

Investing and renegotiating investment contracts in developing countries: the Argentine case.

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A. INTRODUCTION

The classical economic theory on foreign investment takes the position that foreign investment is wholly beneficial to the host economy. The foreign investor brings with him technology which is not available in the host state, and this leads to the diffusion and enhancement of technology in the host economy. Events in the recent past have given great boost to the view that foreign investment brings uniform benefits to developing countries. The dominance of free market theories in the United States and Europe ensured that the classical view on foreign investment dominated thinking on the subject. The process of globalization was regarded as inevitable due to the advances of technology. The view promoted the idea that multinational corporations, which were the harbingers of globalization, should have unlimited movement around the world and that their investments should be protected so that the process of global integration could be advanced. It was also spread by international economic institutions like the World Bank and the International Monetary Fund.[1]

Investment enhances developing countries' economies by creating jobs, transferring new technology, improving locals' life standards, upgrading facilities such as transport, education and health, amongst others. Focus on this beneficial aspect of the foreign investment flows enables the making of the policy-oriented argument that foreign investment must be protected by International law.

The fact that foreign investment enhances developing countries' economies is also asserted in the World Bank's Guidelines on the Treatment of Foreign Direct Investment issued in 1992, it encapsulates the philosophy of the classical theory when it recognizes:

That a greater flow of foreign investment brings substantial benefits to bear on the world economy and on the economies of developing countries in particular, in terms of improving the long term efficiency of the host country through greater competition, transfer of capital, technology and managerial skills and enhancement of market access and in terms of the expansion of international trade.[2]

Since the beginning of the 1900 century and especially after the collapse of the Communist regime, there has been a fierce competition amongst developing countries to attract and seduce foreign investors to invest their moneys in their

respective countries. To do so each country, specially developing countries, developed an array of laws and decrees in order to make their legal systems more appealing and stable.

In this work we will analyze how Governments from developing countries, create, modify, change and, in some cases, suppress investment measures in violation of international obligations such as BITs and international contracts. As the main issue of this work is oriented towards developing countries, we will take Argentina as an example and see how the measures enacted by its administration caused an avalanche of investment disputes in the period of three years starting after its economic default in 2001. Particularly we will briefly see the impact that these measures had on the Gas and Energy sector.

And because of the situation that unexpectedly encountered foreign investors and hence the need to renegotiate their contracts, we will also discuss, in the second part of this work, what is important to bear in mind when negotiating and renegotiating investment contracts in developing countries.

B. INVESTING IN DEVELOPING COUNTRIES: THE ARGENTINE CASE.

This paper is divided in two parts. First, we will deal with the Argentine economic crisis and its legal consequences on the gas and the energy sector. Secondly, we will discuss the different available options to bear in mind when drafting investment contracts.

1. A flood of cases: what went wrong.

In less than two years, Argentina went from having only a few cases registered against it before the ICSID to having more than 30, totaling U.S.\$ 16 billion in claims against it.^[3] Argentina holds two records, namely the number of investment disputes ever submitted against a single country and also the speed in which they grew.

In a period of one hundred years, Argentina went through different economic and politic upheavals. From being the 5th most powerful economy in the world in the end of the 1890s, going through dramatic hyperinflation in the late 1980's to State modernization and privatization during the 1990's. Let's analyze them closely.

a. Argentina and the XIX Century

By the end of the XIX century Argentina was one of the richest countries in the world. Its richness was concentrated in its exportations, which consisted mainly in wheat and beef to Europe. This phenomena was known as the 'agro-exporter' model. Argentina owned its richness to its vast and huge area of fertile land known as 'the pampas'. This economic model and boom was followed by mass immigration coming mainly from Italy and Spain. Its capital, Buenos Aires, with its boulevards and cafés, resembled European cities like Paris or Madrid. Argentina had a flourishing economy and a promising future.

Nevertheless, in 1890 Argentina had its first economic crisis. Due to problems related to its budget, its federal government had to breach the gold clause and re-pay its domestic debt in national currency not readily convertible into gold. Its consequences? Foreign investment left the country for good, its President resigned and substantial inflation hit on Argentinian's pockets. But Argentina surpassed this crisis and enjoyed 30 years of economic growth.

b. Argentina in the XX century

The economic boom elapsed only for 30 years. In 1910, Argentina suffered its first political coup d'Etat. Its political history was not settled until the 1980's. During that 70 year period, Argentina was ruled by military juntas and incipient democracies, devaluated several times its currency and had a considerable amount of immigrants that left the country back to Europe^[4]. Its consequence? Investors started to seek other markets, periods of inflation hit the economy, its foreign indebtedness was enlarged by irresponsible administrations, it lost competitiveness and its economy was intervened several times. One of the most prejudiced sectors was foreign investment.

After 1980 things started to change, at least from a democratic and political point of view. In 1983 Mr. Alfonsín assumed the presidency of Argentina. But, after several years of democratic success he had to resign five months before the end of his term. Some political sectors made the last months of his period a real nightmare. By managing and influencing work forces and different syndicates, they made the country ungovernable. This caused Mr. Alfonsín to resign. By that time, inflation soared and soon it turned into hyperinflation, heating principally Argentinians' way of life. Argentina found itself in a deep economic crisis and after more than 70 years of governmental corruption and erratic economic policies. A sole government, though unseccesfully, tried to put an end and transform Argentina's economy. Thus, and before finishing his period, Mr. Alfonsín called for presidential elections. The peronist candidate, Mr. Menem promised he would put an end to the deficient state of state-owned companies, to the lack of investment in public utilities and especially to hyperinflation. He promised Argentinians a bright future. He became President with an abundant majority in May 1989.

c. The 1990's

In order to comply with his promises, he initiated a privatization campaign. State-owned companies which had been inefficient for more than 50 years needed to be modernized in totum. But to successfully privatize this companies, the country had to become appealing to foreign investors. To do this, legal and drastic economic measures had to be enacted, namely the reform of the legal framework and the pegging of the argentine peso with the U.S dollar. Also, Argentina engaged itself in more than 50 BITs with countries around the world as well as adhering to the ICSID Convention.

Thus, legislation was passed to guarantee equal treatment among foreign and local investors, to eliminate old regulations that required previous approvals for foreign investors to initiate economic activities in the country and to recognize the right of capital repatriation.[5] This law was known as the Government Reform and Administrative Emergency Law No. 23,696.

The privatization scheme created by Argentina targeted foreign investors because foreign capital was deemed essential for the successful operation of the Government's economic recovery plan. The Government's strategy was to encourage foreign investors to purchase shares with guarantees, to promise that all public utilities' tariffs would be calculated in U.S dollars, that tariffs would be automatically and periodically adjusted to the tariffs based on the PPI, that the legal framework would not be unilaterally modified, and it also granted of "licenses" instead of "concessions" with a view to offering the highest degree of protection to prospective investors.[6] And as of March 1991 the Argentine currency was equaled to the U.S dollar. One peso was one dollar, and vice versa.

The non-compliance of the above mentioned strategies constitutes one of the fundamental causes that created an avalanche of ICSID cases against Argentina. Nevertheless the enacted measures and the economic growth, and mainly because of the lack of fiscal restraint, Government overspending, reached a 30 % of the GNP and by 1998 Argentina was immersed in a deep recession.

d. The Economic default

After almost ten years Mr. Menem passed his power to the new elected right centered Mr. Fernando De la Rúa. After an impressive and smart campaign, he became President of Argentina by the end of 1999. Against this background, public service rates, as specified in the concession contracts were due to be adjusted in January 2000 based on the PPI.

Although being contractually obliged to comply, the argentinean administration discussed the possibility of two temporary suspension of the semi-annual tariff adjustments. One in July 2000 and the second in August the same year. The Government and the parties agreed to postpone the said adjustments until June 2002. Meanwhile, Argentina's crisis deepened by the end of 2001. Poverty and unemployment soared. Argentines feared that the Government would default on its debt and that would immobilize bank deposits. Therefore, savings were massively withdrawn from Banks. In effect, the Government enacted a decree which restricted bank withdrawals and prohibited bank transfers.[7] After only two years in office Mr. De la Rúa resigned in the middle of the worst economic crisis of Argentina throughout its history.

A succession of presidents took office and quickly resigned. Mr. Eduardo Duhalde was appointed and under his short presidency, the majority of

measures against foreign investors and international engagements took place. Under his presidency the Convertibility law was modified, devaluating the peso up to 3.30 for one dollar. This modification also transformed all obligations previously engaged in U.S dollars into pesos.

In January 2002 Emergency law No. 25,561 was enacted. Amongst other things, it eliminated the gas transportation and distribution licensees' right to calculate their tariff rates in dollars and nullified the right of public utilities to adjust tariffs semi-annually pursuant to the U.S inflationary index. The energy and gas sector were severely affected.

The Energy Secretariat radically altered the legal framework that had ruled the sector for almost ten years. It unilaterally converted at the rate of Arg. \$ 1 the fuel reference price, which is the factor to calculate the spot price, establishing therefore an arbitrary low price on the energy payments that a generator could receive when selling into the spot market. Electricity distributors had their distribution pessified and had their U.S index adjustments nullified. The oil and gas producers were affected in the same way.[8]

In this scenario the majority of ICSID cases were filed against Argentina.

2. Gas and Energy Investment cases.

The consequence of the Emergency law was devastating, it especially affected the privatized companies and utilities. It is estimated that the value of foreign companies' investment was reduced by up to more than 80%. Therefore, foreign investors tried to seek a way out by submitting their cases to the ICSID tribunals. Hence, the avalanche of cases were caused indirectly by the economic crisis that hit Argentina by the end of 2001 and directly by the Emergency law enacted by the government.

We will briefly describe how a developing country's measures, in this case Argentina, can violate international obligations and prejudice foreign investors. We will briefly focus on the Gas and Energy sectors, as they are most represented in the cases registered by ICSID. Also, the insurance (Continental Casualty Company, ICSID case No. ARB/03/09), the manufacturing sector (Metalpar S.A and Buen Aire S.A, ICSID Case No. ARB/03/05), water & sewer concessions (Suez, Sociedad General de Aguas de Barcelona, S.A., Vivendi Universal No. ARB/03/17/18/19) and the telecommunication sector (Telefónica S.A, ICSID Case No. ARB/03/20 and France Telecom Case No. ARB /03/27) submitted their cases to ICSID.

a. The Gas sector

After years of underinvestment the natural gas transportation and distribution sector was among the public utilities that needed investment the most. Its management and facilities needed a complete renewal. Privatizing it was the

solution. Before its privatization this sector were managed by the state-owned company Gas del Estado S.E.

In order to make them attractive to foreign investors Mr. Menem's Government had to assure them a solid and foreseeable legal regime. In order to do so, the Government first passed the Natural Gas Act and issued a set of regulations that gave legal certainty to investors. The Government also decided to use licenses as the legal vehicle both to grant rights to investors and to authorize their activities. These licenses had the character of a bilateral contract, and were used because they granted the greatest protection under the Argentine law to investors. Among the most relevant rights granted to investors through the Gas Law, the regulations and the licenses were that:

- The licensees would last for a period of 35 years, with a possible 10-year extension.
- Transportation and distribution tariffs were to be calculated in U.S. dollars and expressed in Argentine pesos at the going exchange rate in New York.
- Tariffs had to be adjusted semiannually according to changes in the U.S Producers Price Index (PPI).
- The Government would not amend the licensees, in full or in part, except with the prior written consent of the licensees.
- The Government could not withdraw the licenses except for cause.

Despite this measures, and after taking office in 1999, President de la Rúa's administration initiated an aggressive campaign, and pressured the gas transportation and distribution companies to agree to suspend for six months the PPI adjustment that was scheduled for January 1, 2000. Investors agreed. But a few months later the Government started attacking the gas distribution and transportation companies again and threatened them to postpone the rate adjustment until at least 2003. Under pressure from the Government, companies agreed to freeze the PPI index adjustment of their tariffs for a limited period of two years.[9]

Not only the Emergency law hit the companies in this sector by eliminating their right to calculate gas transportation and distribution rates in dollars and nullifying the right of the licensees to adjust tariffs pursuant to the PPI index mechanism, but also the Decree 214/02 hit the sector with dramatic consequences.

This two measures caused several foreign investors to resort to ICSID arbitration claiming that Argentina violated its treaty obligations under the BITs signed in during 1990s.

The Gas sector was extremely prejudiced by the said laws and acts enacted by the Argentine Government. This clearly shows how the economic climate may change in developing countries all of the sudden, and sometimes companies

may have no other solution to comply with Government's threats in order to avoid a worst scenario.

Let's now turn to the Electric power sector.

b. The electric sector.

As in the natural gas sector, the need for reform and investment in the electric power sector was particularly necessary for Argentina in the late 1980s. The electric power sector was in disarray, suffering from both lack of investment in infrastructure and power blackouts. The electricity market was vertically integrated and thermal and hydroelectric generating facilities, transmission lines and the most important electricity distribution utilities were all owned by state-owned companies, which operated at a loss and lacked the capital needed to maintain and expand the infrastructure. Thus, the new model initiated by President Menem in 1990 meant a significant change in Argentina's electric power sector. Specific energy regulatory frameworks were enacted to emphasize and support Argentina's commitment to a stable and predictable model.

Emergency law and Decree 214/02 had a negative impact in this sector. In its response the Energy Secretariat totally altered the legal framework that had govern the sector for almost 10 years. Therefore, two types of claims followed the changes in the electricity sector. First, electricity distributors have had their distribution tariffs pesified - changed from calculating them in U.S dollars to pesos at an artificially low exchange rate - and have had their U.S index adjustments nullified. Second, power generators have seen their regulatory regime on which they based their investments, altered to their detriment. Also here the prejudiced is the foreign investor, and as in the gas sector, they had to compulsorily comply with Government unilateral's will. Foreign investors claimed that, the government that for years had encouraged them to build capacity and invest in more efficient plants, has now changed the fundamental rules of the game.[10]

When crisis like this arise, parties should be very well prepared and ready to renegotiate its obligations. But sometimes some contracts' renegotiations are much complex and thorny than others. This is why in the next part we will deal with the problems that may arise when renegotiating investment contracts, specially when investing and dealing with developing countries.

C. RENEGOTIATING INVESTMENT CONTRACTS IN DEVELOPING COUNTRIES

Developing countries have encountered throughout their history several economic crisis and social upheavals, namely, the Asian economic crisis in the

1990's, the 'tequila effect' suffered by Mexico in 1995 to the Argentine crisis above described. Investors and their counsel have to be aware of the risk that represent investing in developing countries, especially if we consider that some developing countries were in the majority of the cases, former European colonies, e.g. Indonesia, Latin America, Africa or former communist countries. This means that their economies are opening their way into a very competitive world, and hence their economies are going through a shaping process, which may take more time and effort than expected. Thus, foreign investors cannot expect developing countries' economies to be stabilized and fully predictable. This is why when investing in developing countries, the technics and tactics in renegotiating and adapting investment contracts' clauses becomes a central issue to be bore in mind. In general, counsel adapts or renegotiates a contract comes when political changes or economic turmoil takes place. But after the contracts have already started their performance is very difficult to adapt them to the upcoming and sometimes surprising behavior of developing countries' economies. Hence, it is highly advisable to include this kind of clauses when drafting investment contracts.

1. Renegotiation and adaptation clauses

The renegotiation and adaptation of contractual obligations is a common occurrence in all types of long-term agreements and in particular of investment contracts. There are probably very few investment contracts which during their existence have not been renegotiated and adapted by parties to take account of a change of circumstances or prerogatives. Theses changes are driven by the common desire of parties to be in good terms with governmental authorities, and vice versa. When parties agree on adaptation it is generally irrelevant whether there was a contractual duty to do so or not. Thus, consensual adaptation hardly raises any legal problems.[11]

a. General Commercial Contracts

It is not common to find a Renegotiation clause in an investment contracts. However, parties may reach an agreement a posteriori, even without a contract provision that may abide them to do so. This is what happened in Paiton I[12], where the lack of a renegotiation clause contained in the contract, did not stop the parties in reaching an agreement. In some cases, some contracts contain provisions that explicitly exclude any kind of changes. If this is the case, the affected party may only comply as agreed or pay damages for breach of contract. Whereas in contracts which contain such a clause, chances of reaching an agreement are wider and at the same time, in case of not reaching an accord, parties may resort the adaptation to a third party or at least influence the amount of damages to be paid. This type of clauses are handy when a change in circumstance arise.

b. Investment Contracts

Investment contracts often contain particular clauses intended to address the change of circumstances. Traditionally investors have tried to anticipate all possible future contingencies while excluding any further renegotiation. However, there have always been suggestions in legal literature that the aspired stability would be much better attained by providing for a certain flexibility within the contract. Anticipating renegotiations and structuring them in advance was considered to be more promising than insisting on the enforcement of the original contract. As a consequence drafting techniques from ordinary commercial long-term agreements which allow for a certain flexibility to take into account the change of circumstances can increasingly also be found in investment contracts, especially when dealing with countries which are unstable economically, politically or both. They provide for a mechanism to change originally agreed terms, in particular the price, or even late certain issues to be agreed at a later time when the necessary information is available.[13]

2. Local counseling

Investing in developing countries requires professional counsel that understand local idiosyncrasies and culture. For instance, it would not be the same in drafting a contract for an investment that would take place in an Asian country than for one that would be performed in Latin America. The best approach is to reach a balance between local and foreign counsel. Foreign counsel would provide the expertise in the legal and economic views and local counsel would be more in charge of local negotiations concerning the investment. As foreign investment comprises dealing with local authorities, it would be very useful to count on some local cultural expertise and knowledge. Sometimes even a local joint venture is required. This requirement is a must in several countries, especially in Asian countries, where the mere fact of not having a joint venture with locals impedes foreign investors from developing a project.

Having a local partner is somehow beneficial. Foreign investors may themselves prefer joint ventures in developing countries because it diversifies the risk, gives the foreign investor a lower visibility and provides them with a local partner who will often be an effective mediator with the local government.[14]

Still developing countries' economies are very unpredictable and sometimes unforeseeable, thus foreign investors are strongly recommended to include renegotiation and adaptation provisions in their contracts. These provisions would allow them to be flexible in case when investments become unprofitable. In Argentina, for instance, some investment contracts only included adaptation clauses having U.S inflationary indexes as their base. Tariff rates would be

readjust according to the said indexes. Although this was a provision contained in several contracts, Argentina did not respect them.

3. Hardship clauses

Investment contract law practice indicates an increasing willingness to include renegotiation clauses in foreign investment transactions. The idea that a transaction is affected by a change in the circumstances is common both in domestic and international law. The real function of a hardship or force majeure clauses in contracts is to alleviate the harshness produced by the strict rules on frustration of contracts. Hardship clauses differ from renegotiation clauses by their much broader ambit: the triggering event is not defined as precisely and there are no indications as to what specific provisions are to be changed and in which way.[15] Contract planning cannot take into account all the contingencies that could arise in long term contracts. It is proper that a relationship, which is potentially capable of being rescinded as a result of changed circumstances, should be renegotiated so as to preserve it.[16]

The international prevailing view has been that the various types of negotiation clauses do not entail an obligation to agree, but merely an obligation to negotiate in good faith. The Aminoil tribunal dealing with a renegotiation clause of limited reach clearly stated that ‘an obligation to negotiate is not an obligation to agree’. The logic consequence of this view, however, would be that if parties have fulfilled this duty without agreeing on an adaptation of the contract remains as it is. According to the principle *pacta sunt servanda* the parties would be obliged to perform their contractual duties as originally agreed. Consequently, the party not affected by the change of circumstances, in most cases the investor, would be in a very comfortable situation. If no agreement can be reached and the negotiations have been conducted in good faith, performance of the contract as originally agreed could be requested. Any refusal by the government party to fulfill its contractual obligations would constitute a breach of contracts and the damages due for this breach would be calculated on the basis of the original contract terms. In the end the State party would bear the complete risk of the adverse change in circumstances.[17]

D. CONCLUSION

Investing in developing countries is not an easy issue. In fact when foreign investors search for a place to invest, they spend a considerable amount of time analyzing the different possibilities, studying the economic and politic factors. They would go for the “perfect” host-state. Of course there is no such as a perfect host-state, but nowadays as there is a fierce competition between developing countries in order to attract foreign investors, each country is doing everything at their reach in order to comply with international standards of investment and hence attract foreign investors.

As we explained in this work developing countries economies are not predictable. The Argentine economic crisis and its economic and legal consequences are a clear example of how a prosperous country may declare itself in default from one day to the other.

However, Argentina engaged herself in more than 50 BITs and its adherence to the ICSID Convention, showed that it was a country willing to comply with its international obligations. Argentina made a promise that did not hold. And this is the central point of our work. How governments, specially those from developing countries, contradict their selves and do what ever they can in order to attract foreign investment without measuring the consequences of non compliance.

When investors decide to invest in a foreign country they measure and consider its legal framework and its predictability. In *LGE v. Argentine Republic* the Claimants argued that "...the stability and predictability of the legal framework that laid the foundations for their investment and granted protection to its value are particularly important."^[18] This is exactly what the Argentine Government did not comply with and even in some occasions threaten the investors with more severe measures.

Bearing all this in mind, it is very important to consider the different drafting strategies when investing in developing countries. Its flexibility is key to have successful renegotiations, which are very common in their unstable and unpredictable economies.

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[1] Francis Fukuyama, *The end of history and the last man* in M. Sornarajah, *The International law on foreign investment* (Cambridge, Cambridge University Press, 1994) p, 51.

[2] *Ibid.* supra. p, 55.

[3] See Argentine claims, *El Cronista Comercial*, 8 August, 2004 in R. Doak Bishop & Roberto Aguirre Luzi, *Investment Claims: First Lessons from Argentina* in Weiler, T., *International Investment law and arbitration: Leading Cases from the ICSID, NAFTA, Bilateral treaties and Customary international law*, London, Cameron May 2005.

[4] More than 50% of british immigrants went back to England or head the U.S for better perspectives.

[5] *Ibid.* note 3, p. 428.

[6] *LGE v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006, parag. 49.

[7] *Ibid.* note 6, parag. 56, 60, 61 and 63.

- [8] Ibid. note 3, p. 434.
- [9] Ibid. note 3, p. 436 and 437.
- [10] Ibid. note 3, p. 440 and 441.
- [11] Stefan Kroll, *The Renegotiation and Adaptation of Investment Contracts*, p. 425.
- [12] Paiton I, was a 1,230 MW coal fired power plant in Indonesia with an investment volume of 2.6 billion USD. The sponsors of the project were companies from the United States, Japan and England.
- [13] Ibid. supra note p. 437.
- [14] Ibid. note 1, p. 121.
- [15] Ibid. note 11, p. 440.
- [16] M. Sornarajah, *The Settlement of Foreign Investment Disputes* (The Hague, Kluwer International, 2000), p.117.
- [17] Ibid. supra note 7. p. 448/9
- [18] Ibid. Note 6, parag. 102.

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