The Second Biennial General Conference Of the Asian Society of International Law.

Tokyo, Japan.
August 1-2, 2009.

The surge of investment disputes: Latin America testing the international law of foreign investments.

By

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I. Introduction

Latin America is not the largest recipient of foreign investment in the world. In the year 2007, out of $ 1,833 billion of the world's flow of Foreign Direct Investment (FDI), Latin America only attracted $ 126 billion;[1]that is 6.87 % of the global inflow.[2]

Yet, the majority of arbitration cases filed by investors against States have had a Latin America country as a defendant. In 2009, out of 124 pending cases at the International Center for Settlement of Investment Disputes (ICSID), 69 cases have been filed against Latin American countries.[3] Likewise, it is estimated that there are around 107 non-ICSID investor- State arbitration cases, of which a large portion has a Latin American country as a defendant.[4] As of 2009, out of 318 investment arbitration cases that had been filed,

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[1] U.N.CONFERENCE ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 2008, *available at* http://www.unctad.org/en/docs/wir2008_en.pdf (last visited Apr. 24, 2009)

[2] U.N.CONFERENCE ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 2008, *available at* http://www.unctad.org/en/docs/wir2008_en.pdf (last visited Apr. 24, 2009). The data comprises greenfield FDI and mergers and acquisitions. It does not cover portfolio investments represented in speculative investments where the investor is not involved in management of the investment. The data only relates to investment received by countries also known an inflow and does not represent the amount of outflow investment, that is investments sourced from a country different from the recipient. In 2007 outflow FDI from Latin America amounted $ 52 billion.

[3] INTERNATIONAL CENTER FOR SETTLEMENT OF INVESTMENT DISPUTES (ICSID), PENDING CASES, *available at* http://www.worldbank.org/icsid/cases/pending.htm (last visited Apr. 24, 2009). *See also* U.N.CONFERENCE ON TRADE AND DEVELOPMENT, INTERNATIONAL INVESTMENT RULE-MAKING: STOCKTAKING, CHALLENGES AND THE WAY FORWARD. UNCTAD/ITE/IIT/2007/3 UNCTAD (2008) . http://www.unctad.org/en/docs/iteiit20073_en.pdf

[4] Of the total 318 known disputes, 202 were filed with ICSID (or the ICSID Additional Facility), 83 under the United Nations Commission on International Trade Law (UNCITRAL), 17 with the Stockholm Chamber of Commerce, five with the International Chamber of Commerce and five were ad hoc. One further case was filed with the Cairo Regional Centre for International Commercial Arbitration and one was administered by the Permanent Court of Arbitration. In four cases, the applicable rules are unknown so far. *See* U.N.CONFERENCE ON TRADE AND DEVELOPMENT, LATEST DEVELOPMENTS IN INVESTOR-STATE DISPUTE SETTLEMENT. IIA MONITOR. No. 1. (2009).

Latin American States had been defendants in 113,[5] with 70% of the proceedings initiated in the last 4 years.[6]

Thus, why has there been a surge of investment arbitrations against Latin American States?

There could be different reasons, such as the 2001 Argentine economic crisis which forced the government to devaluate the currency, change the conditions of concession agreement and freeze the prices of utilities and services.[7]

But had there not been an international instrument that provided for the possibility of investors initiating arbitration cases directly against the States, none of the cases would have been possible.

II. International Investment Arbitration in Latin America

In Latin America and the Caribbean, 485 International Investment Agreements (IIAs) are in effect as of 2009. Some of those are treaties for the promotion and protection of foreign investments or Bilateral Investment Treaties (BITs), where each signatory country mutually agree to be subject to arbitral procedures, if all the conditions are met, by investors from the other country. Occasionally countries enter into Free Trade Agreements (FTAs) with investment chapters, under which consent to be subject to international investment arbitration is granted. That has been the case of the North America Free Trade Agreement (NAFTA),[8] the Dominican Republic-Central America and United States Free Trade Agreement (CAFTA-DR)[9] and the United States and Chile Free Trade Agreement,[10] among others.

Those IIAs have been the main source of investment disputes against Latin American States. International investment arbitration is not something that is imposed upon the countries. On the contrary, it is something that the States in free use of the sovereignty agree to. If they so want, they express their consent to be subject to international arbitration initiated by foreign investors in different ways, some of which is within the IIAs.

[5] *Id.*

[6] *See* UNCTAD, INVESTOR-STATE DISPUTE SETTLEMENT AND IMPACT ON INVESTMENT RULEMAKING. United Nations, 2007.

[7] U.N.CONFERENCE ON TRADE AND DEVELOPMENT, OCCASIONAL NOTE INTERNATIONAL INVESTMENT DISPUTES ON THE RISE, U.N. Doc. UNCTAD/WEB/ITE/IIT/2004/2 (NOVERMBER 29, 2004). Accordingly, as of July 2006 Argentina was defendant in 42 ICSID arbitration cases.

[8] North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 605 [hereinafter NAFTA] See Chapter Eleven.

[9] The Dominican Republic - Central America - United States Free Trade Agreement, Aug. 5, 2004, available at http://www.ustr.gov/Trade_Agreements/Bilateral/CAFTA/CAFTA-DR_Final_Texts/Section_Index.html. *See* Chapter Ten.

[10] The United States-Chile Free Trade Agreement, Jun 6, 2003, available at http://www.ustr.gov/Trade_Agreements/Bilateral/Chile_FTA/Final_Texts/Section_Index.html. *See* Chapter Ten.

In Latin America, countries were brought into the realm of public policies favorable to foreign investment in the 90s. As part of policies aimed at reducing the size of the State and open space for private investors, countries were somehow convinced that legal reforms were needed. Amid those reforms, countries were supposed to enter into international agreements that would provide a sound, secure and predictable investment climate to foreign investors. Being signatory to the ICSID Convention, among others and executing BITs with capital exporting countries where investment arbitration was consented were all part of the package better known as the Washington Consensus.[11]

Thus, many developing countries assumed that the path to economic development was marked by foreign investments which, it was argued, would be good on creating jobs, transferring technology, boosting production and fostering savings; things all that were considered essential on reducing poverty and consequently promoting wealth and economic growth.

The argument also followed that local investors would also be indirect beneficiaries of the international investment law. By enhancing the standards of treatment for foreign investors according to international criteria, the standards of treatment for local investors tended to be bettered if not harmonized with the ones provided to foreigners.

In sum, the purpose on entering into IIAs has been economic development. Latin American countries had no interest in protecting investments had it not been beneficial for their economic development; mainly because it meant a major paradigm shift. On protecting foreign investment and foreign investors, Latin American countries were moving away from a historic opposition to international arbitration and compensation for measures tantamount to expropriation, and were providing stronger guarantees to investors under the form of standards of treatment that hinder common business nuisances such as sudden changes in the law.

That has made businesses safer for most foreign investors. And when foreign investors have felt that international protection has been infringed, they have initiated arbitrations. As a result, arbitral tribunals have been established at the request of investors in the context of different circumstances, such as the passing of emergency economic laws that affect businesses, imposition of regulations to property rights or denial of justice, among others.[12]

III. A system with some flaws

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[11] *See* Williamson, John, *Did the Washington Consensus Fail?*, Institute for International Economics, Outline of speech at the Center for Strategic & International Studies, Washington, DC, November 6, 2002, *available at* http://www.iie.com/publications/papers/paper.cfm?ResearchID=488 (last visited Jul. 20, 2006)

[12] *See* U.N.CONFERENCE ON TRADE AND DEVELOPMENT, ISSUES RELATED TO INTERNATIONAL ARRANGEMENTS, INVESTOR-STATES DISPUTES AND POLICY IMPLICATIONS, U.N. Doc. TD/B/COM.2/62 (2005)

In general ICSID is considered a transparent and neutral forum to settle investment disputes,[13] but there has been indication that the system of international law of foreign investment is far from being perfect.

International investment arbitration is primarily a mechanism of protection of the foreign investors' rights. However, the instruments whereby international investment arbitration has emerged have been treaties and conventions between countries, not contracts between investors and States. In other words, although foreign investors have been the main beneficiaries of international investment arbitration, they have not participated in the making of the instruments from which that dispute resolution mechanism has been brought about.

Multinationals are the big beneficiaries of the system with all the rights and no obligations. From the business point of view of the foreign investor the wholly owned subsidiary incorporated in the host country is usually not considered an independent unit but rather as part of an economic unit where they use the same name, the same personnel, the same technology, are ruled by the same management under the same guidelines and have their funds commingled into one account. For strategic purposes, foreign investors operating under the form of corporations might find operating through local subsidiaries very appealing for on doing that they limit their liability to the assets of the local subsidiary. However, that benefit also comes with the burden of restricting the international protection the foreign operations of the foreign investor might be entitled to, unless an exception has been expressly agreed upon. [14] That exception is usually comprised with the BITs through which a wholly owned subsidiary of a foreign investor incorporated in the host State can be considered similar to the parent company in terms of nationality, i.e., a foreigner entitled to international protection. [15] But when the subsidiary is liable to the host State for any wrongdoing the parent company is not responsible. In other words the rationale that is good for international protection is not good for international responsibility.

Moreover, under the current international investment regime given certain treaty provisions international protection can be granted to the whole economic group of the foreign investment, even the wholly controlled subsidiary incorporated in third countries. Likewise, many BITs grant protection to companies incorporated in the home country but with non significant business presence, giving rise to a phenomenon better known as "treaty shopping" whereby investors launch their investments from a country where they have few or non business presence. Investors then incorporate a business in that country

[13] *See* ICSID Client Survey available at http://www.worldbank.org/icsid/highlights/icsid-client-survey-100904.pdf

[14] *See* Case Concerning the Barcelona Traction, Light and Power Company Limited (Belgium v. Spain), 1970, I.C.J. 3, 47 (February 5). After that case a trend was developed whereby countries agreed through treaties to grant international protection to wholly owned subsidiaries if they were controlled by a foreign company.

[15] *See*, García-Bolívar, Omar, *The issue of a foreign company wholly owned by national shareholders in the context of ICSID arbitration*, TRANSNATIONAL DISPUTE MANAGEMENT, Volume 2, issue #05 - November 2005, available at http://www.transnational-dispute-management.com (last visited Jul. 20, 2006). *See also* Orrego Vicuña, Francisco, *Changing Approaches to the Nationality of Claims in the Context of Diplomatic Protection and International Dispute Settlement*, 15 ICSID REVIEW, FOREIGN INVESTMENT LAW JOURNAL, 340, 2000

only to take advantage of the protection granted by the BIT, although in reality the business is controlled by a company incorporated in another country. Moreover, many local investors are taking advantage of loopholes and are incorporating foreign companies in countries with which there is a BIT in order to control the local companies and have access to international protection. Abuses of that nature have been looked at by arbitral tribunals and have been decided in a non-consistent way.[16]

As result, many States are criticizing the lack of obligations by the foreign investors under the current regime of international investment protection. For example, obligations of corporate social responsibility or commitments against human rights violations, environmental damages, corruption or labor mistreatment are not present in most of the IIAs.

It is true that in the absence of international investment arbitration, disputes between foreign investors and host countries can only be settled in two risky ways:

a) The foreign investor initiates a law suit against the host country in the host country's courts. In exceptional circumstances, if accepted by the host country, the foreign investor can be entitled to local arbitration. However, if the host country's judicial system is not independent and reliable; the foreign investor may be subject to a biased trial where chances of success are slim.[17]
b) The foreign investor asks diplomatic protection to his home country. The home country at its sole discretion decides to grant or not the diplomatic protection. However, regardless of where the dispute is presented, in this scenario the foreign investor does not have direct control of the dispute which turns into a dispute between States where the diverse interests of each other, rather than the sole interests of the investor, might play a role.[18]

But abuses of the international law of foreign investment are not good either.

Additionally, some arbitral tribunals have neglected to look at the purpose of the countries when entering into IIAs. A common pattern in many of the awards has been a lack of teleological interpretation of the IIAs, one that takes into account the development purpose of the countries on protecting the investments. Obviously, arbitrators can only

[16] *See* Tokios V. Ukraine (*Tokios Tokelés v. Ukraine*, ICSID Case No. ARB/02/18 (Lithuania/Ukraine BIT, Jurisdiction decision of April 29, 2004) and TSA v. Argentina (*TSA Spectrum de Argentina S.A. v. Argentina Republic*, ICSID Case No. ARB/05/5 (Netherlands/Argentina BIT), award of December 19, 2008).

[17] *See* Greta Gainer, Nationalization: The Dichotomy between Western and Third World Perspectives in International Law, 26 Howard L. J. 1547, 1983. Latin America can claim authorship to the *Calvo* doctrine, which had been incorporated into the constitutions of many countries and whereby foreign investors were not entitled to take disputes with host States to the international arena, and is also a reflection of a historic attitude against foreign investments. Accordingly, investors were subject to the same treatment that domestic investors received in the host State, not better. Therefore, they could only claim diplomatic protection from their home States in a few restricted cases, and then only after exhausting local legal remedies. *See also* Black's Law Dictionary, 4th edition, West Publishing, Eagan, Minnesota, 1951, p. 257

[18] *See, e.g.* Elettronica Sicula S.p.A. (ELSI) (United States v. Italy), 1989 I.C.J. 15, 109 (July 20).

interpret what is expressed in the IIAs, and many IIAs have refused to refer that the purpose of the State on protecting the foreign investments is promotion of their economic development.

Be as it may, some of the awards have made subjective and broad interpretations of standards such as fair and equitable treatment using the non-defined "legitimate expectations of the investor" to favor the investors.

Likewise the lack of consistency by the arbitral tribunals on issues such as what constitutes a regulatory taking, umbrella clause and the most-favored-nation treatment have originated a great deal of criticism, not only by the States but also by the investors.

IV. Impact of BITs

In real terms, the impact of international investment arbitration in Latin America has been uncertain.

Studies show that the relation between BITs and flow of foreign direct investment is weak.[19] Signing BITS and agreeing to international investment arbitration is not guarantee that foreign investors will make business in a given country. At most the international investment law framework creates a positive investment climate which diminishes the risk and with that the transaction costs of doing business. That added to the existence of a business opportunity, plus other business related factors could move the investors to choose that place as a location to invest. However, there are indications that the mere acceptance of international investment law is not sufficient to attract foreign investments.

In Latin America the largest recipient of foreign direct investment is Brazil.[20] Of a total of $ 126 billion of FDI inflow into Latin America in 2007, Brazil attracted almost $ 35 billion. Yet Brazil is not signatory of the ICSID Convention and has not ratified any BIT. Thus, the lack of adherence to the international investment law has not affected Brazil's foreign investments attractiveness.

On the other hand, international investment law might have a negative impact in terms of local governance. Through BITs, for instance, foreign investors may escape local courts and not play a role on the dynamic to reform those institutions.

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[19] *See* Tobin, Jennifer and Rose-Ackerman, Susan, *Foreign Direct Investment And The Business Environment In Developing Countries: The Impact Of Bilateral Investment Treaties*, May 2, 2005, Yale Law & Economics Research Paper No. 293, *available at* http://www.law.yale.edu/outside/html/faculty/sroseack/FDI_BITs_may02.pdf (last visited Jul. 20, 2006). See also Do Bilateral Investment Treaties Lead to More Foreign Investment?, Investment Treaty News, Damon Vis-Dunbar and Henrique Suzy Nikiema, April 30, 2009.

See also Hallward-Dreimeier, Mary, *Do Bilateral Investment Treaties Attract Fdi? Only A Bit... And It Might Bite*, World Bank Policy Research Working Paper Series, Number 3121. Washington, World Bank

[20] *Supra note* 1

In that sense it has been argued that in some cases in developing countries already suffering from low-quality institutions the presence of international alternatives to adjudicatory or regulatory bodies may reduce local institutional quality, by not allowing strong political coalitions to be formed.[21] Foreigners would have no interest on putting pressure for changes in the judicial system, for instance, since they are subject to a special dispute resolution regime.

It has also been said that BITs might reduce the interest of foreign investors in property and enforcement reforms in developing countries. Domestic reforms may be less likely and the country may even regress toward policies that harm domestic investors. Attempts to reform may fail, or no attempts at reform may be made at all. In such cases, the BIT, although benefiting foreign investors, could have a negative effect on the trustworthiness of the business environment for domestic investors.[22]

Obviously BITs are not the cause of weak legal reforms or law enforcement in developing countries, but they might not be helpful on reform efforts or might even make things worse by opening a discriminatory and unfair system of investment protection composed by two paths: the international one for some foreign investors and the weak one for the rest of businesses and for locals. More research needs to be conducted to determine the impact of international investment law in local governance and legal reforms, before a final judgment is issued. For now, we should only say that doubt has been expressed on the positive externalities the whole system of international investment law brings to developing countries in general and to Latin American countries in particular.

Some Latin American countries have reacted by withdrawing from ICSID (Bolivia), by limiting the type of disputes to be submitted to ICSID (Ecuador), by renegotiating BITs (Ecuador), by denouncing BITs (Venezuela), by interpreting restrictively its investment laws (Venezuela), by submitting awards enforcement to its local courts (Argentina), and by announcing withdrawal from ICSID (Nicaragua).

VI. Conclusions

Economic development needs to be financed. Historically developing countries have obtained that financing through the revenues yielded by the sale of their commodities in international markets or through loans granted either by international commercial banks or multilateral entities and through bilateral aid provided by the wealthy countries. It has been until recently that developing countries have accepted the argument that foreign investments could be means to finance economic development directly and indirectly

[21] Ginsburg, Tom, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, International Review of Law and Economics, 25, 107-123 (2005)

[22] *See* Tobin, Jennifer and Rose-Ackerman, Susan, *supra note 19*.

through its positive externalities.[23] In the past foreign investments were either despised and rejected or heavily regulated for they were considered instruments of neo colonialism or dominance.[24]

Enter the Washington Consensus and the pendulum shifted. But although the Washington Consensus delivered some results, it came under heavy criticism in the region mainly because those policies failed to cure the endemic inequality of the western hemisphere and made the rich richer while the poor remained poor if not poorer. Many of the policies portrayed by the Washington Consensus came under scrutiny and a shift of policies has been recommended. [25] In this scenario, the rationale of the international investment law could be questioned; something not to be underestimated if one takes into account that Latin America was the birthplace of the *Calvo doctrine*[26] and of creative nationalization schemes during the 70s.[27] Moreover the current global economic crisis seems to have created a dogmatic scenario not only to question the benefits of economic liberalization policies but also to support protectionist policies.

If the good of foreign investments comes to be in doubt because it is not beneficial to the economic development of the countries, the use of the international investment law would inevitably be on risk. Countries could start judging the pros and cons of the system and eventually reject their outcomes by failing to comply or more likely by denouncing previous commitments assumed under the form of international agreements or by not entering into new instruments of international investment law.

In order to avoid that, the whole system of international investment law, including international investment arbitration needs to be more balanced. Arbitrators need to give more weight to considerations of economic development in the context of their awards, whenever that is feasible. For example, arbitrators need to look at the objective of international investment law in broad terms and find out what is the real purpose of that legal framework: is it only to protect foreign investments or is it to protect foreign investments because they are beneficial to the economic development of the recipient country? If the purpose of the international investment law is merely to protect foreign investments the results of the arbitrators analysis would be totally different from an approach that also considers the economic development of the host State.

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[23] An example of positive externalities is seen in job creation and technology transfer. *See* LALL SANJAYA & PAUL STREETEN, FOREIGN INVESTMENT, TRANSNATIONALS AND DEVELOPING COUNTRIES 5 (1977)
[24] *See* M. SORNARAJAH, INTERNATIONAL LAW ON FOREIGN INVESTMENTS (1994).

[25] *Id . See also* See Kuczynski, Pedro-Pablo and Williamson, John. *After the Washington Consensus: Restarting Growth and Reform in Latin America.* The Institute for International Economics, March 2003, *available at* http://www.cid.harvard.edu/cidtrade/issues/washington.html

[26] *See Supra Note* 17.
[27] *See* KNUDSEN HARALD, EXPROPRIATION OF FOREIGN PRIVATE INVESTMENT IN LATIN AMERICA (1974). For instance Kennecott's copper mining was expropriated in Chile in 1971 using the argument of "excessive profits" for not compensating.

However, arbitrators can only look at the law as it exists, not as how it should exist. Thus, although they might be willing to make interpretations of the law when possible, and look at the purpose of the treaties and the intention of the States, they cannot make up an objective that have not been expressed by the parties to the agreement.

For that reason the treaty negotiators should bear in mind that the law is only as good as they make it. For countries bearing skepticism about the benefits of international investment law in general and of international investment arbitration in particular, the importance of clearly stating their economic development objectives vis-à-vis foreign investment cannot be underestimated.

Likewise, within the treaties, the impact of foreign investments in economic development should expressly be made part of the criteria to be taken into account by the arbitral tribunals when admitting a claim and upholding jurisdiction and when awarding monetary compensations.

Fairness and balance should be the rationale of these approaches. For instance, there is a need to amend the practice whereby the legal personality of the foreign investor can be disregarded for purposes of granting international law protection to a host State incorporated subsidiary while the same is not contemplated for purposes of liability of the parent company. The policy of granting international law protection to wholly owned subsidiaries incorporated in the host State is good and makes sense. However, the same criterion should be applied for purposes of liability and under certain circumstances; the personality of the local subsidiary could be disregarded to make the foreign parent company and the whole economic group liable for the doings of the local subsidiary. For that to be possible negotiators should devise mechanisms to be included in the relevant treaties.

Latin America in general does not seem prone to move away from the system of international law of foreign investment and return to inward investment protectionism. Many Latin American companies are major investors in developing countries. That is the case of Brazilian ODEBRECHT and PETROBRAS, Mexican CEMEX, Venezuelan PDVSA, Chilean LAN CHILE, just to name few. Many of those companies might be interested in having international protection when investing globally. Although it is not up to them but to their governments to negotiate that kind of protection, their leverage with their governments might influence the future approach of IIAs in the region.

Likewise, some governmental officers have expressed interest in the creation of an arbitral center in South America devoted to investment disputes involving countries from the region. Similarly poor countries in Central America have talked about a legal aid fund that might assist them not only in covering the legal fees but also in developing a local expertise that might be useful to develop a proactive and reactive strategy vis-à-vis the investment disputes.

All these signs show that Latin American countries are willing to change the current regime of international law of foreign investment.