

CLASS 2
INTERNATIONAL, NATIONAL AND CONTRACTUAL
FRAMEWORKS OF INVESTMENT PROTECTION

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MULTI-LAYER INVESTMENT PROTECTION FRAMEWORK

The notion of “investment” must be placed in context. The regulatory framework that governs the relations between the three main actors of the game (the investor, the host State and the home state) is called the investment legal framework, which is composed of legal norms and institutions, embodied in various instruments of varying legal nature. The investment legal framework is sub-divided into three main legal frameworks, which are closely linked and interrelated.

- **Contractual Legal Framework**
- **Domestic / National Legal Framework**
- **International Legal Framework**

What do these frameworks mean? How do they work in synergy together?

NATIONAL LEGAL FRAMEWORK

What is national legal framework? What are its constitutive parts?

Composed of the regulatory acts of the State that has jurisdiction over the investment – laws, decrees, decisions, judgments, individual acts.

How is Armenia treating foreign direct investment?

Two poles in general:

- **Investment encouragement** – states attempt to attract FDI by granting increased incentives and margin of action (tax exemptions, property titles, etc.)
- **Investment control** – at the same time states attempt to regulate, control and restrict investment to their benefit by adopting measures such as licensing, exchange controls, high tariffs, etc.

NATIONAL LEGAL FRAMEWORK

Each national system is assessed from an investor-perspective on the basis of two criteria. An investor will assess all of these criteria, when he will choose where to invest his assets:

- To what extent are property rights protected?

The purpose of the institutional framework over property rights is to constrain the behavior of other persons or institutions that seek to appropriate the labor, goods and services of another person. This is of special concern for foreign investors. Why?

- To what extent are contractual rights protected?

- Contractual freedom**
- Security and enforcement of contracts**

CONTRACTUAL LEGAL FRAMEWORK

What are the constitutive parts of contractual legal framework?

The contractual legal framework is comprised of all the contractual agreements concluded between:

- (a) Investors *inter se*
- (b) Investors and the State
- (c) Investors and external third parties (finance, supply/sales contracts)
- (d) Investors and insurance providers (can be companies and governments)

CONTRACTUAL LEGAL FRAMEWORK: INVESTOR CONTRACTS

What contracts can you name between investors?

What are investors contracts meant to cover?

- common understanding of the project
- respective rights and obligations
- conditions of incorporation and governance of the company □ charter, etc.
- shareholder agreement
- voting rights
- project management details

CONTRACTUAL LEGAL FRAMEWORK: STRUCTURE OF INVESTMENT

1. Wholly owned foreign direct investments

Single investor acquires a productive asset in a foreign country and controls and operates the assets for profit. Forms include: (1) subsidiary, (2) branch.

2. International Joints Ventures

- Most commonly used form in international investment projects
- Legal relationship between two or more investors to perform a specific business activity
- Two forms: (1) equity JVs, (2) contractual JVs
- Advantages of JVs: (1) engages local investors, (2) transfer of technology, (3) contributes to nationally owned industries

INTERNATIONAL JOINT VENTURES

Would you favor a JV structure if you were an investor?

No, if they are not willing to share profits, they fear management issues, unwillingness to reveal valuable technology and business secrets

Yes, if they are willing to share the risks, obtain additional capital, penetrate the market by using expertise and marketing of JV partner, obtain technology and know-how they do not possess, minimize risks through involving local interests.

INTERNATIONAL JOINT VENTURE AGREEMENTS

- Takes the form of a legally binding JV agreement
- Between foreign investors, local investors, Government, Government-owned enterprises
- Takes the form of several agreements: preliminary JV agreement, founders' agreement with underlying contracts such as services, management, loans, trademarks, marketing, technology, etc.

INTERNATIONAL JOINT VENTURE AGREEMENTS

1. Preliminary JV agreement

- pre-agreement to determine how the investment idea will be transformed into reality
- Financial structuring
- Feasibility study of the project
- Likelihood of success
- Profitability and expected resources
- *Kenana Sugar Company v Sudan case*

INTERNATIONAL JOINT VENTURE AGREEMENTS

2. Founders JV agreement and auxiliary agreements

- Entered into when all the boxes are checked in the preliminary stage
- (1) to define the legal relations between the parties, (2) to take the necessary commitments from the participants of the project, (3) to assure that the parties will cooperate in good faith to achieve the agreed upon purposes and actions, (4) to secure the provision of resources and services on the part of the partners.
- separate agreement will oblige the partners to found an entity which will enter into different contracts for the project **pre-incorporation contract**

INTERNATIONAL JOINT VENTURE AGREEMENTS

Pre-incorporation agreement

1. **Company statutes:** will define the structure, management and function of the JV
2. **Management structure description:** outlines the management organization of the JV
3. **Land purchase agreement:** the JV undertakes to buy the land by one of the partners
4. **General assistance:** one of the partners undertakes to provide assistance & technical guidance to JVs

INTERNATIONAL JOINT VENTURE AGREEMENTS

5. **Machinery and Equipment agreement:** the JV agrees to buy from one of the partners the necessary machinery
6. **Technical license:** by which the partner provides a license to the JV to use its patented technology
7. **Trademark license:** by which the partner provides a license to the JV to use its trademark
8. **Marketing policy:** by which the partners decide that the JV will carry out a predetermined marketing policy.
9. **Shareholder agreement:** the partners decide to vote their shares to carry out specific policies and agreements

INTERNATIONAL JOINT VENTURE AGREEMENTS

Founders JV agreement

- **Preamble and recitals:** it reveals the intentions of the parties and their common understandings.
- **Main text:** the main text regulates the most sensitive topics to be covered by the agreement:
 - The object of the JV
 - The legal form of the JV and the governing law (usually the host state's law)
 - The capital of the JV to be contributed by each party.
 - The contributions: contributions may be made in money (in which case the agreement defines the currency and exchange rates) or in material or non-monetary contributions (e.g. products, land, services, technical assistance, marketing support, trademark, patented technology, staff, training, etc). In the latter case the agreement contains the method for evaluating non-monetary contributions.

INTERNATIONAL JOINT VENTURE AGREEMENTS

Founders JV agreement

- **Control and management:** one of the most sensitive issues is to define the size of the Board of Directors, how directors will be appointed by each partner, the election process, the representation of minorities, the creation of independent executive committees to which the Board will delegate with powers on the execution of the projects (to make a more flexible organizational scheme), veto rights, unanimity requirements etc. In case of disagreements between minority and majority, the Statutes may provide for means of friendly settlement, such as conciliation, mediation or in the worst event, arbitration.
- **Reimbursement of pre-incorporation costs:** sometimes, the preliminary phase of a project requires a considerable amount of money to conduct feasibility studies, or to set up the company, seek for licenses etc. Parties may either be reimbursed by the JV entity for these costs, or capitalize these costs as their contribution to the company's capital. Sometimes, individual investors may however bear some of the costs, as long as they're reasonable.

INTERNATIONAL JOINT VENTURE AGREEMENTS

Founders JV agreement

- **Financial policies:** the parties shall also agree on the financial policies to be followed; once the company is profitable, foreign investors will seek to distribute the profits by means of dividends. On the contrary, local partners (or the government) might seek to retain the profits, capitalize them or use them for expanding the enterprise. Hence, the initial accord may regulate the distribution of profits, by providing various solutions, such as partial distribution, meeting the JV's capital etc.
- **Obligations of the Host State as a partner:** if the State is a JV Partner, the investor might wish to concretize its obligations and promises by stipulating specific obligations in terms of benefits. Such obligations may include: concessions, grants, tax exemptions, licenses and benefits, subsidized loans, immunities etc.
- Accounting and auditing by an internationally recognized accounting firm.
- Transferability of shares: either freely, or subject to approval by other JV participants.
- Applicable law and dispute settlement.
- Termination of JV

CONTRACTS BETWEEN INVESTORS AND HOST GOVERNMENT

- Are mainly aimed to provide assurances and privileges to investors
- in 991 AD, the Byzantine Emperors Basil II and Constantine VIII, in a document known as a chrysobul, granted directly to the merchants of Venice the rights to trade in the ports and other places of the Byzantine Empire without paying customs duties, as well as the right to a quarter in Constantinople
- Nowadays such investor-state negotiations take the form of contractual agreements, which have two main features: (1) they seek to provide for benefits and protective guarantees to attract investors; (2) they seek to regulate and control the conduct of the investor and in case of failure by the investor, to impose sanctions and penalties thereupon.

STATE CONTRACTS: CONCESSION AGREEMENTS

A concession is an agreement by which the host government permits a private entity [an individual investor, a consortium or a joint venture] to provide a service to the public that had previously been a public service run by the State (e.g. water supply, electricity, transport, telecommunications, roads, ports, airports, gas, oil etc.) and to collect revenue from consumers in return for this service.

- Started with petroleum concession agreements, which were one-sided agreements
- Early characteristics:
 - State granted the investor rights to mineral development for vast areas
 - Concession would last over a long period of time
 - Extensive control by the investor over the project
 - Government had very limited rights
 - The contract received extensive tax privileges

STATE CONTRACTS: CONCESSION AGREEMENTS

Contemporary characteristics:

- Capital importing states regained economic sovereignty
- Concession areas are more specific
- Rights of the contractors have been subjected to segregated licensing
- Shorter time-periods
- Nature of obligations
- Change of economic equilibrium

Old agreements were replaced by PSAs, licenses, risk service contracts, JVs, BOTs and BOOs

STATE CONTRACTS: PRODUCTION SHARING AGREEMENTS

In the most classing type of PSA, the Government contributes the acreage for exploration and extraction whereas the concessionaire contributes the technology, infrastructure, staff and equipment to explore the land in a specific time frame and extract mineral resources.

- The investor undertakes the opportunity at its own cost and expenses
- If no profitable reserve □ the investor bears the cost and risk
- If commercially marketable reserve is found, the contractor gets the title to first production to cover its cost / expenses and reasonable profit OR the ownership may rest with the state but the revenue from sales goes to the corporation for some time
- Then the state and corporation share the profits for a certain period after which the percentage of the corporate diminishes over time

STATE CONTRACTS: LICENSES

Government grants licenses to explore OR to produce EITHER onshore OR offshore.

(1) **The exploration license** allows the contractor to explore an area that potentially contains rich mineral resources; nonetheless, the licensee has no right to extract the minerals (if found), but has to acquire a second, production license. The fact that the licensee has an exploration license does not grant it a preferential right to a production license. In both licenses, the risk of exploration and production lies with the licensee.

(2) **The production license** is a more complicated license that allows the licensee to extract petroleum resources on an exclusive basis. It grants the 'exclusive license and liberty to search and bore for and get petroleum in the sea bed and subsoil' under a specified seaward area.

STATE CONTRACTS: LICENSES

- The license may last up to 40 years, depending on the meeting of certain obligations contained in a schedule, for the continuance of the license
- The Government retains extensive powers over the licensee, such as inspection of its facilities by authorized persons, approval obligations for the commencement of exploration, production or drilling and most importantly: the license can be revoked on various grounds
- Payments: (1) required payments of the investor on a square kilometer basis, (2) royalties payable in cash based on the value of petroleum relating to the preceding 6 months [the petroleum's value also includes natural gas produced along with oil](3) Sometimes the licensee may be obliged to pay the government part of its royalties in kind (the decision lies exclusively with the Government).

STATE CONTRACTS: RISK SERVICE CONTRACTS

- RSC are based on a simple formula: the contractor provides all capital associated with exploration/development of petroleum resources and in return, if exploration efforts are successful, the government allows the contractor to reclaim his costs by selling the oil or gas and compensates him with a fee, based on a percentage of the remaining revenues (this is subject to taxes).
- But in that case, the contractor **does not get a 'share' of production, therefore the Profit Sharing Agreement is not applicable**. RSC are solely an agreement of services. If the exploration efforts are unsuccessful, then the investor loses it all and bears the onus of losses and risks.

STATE CONTRACTS: INVESTMENTS IN INFRASTRUCTURE

- **BOTs (Build-Operate-Transfer)** is an agreement in which a sponsoring foreign investor (or consortium of investors and lenders) supervises the construction and operation of an infrastructure facility (e.g. an airport) for a determined length of time and subsequently transfers ownership of control thereupon to the Government. At the heart of a BOT lies a concession agreement by which the host State permits the private party or parties (in the form of Joint Venture) to provide for a public service and impose charges on the consumers/users for the use thereof, for a certain amount of time. The precise length of the concession is determined by the estimate time required to obtain sufficient revenue to pay bank accrued debt and provide a 'reasonable return of profit' in the form of equity for the investors in the Project's Company.

- **BOO (Build-Operate-Own)** is a similar agreement, with the exception that there is no reversion of ownership of the assets of the project; the investor or consortium retains the ownership of the project's assets. This has the drawback that many governments for ideological and political reasons will not allow a foreign investor to own the facility for an undetermined period of time.

STATE CONTRACTS: INVESTMENTS IN INFRASTRUCTURE

What are the risks, costs and benefits?

1. This allows the host State to obtain efficient, modern infrastructure, without raising the capital or increasing public deficit. This does not increase the State indebtedness or divert government funds for other purposes nor does it require guarantees of loans from the State (the project is financed on a nonrecourse basis, which means that the project sponsors, which are usually international commercial banks, rely on the assets and revenues of the project rather than on the credit of the investors for the repayment of loans).
2. The investor has the motive to engage in BOTs since it allows him to penetrate previously restricted sectors of the economy which have an increasing demand in the public, with considerable profits.
3. BOTs do not make the foreign investor the permanent owner of the infrastructure, some governments have enacted legislation that allows ONLY for BOTs in certain sectors.

STATE CONTRACTS: INVESTMENTS IN INFRASTRUCTURE

4. The operation of the investment gives incentives for low-cost projects: since the builder, operator and designer of the project is a single private firm (or a consortium) that acts only for a limited amount of time, it has the incentive to act promptly, provide for quality services and lower the costs, so as to recover costs and make profits as soon as possible.
5. Besides, the investor has an interest to transfer technology and managerial skills, to achieve effectively profits. However, even when the investor is gone, the spill-over effects of the investment shall remain.
6. Host countries may oblige the foreign investor to contract with a local company (or a government owned enterprise) in the form of a Joint Venture, in order

STATE CONTRACTS: INVESTMENTS IN INFRASTRUCTURE

- Yet, the limited liability of project financing poses the risk that investors may engage in risky practices at the risk of the public. Any problems may be passed on to users, subscribers of the service, in the form of additional costs, low quality services and mismanagement.
- Investors run considerable risks as well: completion risks, political risks, operation risks, market risks, currency risks etc. Threat of nationalization is also present, but attenuated by the fact that collaboration with a local company may serve as a means to limit clashes with governments.

CONTRACTS BETWEEN INVESTORS AND THIRD PARTIES

- Contracts with external partners that provide the investment operator (e.g. the investment enterprise) with the necessary materials, resources, services and assistance to operate the project.
- This includes: loan agreements with banking institutions, service providers such as technology, components in the manufacturing process, assistance in the supply chain, disposition in the sale of products, etc.
- The enforceability of the contractual rights of the investor against his debtors is an essential factor to be taken into account in determining the appropriate environment for the investment.

INSURANCE CONTRACTS

- The investors or the enterprise in which they have invested may enter into a variety of insurance contracts to protect against various risks faced by their investment.
- One important type is **political risk insurance**, which is offered by three sources: national governments, private insurance companies, and international organizations.
- For example, many home governments offer foreign investment insurance to their nationals, and such insurance contracts, which are designed to protect the investor against political risks such as expropriation, currency inconvertibility and political violence, become an important part of the investment's contractual legal framework.

INTERNATIONAL LEGAL FRAMEWORK

- Evolution of international law and its actors

International law affects private international investment transactions in at least three ways:

1. It influences domestic legislation affecting transactions. Many elements of national legislation and regulation governing international business have their origin in or are at least linked to the international system, and individual states enforce them because they are bound to do so by international agreement. For example, many national regulations on monetary matters or trade questions are determined by prevailing international treaties, such as the Articles of Agreement of the IMF and the GATT.

2. Certain rules of international law apply directly to individuals and companies and may even afford them an international means of redress when a State fails to respect those rules. For example, bilateral investment treaties guarantee foreign investors a specific level of protection under international law and grant them the ability to invoke international arbitration when a host State fails to respect its obligations.

3. International law creates international organizations and institutions, such as the International Centre for Settlement of Investment Disputes (ICSID), which play important roles in many areas of international investment.

INTERNATIONAL LEGAL FRAMEWORK

1. International Conventions

- Binding agreements between states
- NAFTA, ECT, ICSID
- Article 38 of ICJ Statute □ cites convention first as source of international law
- Treaty prevails over custom unless *jus cogens* □ accepted and recognised by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character
- If there is reference to IL, the tribunal will refer to customary international law

INTERNATIONAL LEGAL FRAMEWORK

2. International Custom

- Is a second source of international law under Article 38 of the ICJ Statute. International custom is defined simply as “a general practice accepted as law.”
- Thus, a customary rule of international law must meet two criteria: 1) it must be a general practice of states, and 2) states must engage in that practice out of a sense of a legal obligation.
- As will be seen, the field of international investment law, for example, has generated significant disagreement among nations as to the nature and content of applicable international rules. As a result, in many forums the very existence of customary international investment law has been questioned, if not challenged outright, over the years.

INTERNATIONAL LEGAL FRAMEWORK

3. General Principles of Law

- Referred to in the ICJ statute as “general principles of law recognized by civilized nations,” they constitute the third and final source of international law.
- Refers to the legal principles that are common to the world’s major legal systems. These “general principles” are often seen as a source to help fill in gaps where no applicable treaty provision or international custom exists.
- While certain general principles, such as *pacta sunt servanda*, have emerged to become custom, Tribunals will generally be hesitant to find such a general principle unless it is clear there is broad acceptance in the world’s legal systems.

INTERNATIONAL INVESTMENT AGREEMENTS

Contractual instability in international investment agreements. Why?

- Investment contracts are **imperfect**
- Cultural misunderstandings
- **Unforeseeable circumstances** in foreign legal order
- Protection of **national sovereignty** or public welfare
- Recourse to **justice** is more scarce, difficult or costly

Thus, parties may seek for ways to stabilize the uncertainties

RENEGOTIATION CLAUSES

What are renegotiation clauses?

a. **post-contract renegotiation clauses**

- a. Previous experience of parties affects negotiations
- b. Previous contract may affect their obligations and scope of negotiations
- c. Duty to negotiate

b. **Intra-contract renegotiation clauses**

- a. Implicit renegotiation clauses
- b. Review clauses
- c. Automatic adjustment clauses
- d. Open-term provisions
- e. *Stricto sensu* renegotiation clauses
- f. Wintershall v Government of Qatar

c. **extra-contract negotiations**

STABILIZATION CLAUSES

What are stabilization clauses?

a. Importance for the energy sector

- a. Highly costly sector
- b. Elusive chances of success
- c. Importance of stabilized legal order

b. Definition and taxonomy

- a. Stability or freezing clauses
- b. Intangibility clauses
- c. Indirect stability clauses

c. Criticism

- a. Practically meaningless and redundant
- b. Fettering national sovereignty □ *AGIP v Congo*, *LETCO v Liberia*, *Aminoil v Kuwait*

d. Evolution

- a. Transformation
- b. Risk allocation clauses

FORCE MAJEURE CLAUSES

What are force majeure clauses?

Definition: *National Oil Corp. v Lybian Sun Oil*

- a. Beyond control
- b. Unforeseeability
- c. Impossibility

The force majeure clauses typically is accompanied with:

- a. Non exhaustive list of events
- b. List of non-force majeure instances
- c. Obligation to notify
- d. Obligation to mitigate effects