to satisfy any reasonable "adequacy" standard. Although this experience may support the "prompt, adequate and effective" standard espoused by the U.S. government, the Iranian claims process is *sui generis* because of the vast funds that Iran owned on deposit in the United States at the time of the nationalizations. If any conclusions are to be made regarding current international law of compensation, it seems clear that it is not *called* prompt, adequate and effective, but something very close to those terms seems to be included in the definition of appropriate or just compensation.

If the issue of compensation is reached, the value of the expropriated property must be established. That value may be established by direct negotiations with the taking government. Alternatively, valuation might be decided by an arbitral panel, as in the case of the Iranian nationalizations. But if the taking state refuses to pay compensation, the issue of valuation may come before a court outside the taking state. That could be an international forum, or, more likely, a court either in the nation of the expropriated investor or in a third nation where the taking nation has assets. Because of lack of standing in the Interna-

tional Court of Justice, or reasons associated with defenses either of sovereign immunity or the act of state doctrine, of even because of possible obstacles to collecting under an OPIC or MIGA insurance policy, satisfaction of the claim may have to wait until the U.S. government has negotiated a lump sum settlement with the taking nation. The wait may be long; the 1960 Cuban nationalizations remain unresolved as the new century unfolded. Once payment is made to a nation which has negotiated the claims on behalf of its nationals, international law plays no role in how that sum is divided among claimants.

UNITED STATES LAWS AFFECTING THE NATIONALIZATION PROCESS

The U.S. Congress enacted several laws disclosing a national position that expropriation must be accompanied by compensation, or, if not, the United States will use its powers to deny various benefits the nationalizing country otherwise might receive from the United States. Treaty commitments and provisions of other international agreements between the United States and investor hosting nations may serve to narrow expropriation uncertainties, such as provisions in the earlier, frequently negotiated Treaties of Friendship, Commerce and Navigation, or their successor, Bilateral Investment Treaties (BITs). But BITs have not been concluded with many important Third World nations where there is much foreign investment by U.S. nationals (e.g., Mexico, India, Brazil).

In addition to provisions governing expropriation, Bilateral Investment Treaties have three significant provisions dealing with (1) nondiscrimination in establishing and operating investments; (2) rights regarding transfers of investments; and (3) mandatory dispute resolution methods. Where these treaties do exist there is always the threat that a successor government may reject them, however in violation of international law such action may be. They are important treaties, nevertheless, and investors do gain an added challenge if their property is taken by a nation which has signed such a bilateral treaty with the United States.

The North American Free Trade Agreement (NAFTA) has a detailed provision in Chapter 11 governing the taking of property of a foreign investor from a Party. The right to take property is acknowledged, but only where there is a public purpose, a non-discriminatory taking, due process of law and minimum standards of treatment as contained in the NAFTA, and the payment of compensation. The compensation provisions do not refer to the prompt, adequate and effective standard urged by the United States, but quite clearly meet that standard by more specific language. Chapter 11 cases are developing a NAFTA jurisprudence on taking of foreign property that has drawn much criticism from challenged NAFTA Parties and observers, especially environmental law groups. Government regulations, often directed to environmental issues, have been ruled to constitute expropriation in the manner they have

been implemented. While the NAFTA covers the compensation side of expropriation in considerable detail, it does not adequately define what constitutes an expropriation. This must be resolved if investment and investment expropriation is to be included in further trade agreements.

The WTO Agreement on Trade-Related Investment Measures (TRIMs) has provisions that are not as encompassing as those in the NAFTA, and do not include provisions governing the taking of investment property. Perhaps as the issues noted above with the NAFTA expropriation provisions are resolved, further revisions to the WTO TRIMs will include this important investment issue.

Other domestic laws of the United States apply to nations which have expropriated property of U.S. nationals and have failed to provide compensation or to illustrate a willingness to negotiate a compensation agreement. Subsequent to the Cuban nationalizations, the Hickenlooper Amendment to the Foreign Assistance Act was enacted and provides, in part, that the:

> President shall suspend assistance to the government of any country to which assistance is provided under this chapter or any other Act when the government of such country. . . (A) has nationalized or expropriated or seized ownership or control of property owned by any United States citizen . . . (C) has imposed or enforced discriminatory taxes or other exactions,

> or restrictive maintenance or operational conditions, or has taken other actions, which have the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property so owned, and such country, government agency, or government sub-division fails within a reasonable time . . . to take appropriate steps . . . to discharge its obligations under international law toward such citizen . . . including speedy compensation for such property in convertible foreign exchange, equivalent to the full value thereof, as required by international law, or fails to take steps designed to provide relief from such taxes, exactions, or conditions, as the case may be; and such suspension shall continue until the President is satisfied that appropriate steps are being taken.

The Sabbatino, or Second Hickenlooper, Amendment was passed by an angry Congress soon after the U.S. Supreme Court, in *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964), held that the Act of State doctrine prevented U.S. courts from hearing cases of foreign expropriation, even where there were allegations of violations of international law. The Congressional response reversed the presumption of *Sabbatino*, allowing U.S. courts to proceed unless the President stated that such adjudication would embarrass the conduct of foreign relations. Additional acts prohibit the United States from casting votes in organizations such as the World Bank or InterAmerican Development Bank (IADB) for loans

to countries which have expropriated property of U.S. nationals and refused compensation.

The U.S. 1996 Cuban Liberty and Democratic Solidarity (Libertad) Act promoted what could become a massive challenge to U.S. courts to address the Cuban expropriations. Title III of this commonly called Helms-Burton Act provided for expropriation claims against those foreign parties "trafficking" in property once owned by U.S. nationals. But each president has deferred the implementation of that provision and the litigation has been thwarted.

INSURING AGAINST THE RISKS OF FOREIGN INVESTMENT LOSSES

Investments abroad often are subject to risks that are not significant concerns to a domestic investment. An investment in the United States is not at risk from military conflict, or uncompensated expropriation, or losses from a currency that becomes inconvertible. Because these risks are not present in most developed, democratic nations, and because they present extremely complex risk measurement problems for investors entering developing nations, the *domestic* insurance industries generally have not offered insurance to cover such potential losses for investments made in high risk nations. It is thus to individual government and multi-nation organization investment insurance programs that foreign investors often must turn to reduce the consequences of these risks.

INSURANCE FOR FOREIGN INVESTORS—OPIC

National insurance programs, such as the U.S. Overseas Private Investment Corporation (OPIC), support government policies that encourage domestic industries to engage in investment abroad. But critics of government "backed" insurance of U.S. investment abroad argue that the program encourages and subsidizes the transfer of productive facilities abroad, at the cost of jobs in the United States. Although OPIC has been the preeminent U.S, insurer of foreign investment risks, many members of Congress believe its role should be assumed by the private sector. They reject the concept that the government should engage in private sector support activities, and worry about the potential burden on U.S. taxpayers. While OPIC is supposed to write insurance adhering to private insurance industry principles of risk management, and on a self-sustaining basis, it does not always or even regularly do so, perhaps because OPIC insurance is backed by the full faith and credit of the United States. Because of the absence of significant expropriations over the past few decades, at least since those by Iran, OPIC has been a financial success that has allowed it to build reserves in excess of $4 billion, while claims have been nearly non-existent. As long as insurance claims remain dormant, OPIC is likely to avoid serious criticism from Congress and others about the risk to the general public. OPIC's role is increasing in financing foreign investment, however important its insurance programs remain.

Until the 1969 creation of OPIC, AID was the primary organization through which the U.S. government issued risk insurance to U.S. investors in developing nations. OPIC was established to "mobilize and facilitate the participation of U.S. private capital and skills in the economic and social development of less developed countries and areas, and countries in transition from nonmarket to market economies."

Initially three principal risks were covered by OPIC—risk of loss due to (1) inconvertibility, (2) expropriation or confiscation, or (3) war, revolution, insurrection or civil strife, now referred to as political violence. Expropriation "includes, but is not limited to, any abrogation, repudiation, or impairment by a foreign government of its own contract with an investor with respect to a project, where such abrogation, repudiation, or impairment is not caused by the investor's own fault or misconduct, and materially adversely affects the continued operation of the project." OPIC contracts have followed a more specific and enumerative approach, because the law does not define more specifically what actions constitute expropriation. The third major form of coverage, political violence, covers loss of assets or income due to war, revolution, insurrection or politically motivated civil strife, terrorism or sabotage. The usual OPIC contract provides protection against injury to the "physical condition, destruction, disappearance or seizure and retention of covered property directly caused by war or by revolution or insurrection and includes injury to the physical condition, destruction, disap-

pearance or seizure and retention of covered property as a direct result of actions taken in hindering, combating or defending against a pending or expected hostile act whether in war, revolution, or insurrection." With terrorism becoming the major focus in many parts of the world, this class of OPIC insurance may become the most important. But the terrorism has been in developed nations, not in the nations where the insurance is written.

The investor must exhaust remedies before OPIC becomes obligated to pay any claim. All reasonable action must be taken by the investor, including initiating administrative and judicial claims, to prevent or contest the challenged action by the host government. Prior to the receipt of payment of a claim, the investor usually will be required to transfer to OPIC all right, title and interest in the insured investment, including when the government expropriatory action consists of preventing the investor from exercising effective control over and withdrawing funds received from the foreign entity as dividends, interest or return of capital. The investor has an ongoing obligation to cooperate with the U.S. government in pressing claims against the host government.

Otherwise qualifying countries may be denied OPIC insurance if they do not extend internationally recognized workers' rights to domestic workers, or if they do not respect human rights, but presidential discretion may result in a waiver of this prohibition on national economic interest grounds.

INSURANCE FOR FOREIGN INVESTORS—MIGA

OPIC insurance is limited to U.S. investors. To encourage increased investment in the developing nations, similar insurance has been established on an international level by the World Bank's 1985 Multilateral Investment Guarantee Agency (MIGA). With the expected completion of Mexico's admission process, all the major nations are subscribers to MIGA.

Risks covered by MIGA include inconvertibility, deprivation of ownership or control by governmental actions, breach of contract by the government where there is no recourse to a judicial or arbitral forum, and loss from military action or civil disturbance. The insurance may cover equity investments or loans made or guaranteed by holders of equity (probably including service and management contracts), and also licensing, franchising and production sharing agreements.

Generally, investors must be from a member country, and only foreign investors qualify. There was considerable discussion regarding insuring only in those developing nations which adopted standards for protecting foreign investment, but the final Convention did not include any such conditions. Such standards may nevertheless be a factor in writing insurance, if any measure of risk management principles is to be followed. The highest percentage of MIGA coverage is in sub-Saharan Africa, followed by Asia, and then by Latin America and the Caribbean.

The viability of MIGA is dependent both on its care in selecting risks to insure, and its ability to negotiate settlements after paying claims. Unlike national programs, such as OPIC, MIGA has the backing of a large group of nations when it presses a claim. Only experience will disclose the extent to which politics will enter the claims procedures. The intention is to avoid political interference and consider solely legal issues. MIGA has yet to face claims experience. If over time the risks MIGA insures diminish, the use of such insurance will decrease. If on the other hand the risks become reality, the effectiveness of the claims procedures will become evident.

Creating MIGA within the World Bank structure offers benefits a separate international organization would lack. MIGA has access to World Bank data on nations' economic and social status, thus helping the assessment of risks. The World Bank has considerable credibility that favors MIGA, and encourages broad participation. It is not certain how MIGA will affect national programs, such as OPIC. A U.S. company, for example, might prefer dealing with OPIC because of greater confidence of claims being paid, of maintaining information confidentiality, and benefitting from legal processes established in bilateral investment treaties. MIGA acts to some degree as a gap filler for U.S. investors when OPIC insurance is not available or inadequate for the project. MIGA's success will likely be where it fills gaps rather than competes with established national insurance programs. Its real test will be when significant claims

are made (only three have been paid and some fifty disputes have been resolved)—the past two decades have not witnessed the expropriations that tested the viability of OPIC in the 1970s.