CLIFFORD CHANCE

BANKS, BITS AND BAILOUTS – INVESTMENT TREATY PROTECTION IN THE FINANCIAL SERVICES SECTOR

— THOUGHT LEADERSHIP

FEBRUARY 2022

BANKS, BITS AND BAILOUTS – INVESTMENT TREATY PROTECTION IN THE FINANCIAL SERVICES SECTOR

In times of financial and economic crisis, Governments and monetary authorities may take a range of measures which could have adverse impacts on investors in the banking and finance sector, including bailouts, restructuring of sovereign debt and implementation of restrictive financial regulations. The response to Covid-19 has seen unprecedented regulatory measures such as these being taken around the globe to ease the economic impacts of the pandemic. Banks, financial institutions and investors may suffer adverse impacts as a result of these measures, therefore it is important to be aware of the protections offered by international investment treaties, such as bilateral investment treaties (BITs) and Free Trade Agreements (FTAs). However, advance planning is essential to ensure the protections offered by BITs and FTAs are available to banking and finance investors if a dispute emerges.

Key issues

- Effective mechanisms in BITs protect foreign investment in the financial services sector by allowing qualifying investors to take direct action against unfair regulation by a foreign State.
- The impacts of Covid-19 on international economies have seen significant changes to the regulatory landscape of the financial services sector. Historically, where such measures have been introduced, the result has been an increase in claims being brought against Governments by qualifying investors in the banking and financial sector through ISDS mechanisms.
- Access to ISDS provisions must be considered well before any dispute arises. Hence, it is an important consideration for the financial services sector at the front end stage of a transaction.
- Case studies are used in this briefing to demonstrate the significance of ISDS in BITs in the banking and finance sector.

Following financial crises or events of economic instability, governments have taken measures in the banking and finance sector to ensure economic survival. These measures are often focused on the protection of domestic interests, which may exclude or prejudice foreign investors. Such measures have included discriminatory bailouts or the forced restructuring of sovereign debt following the 2008 Global Financial Crisis, 2011 Argentine Financial Crisis and the 2011 Greek Financial Crisis. To protect themselves, and their investments, qualifying investors may rely on enforceable protections provided under BITs. Over 130 banking and finance related claims have been made against a multitude of States under investment treaties.

This article looks at the key protections afforded to qualifying investors in the financial services sector under BITs and explores several case studies to explain how these provisions operate.

Bits and their enforceable rights

What is a BIT?

A BIT is a form of investment protection treaty concluded between two sovereign States in which each agrees to promote and protect investments made in its territory by investors of the other State.

The purpose of a BIT is to:

– reduce sovereign risk and encourage foreign direct investment;

– establish fundamental (and reciprocal) standards of treatment; and

– allow foreign investors to enforce breaches of these standards directly against host States, particularly by way of a powerful arbitration mechanism.

In addition to BITs, other treaties such as FTAs include investor protections much like BITs. In all, there are close to 3000 international investment agreements in existence.

BIT Dispute Settlement Provisions

Most investment treaties contain an investor-State arbitration clause in which a State consents in advance to arbitration if an investment dispute arises under the treaty. A treaty is usually worthless to the investor without this right to go to arbitration. This is because without an arbitration clause, the investors' rights under the treaty will not be enforceable. Indeed, in the absence of an international arbitration clause, the investor will generally only be able to seek recovery under domestic law in the courts of the host State (who typically have no jurisdiction to hear claims concerning treaty breaches). This means the investor is vulnerable if domestic laws and/or courts are subject to government influence or control.

Dispute settlement provisions in investment treaties typically also contain a consultation or negotiation period obligation which may bring about a swift and high-level response by the State given that a treaty dispute functions on an international rather than a domestic level. As an indication of the high-level nature of a BIT dispute, an investor often initially notifies a treaty dispute to the Prime Minister (or equivalent) of the disputing State.

Substantive Protections

Although each BIT is individually negotiated, the following substantive protections are commonly offered to foreign investors:

- Prohibition against Expropriation: A State must not expropriate investments of a covered foreign investor without providing full compensation.
- Fair and equitable treatment (FET): A State must not harm covered investments through unreasonable, non-transparent or arbitrary conduct.
- Full protection and security: A State must exercise due diligence to protect covered investments (physically and legally).
- Non-discrimination: A State must not discriminate against covered investors or their investments.
- National treatment: A State must grant investors the same treatment that is given to its nationals.
- Most-favoured-nation (MFN) treatment: A covered investor is entitled to the same or better treatment that a State gives to nationals of any third countries.
- Umbrella clause protection: A State must comply with all its obligations entered into with a covered investor, including contractual obligations.
- Free transfer of funds: A State must permit a covered investor's funds to be transferred without unreasonable delay and in freely convertible currency.

How is BIT Protection Acquired?

For an investor to acquire the protections under an BIT, at the least, the following two criteria must be satisfied:

– the investor must fall within the BIT's definition of "Investor"; and

– the investor's asset must fall within the BIT's definition of "Investment".

In practice, if an investor is not incorporated in a State that has a robust investment treaty with the State into which its investment is made, it must engage in treaty planning to ensure that a company within its corporate chain is incorporated in such a State. This corporate structure must be in place before a dispute arises with a State, otherwise the relevant arbitration rights may not be effective. Clifford Chance has developed detailed treaty planning guides to assist clients in understanding the process and its pitfalls, which we will be happy to provide on request.

Investment treaty claims in the banking sector

Following periods of past financial crises, Governments have taken various measures in the banking and finance sector to respond to such crises, and some of these measures have given rise to investment treaty claims by investors.

Bank Bailouts

A number of banking related treaty claims have arisen out of bank bailouts. The leading case in this context is that of *Saluka Investments B.V. v The Czech Republic* (PCA Case No. 2001-04). Saluka owned Investiční a Poštovní banka a.s. (IPB), one of the "Big Four" Czech Republic banks in the late 1990s. A systemic bad debt problem was encountered in the Czech banking sector. As a result, the Czech Republic provided the other three banks, which were in a comparable position to IPB, with state assistance. No state assistance was provided to IPB, making it impossible for IPB to survive and resulting in Saluka's loss of investment. The Tribunal held that the discriminatory conduct of the Czech Republic violated its FET obligations, as Saluka had a justified expectation that it would be provided state assistance in a consistent manner and therefore be included in the financial assistance plan.

Most recently, in *Bank Melli Iran and Bank Saderat Iran v Bahrain* (PCA Case No. 2017-25), a tribunal found Bahrain liable for breaching the Bahrain-Islamic Republic of Iran BIT. Bank Melli, Bank Saderat and Bahrain's Ahli United Bank had previously formed a new bank in Bahrain, called 'Future Bank', with each investor holding a 33% stake. The claims arose out of the decision of Bahrain's Central Bank to close Future Bank in 2016 after placing it under administration in 2015. The Claimants relied on a Wikileaks cable which suggested that Bahrain's conduct towards Future Bank was politically motivated and influenced by the US and Saudi Arabia.

Another interesting case is that of *Hesham Talaat M. Al-Warraq v Republic of Indonesia* (UNCITRAL Case). In this case, the Claimant was an investor in Bank Century, which began experiencing significant liquidity problems in 2008. In response, Bank Indonesia injected up to USD 700 million into Bank Century, however there were reports that these bailout funds were used for improper purposes. The Claimant was prosecuted and convicted of money laundering and corruption in *absentia*. Claims were brought under the OIC Investment Agreement.

The Tribunal found that Indonesia had breached the FET standard due to a denial of justice (in deciding the corruption and money laundering matter while the Claimant was not present). However, the Tribunal also found that the Claimant had committed an "*act prejudicial to the public interest*" and so no damages were awarded. The bailout itself was considered to be a reasonable measure.

Sovereign debt restructuring

Following the 2011 Greek Financial Crisis, a number of claims were brought by investors in response to the forced restructuring of Greek Government Bonds (GGBs). In *Marfin Investment Group Holding S.A, Alexandros Bakateslos and Others v Republic of Cyprus* (ICSID Case No. ARB/13/27), the Claimants held shares in Laiki Bank (now, Marfin Popular Bank), which was heavily exposed to GGBs. At that time its portfolio was valued at EUR 2.9 billion. However, in 2011, Laiki Bank recorded significant losses in relation to their GGBs (whose face value had been reduced by 53.5%). Cyprus intervened and restructured the Laiki Bank, and removed the existing management of the Bank. In doing so, the Claimants alleged that Cyprus had breached their FET and FPS standards of the BIT.

The Claimants' ownership of Laiki Bank shares was found to be a protected "Investment" under the Greece Cyprus BIT. However, the Claimants' did not ultimately succeed because they could not establish that Cyprus had sought to nationalise or expropriate Laiki Bank. Rather, Cyprus had taken proportionate action for legitimate purposes, including a change in the ownership structure where the Bank was in financial distress. The removal of key personnel was said to be an exercise of regulatory powers which were used in good faith and in a non-discriminatory manner. The Tribunal weighed up competing interests to protect public welfare and the investor's legitimate interest in continuing to manage its investment.

Another case relating to the restructuring of Laiki Bank was commenced by a group of 677 claimants who were holders of financial instruments and bank deposits in Laiki Bank (*Theodoros Adamakopoulos and others v. Republic of Cyprus*, ICSID Case No. ARB/15/49). They allege that the restructuring of Laiki Bank (which involved a merger with the Bank of Cyprus) violated the Cyprus-Greece BIT. Jurisdiction was found by a majority of the arbitral tribunal on 7 February 2020 and so the case is now being considered at the merits stage.

Loans and Mortgages as Protected Investments

For investors in the banking sector, whether a loan or mortgage is considered to be a protected investment is critical, since protection under a BIT or FTA is dependent upon this criterion being satisfied.

In *British Caribbean Bank Limited v The Government of Belize* (PCA Case No. 2010-18), British Caribbean Bank Limited (BCB) granted loans in 2005, which were backed by security agreements, to Belize Telemedia and its related entities. In 2009, Telemedia was nationalised by Belize. Following this change of ownership, the loans were not repaid and BCB considered the loan facilities to be in default. BCB commenced arbitration under the UK-Belize BIT.

Article 1 of the UK-Belize BIT provided that an "Investment" means every kind of asset and includes "*property rights such as mortgages, liens or pledges*" and "*claims to money or to any performance under contract having a financial value*." Based on this definition, the Tribunal held that the Loan and Security Agreements were covered by the treaty.

As Belize could not show a legitimate public purpose behind the nationalisation of Telemedia, both the Loan and the Security Agreements were found to have been expropriated. Additionally, the Tribunal found that Belize breached its FET obligation: there was a legitimate expectation that the taking of property would be done for a proper purpose. Having decided in favour of the investor, the tribunal awarded BCB damages of USD 25.20 million.

Another example where an investor was successful in its claims relating to loans and mortgages was that of *Lion Mexico Consolidated L.P. v. United Mexican States*, (ICSID Case No. ARB(AF)/15/2). In 2007, Lion Mexico Consolidated (LMC) made three loans (US$32.8 million) to a real estate developer in Mexico for two significant projects in Jalisco and Nayarit. LMC secured these loans through three mortgages over those properties. Without notice to LMC, the debtors filed a fraudulent lawsuit in 2012 against LMC in Jalisco and obtained a court judgment that cancelled the mortgages. The objective of this fraudulent scheme was to legally extinguish the mortgages to avoid foreclosure. At the centre of the scheme was a fraudulent settlement agreement allegedly consented to by LMC.

LMC commenced an investment arbitration against Mexico under the North American FTA (NAFTA), claiming that the cancellation of the mortgages in its absence, and being repeatedly denied the opportunity to prove the fraud before a Mexican court was a denial of justice. The Tribunal found that the mortgages qualified as protected investments under NAFTA and that Mexico breached NAFTA by denying LMC procedural justice and FET. Consequently, The Tribunal awarded LMC the value that its investment would have been worth, but for the State's conduct, being USD 47 million.

Protection from Discriminatory Measures and Due Process Violations

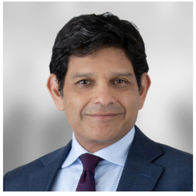
The final category of banking-relating cases to be considered are claims relating to discriminatory measures and due process violations. In *Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka* (ICSID Case No. ARB/09/2), the Sri Lankan Supreme Court issued interim orders to suspend payments under a Hedging Agreement between Deutsche Bank and Sri Lanka's national oil company without due process. The Central Bank subsequently launched an investigation into the Hedging Agreement with an unfavourable outcome and did not give Deutsche Bank an opportunity to respond. The Hedging Agreement was held to be a covered investment because it was a "*claim to money*" or "*claim to any performance having an economic value*". The Tribunal held that the treaty was breached, and the Deutsche Bank was awarded over USD 60 million.

More recently, HSBC has initiated a claim against El Salvador in *HSBC Latin American Holdings (UK) Limited v Republic of El Salvador* (ICSID Case No. ARB/21/46). The claims allege that El Salvador's Supreme Court issued a decision against it which was discriminatory and in breach of the FET standard in the UK-El Salvador BIT. Initially, HSBC had sought repayment of a US$2 million loan granted to a local business. HSBC succeeded in the lower courts, however the Supreme Court subsequently overturned this decision and ordered HSBC to pay the local business a significantly larger sum of US$49 million. The treaty arbitration is ongoing.

Conclusion

ISDS provisions have the potential to enhance protections for foreign investors by permitting direct arbitral redress against a host State. Jurisdictional barriers can be difficult to overcome, and the level of protection afforded will depend on whether and to what extent the investor and investment are covered by a BIT or other treaty. Given the measures which governments across the globe have introduced into the banking and finance sector, it is likely that disputes of this kind will be on the rise as more foreign financial investors feel the backlash of regulatory and policy changes. In these circumstances, it is important to structure investments in a way that affords BIT protection to the investor. It is also necessary to scrutinise government actions and identify potential breaches early. This may provide investors with required leverage to challenge government actions or allow them to seek further recourse in the event that a commercial resolution cannot be achieved.

CONTACTS



Romesh Weeramantry
Senior Consultant
Singapore
T: +65 6410 2257
E: romesh.weeramantry@cliffordchance.com

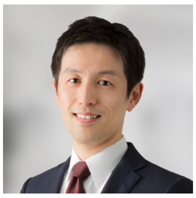
Peter Harris
Counsel
Tokyo
T: +813 6632 6635
E: peter.harris@cliffordchance.com

Nish Shetty
Partner
Singapore
T: +65 6410 2285
E: nish.shetty@cliffordchance.com

Nicholas Wong
Partner
Singapore
T: +65 6410 2218
E: nicholas.wong@cliffordchance.com

Sam Luttrell
Partner
Perth
T: +61 8 9262 5564
E: sam.lutrell@cliffordchance.com

Thomas Walsh
Partner
Hong Kong
T: +852 2825 8052
E: thomas.walsh@cliffordchance.com



Yusuke Abe
Partner
Tokyo
T: +813 6632 6332
E: yusuke.abe@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

2202-001430