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BUSINESS LAW

An International Framework for the Protection of Investment

by N. Stephan Kinsella

We'll take and take until not even the nails in their shoes are left. We will take American investments penny by penny until nothing is left.

—Fidel Castro, 1960[1]

Less than seventy-five years after it officially began, the contest between capitalism and socialism is over: capitalism has won.

—Robert Heilbroner, 1989[2]

IN THE NOT-too-distant past, socialism and central planning were held up as ideals, and capitalism, private property rights and free trade were scorned; today the reverse is the case. One reason for this change is the spectacular and unambiguous collapse of various forms of socialism and central economic planning around the globe, which has led to an unprecedented and relatively widespread appreciation of the benefits of free trade and private property. Most serious people now acknowledge, albeit sometimes reluctantly and inconsistently, the essential role of free trade and private property for civilized human survival. Whatever the reason for this change in the evaluation of capitalism, it is hard to deny the growing recognition, among both industrialized and emerging countries, of the importance of protecting the private property rights of investors and of reducing political risk so as to make investing in foreign countries more feasible and attractive to investors.

Despite these improvements, investors are still often wary of investing in foreign countries since there is a danger of expropriation—direct or indirect, sudden or gradual—of their investments by the host state. This wariness is heightened when one of the jurisdictions is a relatively unstable, developing regime where property and contract rights are uncertain. Many of these regimes, such as Russia, Cuba, Mexico and Libya, have expropriated or nationalized foreign investment in the past and have not fully, consistently or even substantially embraced capitalism or respect for private property rights. For this reason, the political risk of investing in emerging economies is often prohibitively high. This is unfortunate, since it is these countries that desperately need injections of Western capital and know-how, in order to help them rise out of the decimation caused by decades of inefficient and brutal central planning.

One way to help investors overcome this wariness is to strengthen the protection of foreign investment through the use of treaties. By entering into a treaty, a state "internationalizes" the commitments contained in the agreement, thus making a breach of those obligations an independent and serious breach of international law, under the principle *pacta sunt servanda* (agreements are to be respected). Host states are, therefore, reluctant to breach a treaty obligation that has been voluntarily and expressly undertaken. Accordingly, through such agreements with other nations, a prospective host state can bind itself under international law to respect foreign investment, thereby rendering any arguable uncertainty in general principles of international law moot—even if the host state itself has previously resisted the Western interpretation of general principles of international law.

Currently, some regional treaties, such as NAFTA and the Treaty of the Establishment of the Caribbean Common Market (the Andean agreement), do address investment protection issues on a regional basis, but they do not cover all nations. Similarly, a growing nexus of so-called bilateral investment treaties obligate the signatory parties to respect the property rights of foreign investors. Hundreds of these treaties have been executed to date—America, for example, has concluded dozens with countries ranging from Albania to Zaire. However, since each treaty covers only one pair of countries, there is now a huge, unwieldy number of bilateral agreements, many having different standards and scope, and many pairs of countries are not even covered.

The proposed Multilateral Agreement on Investment (MAI) may repair this gap. Currently being negotiated by the twenty-nine member countries of the Organization for Economic Cooperation and Development,[3] the MAI would obligate its signatories to respect foreign investment through a binding treaty. Although mostly industrialized, developed countries are negotiating the treaty, it is hoped that once the MAI is ratified, a wide number of countries, including developing nations, will join in the agreement, thus making the standards for protection of foreign investment more universal and uniform than those provided by the inconsistent patchwork of bilateral and regional treaties. Talks on the MAI were initiated in early 1995 and are expected to be concluded by mid-1998. Among other things, the MAI is expected to provide for nondiscrimination, limits on expropriation, and effective dispute resolution.

Under the MAI, for example, host states are expected to agree to expropriate foreign investment only if the expropriation is (a) for a public purpose, (b) performed in a nondiscriminatory manner, and—the most essential protection—(c) accompanied by prompt, adequate and effective compensation equivalent to the fair market value of the investment. The dispute resolution measures should provide for a predictable and peaceable means of settling disputes between foreign investors and the host state, and for disputes between the investor's home state and the host state.

In explicitly calling for a fair market value compensation standard, the MAI should remove the uncertainty that has settled on the compensation issue in decades past. In a sense, the MAI signals the re-emergence of a framework for the protection of foreign investment, which had existed in one form or another until it was watered down in the socialist turmoil of this century. Additionally, since states are reluctant to breach treaties, tying investment protection standards to a treaty should cause developing states to be even more reluctant to expropriate foreign investment in breach of the MAI's standards.

Thus, the MAI should serve to lower political risk and increase foreign direct investment. It is also possible that the MAI negotiations will be expanded to include provisions to inhibit and deter investments in property expropriated without compensation or otherwise in violation of international law—similar to the prohibitions against trafficking in illegally confiscated property in the so-called Helms-Burton, or Libertad, Act of 1996—which should help further dissuade host states from illegally expropriating investment.[4]

The MAI should improve on other current practices for protecting investment as well. For example, some developing states provide for investment protection in national legislation, such as investment codes. These laws, however, may be changed at will by the host state, without necessarily violating international law. Since states are less likely to breach a treaty than to change their own laws, the MAI would give investors more security in their property rights.

Another technique open to some investors is the negotiation of agreements directly between the investor and the host state, referred to as concessions or investor-state agreements. These agreements, like treaties, can provide for strong protection of the investor's property and other rights, and can be structured to make the host state obligated under international law to respect the agreement. This option is expensive to negotiate, however, and not usually feasible for smaller investors, whereas a treaty such as the MAI would protect all investors.

Foreign investors also often deal with political risk by acquiring political risk insurance. Such insurance is available from a number of sources, including state-sponsored insurance agencies such as the United States' Overseas Private Investment Corporation, private insurers such as Lloyd's of London, and multilateral agencies such as the World Bank's Multilateral Investment Guarantee Agency. Of course, investors would prefer to have political risk itself lowered so that expropriation is less likely (and so that political risk insurance becomes cheaper). Additionally, government-sponsored insurance, which dominates the field, is morally and economically problematic since it involves redistribution of wealth and the economic inefficiencies that inevitably accompany government intervention in the market.[5] Thus, the MAI is also to be welcomed, to the extent that it reduces the resort to government-sponsored investment insurance schemes.

Today we seem to be entering a golden age of international trade, with ever-diminishing barriers and increasing economic integration and foreign investment. This tendency is more advanced among the industrialized economies of the West, but it is spreading to developing countries, as they begin to crave foreign investment.

The MAI promises to improve the present international system for the protection of foreign direct investment. If it is ratified by a large number of both developing and developed states, the MAI stands to benefit both investors and host states, thereby further increasing the wealth of nations.

(N. Stephan Kinsella is a member of the intellectual property department and international law group of Duane, Morris & Heckscher LLP. He is co-author of Protecting Foreign Investment Under International Law: Legal Aspects of Political Risk, 1997, Oceana Publications, Dobbs Ferry, New York.)

Notes

1. *The New York Times*, 21 August 1960, Section 3(F), p. 1, quoted in Eric N. Baklanoff, *Expropriation of U.S. Investment in Cuba, Mexico, and Chile* 112 (1975).

2. Robert Heilbroner, "The Triumph of Capitalism," *The New Yorker*, Jan. 23, 1989, p. 98. The superiority of capitalism over socialism had been rigorously proved back in 1920 by the great Austrian economist Ludwig von Mises. See Ludwig von Mises, *Economic Calculation in the Socialist Commonwealth* (1990) (1920); see also Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (J. Kahane trans., 3d rev'd ed. 1981) (1922). Mises' ideas were initially thought to have been refuted by socialist economists, in what is known as the "socialist calculation debate." The false conclusion that the socialists won the debate by disproving Mises' claims was perpetuated in the following decades by economists such as Heilbroner. See, e.g., Robert Heilbroner, *Between Capitalism and Socialism* (1970), pp. 88-93, in which Heilbroner claimed that Mises was wrong, that socialist economic calculation was possible and that the "superior performance" of socialism would "soon reveal the outmoded inadequacy of a free enterprise economy." Despite decades of unjust and unfortunate neglect, Mises has finally been vindicated by the universally acknowledged failure of socialism as a viable economic system. See Gertrude E. Schroeder, "The Dismal Fate of Soviet-Type Economies: Mises Was Right," *Cato J.*, v. 11, no. 1 (Spring/Summer 1991), p. 13; "Labor Party leader flips on policy," *The Philadelphia Inquirer*, Apr. 8, 1997, p. A2 (describing the British Labor Party's endorsement of privatization of state-owned enterprises and recent elimination of a Marxist clause in its constitution advocating common ownership of the means of production). Even Heilbroner now admits: "It turns out, of course, that Mises was right." Robert Heilbroner, "After Communism," *The New Yorker*, Sept. 10, 1990, p. 91, 92. See also Mark Skousen, "'Just because socialism has lost does not mean that capitalism has won': Interview with Robert L. Heilbroner," *Forbes*, May 27, 1991, p. 130. For further discussion of the socialist calculation debate, see Murray N. Rothbard, "The End of Socialism and the Calculation Debate Revisited," 5 *Rev. Austrian Econ.* 51 (1991); Don Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (1985); David Ramsay Steele, *From Marx to Mises: Post-Capitalist Society and the Challenge of Economic Calculation* (1992).

3. For further discussion of the MAI and related issues, see "American Bar Association Section of International Law and Practice Report to the House of Delegates: Multilateral Agreement on Investment," 31 *International Lawyer* 205 (1997); and William H. Witherell, "Developing International Rules for Foreign Investment: OECD's Multilateral Agreement on Investment," 32 *Business Economics* 38 (January 1997). Other information on the current status of the MAI negotiations was obtained from the U.S. Department of State, Office of Investment Affairs, International and Financial Development, Bureau of Economics and Business Affairs, and from the Organization for Economic Cooperation and Development's Web site at www.oecd.org.

4. See, e.g., Stuart E. Eizenstat, "A Multilateral Approach to Property Rights," *The Wall Street Journal*, Apr. 21, 1997.

5. But see Maura B. Perry, "A Model for Efficient Foreign Aid: The Case for Political Risk Insurance Activities of the Overseas Private Investment Corporation," 36 *Va. J. Int'l L.* 511 (1996) (arguing that the Overseas Private Investment Corporation is more efficient than private political risk insurance because, *inter alia*, it is able to actually reduce political risk because host states are reluctant to illegally expropriate an investment insured by an agency of the United States government).

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