Investor-State Dispute Settlements and Financial Markets

What are investor-state dispute settlements?

Since the 1950s, bilateral investment protection agreements have become more common between states. The reason: investors from industrial countries desired a secure environment for their investments and better protection from expropriation in reputedly volatile developing countries. Claims by foreign investors are heard in front of an arbitration board. While these are often called “arbitration courts”, the arbitrators are not state judges, but – as a report of CEO shows – generally lawyers from international law firms that meet in secret, only publish essential documents after a judgement has been issued and cannot authorise any appeal or revision.

Such agreements are no longer exclusively concluded between industrial and developing countries, but also between industrial countries themselves. Nevertheless, constitutionally ungoverned arbitration boards are still maintained, the most important of which is the International Centre for Settlement of Investment Disputes (ICSID) – an institution of the World Bank.

The current “front runner”, in terms of arbitration board-mandated settlements, is the U.S. concern Occidental, which was awarded 1.77 billion U.S. dollars from Ecuador. For the South American nation, this sum represents nearly 20% of the annual state budget.

Enforceable property rights

The principles by which arbitration boards reach decisions can be roughly summed up in a few main points. All deal with the question of whether investors have suffered losses or profit setbacks due to state actions.

- **Expropriation**: This is the most obvious measure by which an investor can suffer such a loss. It can be either direct or indirect (e.g. via regulation). In addition, investors must be protected by specific minimum standards, normally referred to as “fair and equitable treatment” and “full protection and security” in legalese. These formulations remain so vague that virtually every legal action is based on them. Even the “legitimate expectations” of investors are frequently protected.

- **Discrimination**: This concerns a differing treatment to the detriment of foreign investors, either in favour of other foreign companies (most favoured nation clause) or in favour of domestic companies (national treatment). Such discrimination is prohibited, depending on the details of the specific agreement.

- **Freedom of transfer**: This refers to the transnational protection of fund transfers associated with an investment. With some exceptions, the free flow of funds must be guaranteed.

- **Market access**: This catchphrase comprises many important regulatory instruments. It entails as little restriction on markets as possible through regulation and the guideline that generally speaking, markets should take the place of monopolies. Restrictions on business activities or product approvals and limitations on foreign shareholdings should also be disposed with or only permitted in exceptional cases.

- **Umbrella clause**: Such a clause guarantees that countries meet the contractually stipulated payment obligations to investors of the other country. However, this blurs the distinction between obligations stipulated by the investment protection agreements and obligations stipulated by a private-law contract between the state and the investor. Any breach of contract on the part of the state towards an investor – normally the clear sovereign territory of national legal institutions – could thus lead to legal action before an arbitration board.

What is being litigated and is this a problem?

As investment protection agreements have long existed, there are a number of past and current arbitration cases related to the financial market. On the basis of four cases, the following section illustrates how diverse the effects can be on financial markets:

- **Haircut**: In late 2011, Greece was unable to repay its sovereign debt, which led to a debt haircut. The Greek government, therefore, introduced a so-called collective action clause (CAC) for its government bonds. This clause makes it possible to force a haircut for all bondholders if a certain majority voluntarily agreed. As over 90% agreed to a haircut in this case, opponents of the haircut were forced to comply. Among these “involuntary volunteers” was the Slovak Bank Poštová, which then brought an action against this measure. The claim, which has not been published, presumably rests on two points: expropriation and discrimination. The former concerns the haircut as such, which due to the exchange of old bonds for new ones that are half as valuable, is interpreted as expropriation. The unequal distribution of losses represents another possible point of attack. Public institutions were excluded from the debt restructuring, in particular the European Central Bank (ECB). The reasoning here was that including the
ECB would amount to direct government financing, which is not permissible under ECB statutes. Nevertheless, according to the claimant, the ECB should have been included in the haircut. Should the claimant win the action on the grounds of expropriation, the consequences for haircuts in general would be immense. CACs are currently considered the ideal basis for debt restructuring due to their practical feasibility. If, however, the claimant wins the action on the grounds of discrimination, the ECB could relinquish bond purchases in order to respect its statutes – even though these are a key instrument of crisis management.

• **Bail-in**: As a direct result of the financial crisis, Fortis Bank was nationalised by the Belgian and Dutch governments. Due to this nationalisation and the subsequent sale of Belgian shareholdings to the French bank BNP Paribas, the Chinese insurer Ping An lost nearly 100% of its investment of over two billion euro. In 2012, **Ping An brought an action against the Belgian State, which is still ongoing.** The scope of a ruling in favour of Ping An should not be underestimated. Any financial participation on the part of shareholders with regard to required measures for bank bailouts could stand on legally shaky ground, even though this was recently prescribed for the liquidation of insolvent banks in the context of the EU banking union.

• **Currency rate adjustment**: At the peak of the Argentinian financial and debt crisis in 2002, the Argentine government uncoupled the peso from the U.S. dollar, which led to a dramatic devaluation of the peso. Investments in Argentina’s commodity sector, which has been privatised in the mid-90s, lost a significant share of their market value. This led to **foreign investors suing Argentina for more than 16 billion U.S. dollars in damages.** Since the devaluation was considered an expropriation, most of these lawsuits were upheld. Argentina’s defence, which emphasised the exceptional circumstances of the crisis and the overall state of emergency, was mostly ineffective. Argentina, the arbitration board ruled, was partially to blame for the crisis, and alternatives existed which could have entailed lower losses for investors. The fact that a ruling was made against currency rate adjustment raises the question of whether leeway still exists for state authorities in this area. Monetary policy is considered a cornerstone of national sovereignty and also a good means of defusing crises.

• **Banking licence**: In the context of a dispute over the cost of acquiring an insolvent bank branch, the Estonian Central Bank withdrew the banking licence of the Estonian Innovation Bank (EIB) in 1997. This was due to the EIB withholding important information regarding its owners as well as specific payments. The owners subsequently brought an action before an arbitration board to contest the licence withdrawal and for compensation for losses suffered, including the potential market value of the liquidated EIB. The arbitration board did recognise serious failures in the approach of the Estonian Central Bank. However, Estonia escaped judgement due to the unique circumstances in the country following the collapse of the Soviet Union. Even if the action was not successful, certain findings of the judgement on licence revocation set a precedent for claims in other cases.

**Conclusion**

These cases show that as a result of investor-state dispute settlements, there is a growing risk of states losing leeway for regulating financial markets or resolving financial crises. In the future, more and more laws and policies could be directly annulled. Governments already anticipate potential lawsuits in their legislative processes. In light of the financial crises over past decades and the difficulties which arise, this is a highly worrisome prospect. In the long run, strong regulations on market access in conjunction with investor-state dispute settlements could put pressure on certain structures of the German financial system as these could create market distortions from the investor perspective.

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**Further information:**

**CEO report (2014): „Profiting from Crisis“**

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