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# THE GLOBAL FINANCIAL CRISIS: WILL STATE EMERGENCY MEASURES TRIGGER INTERNATIONAL INVESTMENT DISPUTES?

by

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*Introduction*

Several developed countries have introduced emergency measures to mitigate the effects of the Global Financial Crisis, including Australia, Germany, Ireland, the United Kingdom, and the United States. Although the measures taken are still undergoing changes by the executive branch and are thus a "moving target", our survey reveals early evidence of differentiation between foreign and domestic actors in the emergency plans adopted by this sample grouping. It is this differentiation that may give rise to liability as breaching guarantees against discrimination of foreign investors under international investment law.

In general, the emergency measures passed to date can be grouped into three broad categories: (1) measures designed to bolster the stability of the financial services industry; (2) measures directed at the financial services industry but structured to increase the availability of credit to other sectors of the economy; (3) general fiscal measures designed to boost public spending and targeting select and strategic industries (including the automotive industry). Our focus is on the first and second categories which we regard as presently most likely to engage international investment law.

*The Emergency Measures*

The extensive measures undertaken in this first category are designed to increase the confidence of market participants and to ensure the continuation of bank funding. They encompass liquidity support, recapitalization (through share purchases or otherwise), purchase of specific assets (including "toxic" bank assets), inter-bank (wholesale) lending guarantees and increases in retail deposit guarantees.

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Australia and Ireland have introduced new insurance schemes for retail deposits, wholesale lending, and, in Ireland's case, guarantees for covered bonds, senior and dated subordinated debt. Both measures triggered flight of wholesale capital from excluded foreign bank branches to domestic guaranteed institutions. Those countries are not alone in building adverse incentives for regulatory arbitrage. The financial stabilization programs in Germany and the United Kingdom cover only financial institutions with their seat in the respective state and also exclude branches of foreign institutions (as authorized deposit takers). In contrast, Switzerland has elected to bail-out specific institutions taken to be of systemic importance. To date, the benefits of this program have only been extended to one Swiss bank – UBS - with a promise to do the same for another, Credit Suisse. The U.S. Emergency Economic Stabilization Act authorizes purchase of distressed assets (especially mortgage-backed securities) in financial institutions if they have "significant operations" in the United States. Early reports suggest that domestic U.S institutions are the majority if not exclusive recipients of capital injections under the scheme. If this trend continues, there may be differentiation against foreign institutions as a matter of fact, even if not on the face of the law.

The second category of emergency measures also targets the finance sector but is designed to directly foster the provision of credit throughout the economy. Both the United Kingdom and Germany have structured their plans so that participants *must* support lending to credit worthy borrowers - mainly small to medium sized enterprises - as a condition of the receipt of governmental support. Much again will depend on how this aspect of the scheme is implemented in practice. If this condition leads to the provision of credit solely to national industry, this too will evidence differentiation against foreign actors as a matter of fact, even if not on the face of the law.

*Implications under International Investment Law*

There are approximately 2800 bilateral and regional investment treaties (including investment chapters in free trade agreements) in operation across the globe. Except for Ireland, the countries we have surveyed have all entered into multiple investment treaty commitments. Most of the newer investment treaties of the sample grouping have been signed with developing countries and Eastern European states. On first view, this might preclude claims by foreign investors of OECD countries against other OECD countries since there are almost no investment treaties in operation among them, although they are both the source and the target of the major financial transactions. However, treaty shopping might enable investors to make use of an investment treaty by channeling their investment through any other country that has concluded a BIT with an OECD country. Furthermore, older investment commitments – including Friendship, Commerce and Navigation treaties – remain in operation across a range of OECD states (including a number of states we have surveyed). These treaties usually allow disputes to be brought before the International Court of Justice and, at least in the case of the U.S, may be self-executing as a matter of U.S constitutional law giving investors of a State Party the ability to initiate claims before U.S courts (see Asakura v City of Seattle, 265 US 332 (1924)).

Newer investment treaties normally confer direct rights of international dispute settlement on foreign investors of a signatory state. The ability to do so will depend initially on whether the measures in question fall within the scope of a given treaty instrument. Investment treaties commonly structure their operations on an expansive "negative list" system (whereby all government measures including those relating to the finance sector are covered unless specifically exempted). This is in contrast to more conservative scheduling systems such as the "positive list" method of the WTO General Agreement on Trade in Services.

If action is brought, there is a possibility that the measures we have surveyed may attract liability under investment treaty commitments or in certain national courts. In particular, we see a case for breach of the obligation to accord national treatment. These measures may also breach the "fair and equitable" standard, most notably its limitation on discriminatory conduct on the part of a signatory state. There is, however, considerable uncertainty both in arbitral jurisprudence and among commentators on the precise outer contours of the "fair and equitable" guarantee. With that in mind, we focus our analysis on national treatment.

National treatment proscribes "less favourable treatment" of a foreign investor that stands "in like circumstances" or "like situations" with a domestic actor. The fact that a measure is temporary and triggers loss but is then removed (as in Australia) does not excuse legal liability, *per se*. Moreover, the obligation to accord national treatment will cover instances of both *de jure* (in law) and *de facto* (in fact) discrimination. The latter covers measures that may not explicitly distinguish on nationality but pose a greater adverse burden on foreign actors in the host state. The non-binding OECD National Treatment Instrument is a relevant source for guidance on the constituent elements of the national treatment obligation. Investor-state arbitral tribunals have drawn on the OECD National Treatment Instrument in looking to competitive interactions as a necessary condition of finding that domestic and foreign investors operate "in like circumstances". They have also, on occasion, interpreted these parameters rather broadly, which might see the whole financial sector (rather than a specific industry grouping) as the basis for comparison between foreign and domestic actors. Ultimately however, the question of breach will come down to whether a tribunal requires evidence of some malign governmental purpose, particularly on claims of *de facto* discrimination. Certain cases have explored – with different emphases - whether the distinction is based on legitimate policy grounds and justifiable or solely as a means of conferring protection to domestic actors and thus impermissible. Much will depend here on the *indicia* employed by a tribunal in a test for protectionist purpose. Even on a test requiring evidence of constructed purpose, some of these measures may not withstand scrutiny. Indeed, similar forms of discrimination to those we have surveyed were employed by the Czech Republic - in response to a domestic financial crisis in the late 1990s - and were ruled to be in breach its investment treaty obligations (in *Saluka v. Czech Republic*).

There are exceptions for host state conduct in the event of a finding of liability for breach of national treatment. Some investment treaties include qualified exemption for prudential measures in the finance sector (modeled on the GATS). But one should keep in mind that the most-favored nation clause in those treaties may afford claimants better treatment if their host country has concluded other treaties without those carve-outs. Older investment treaties typically only exempt measures necessary to maintain "public order" or protect "essential security interests". While newer iterations of these exceptions are self-judging, most of the older formulations clearly contemplate a role for an adjudicator in the application of the exception. Indeed, the scope of this vague exemption was assessed in a range of cases brought against Argentina in the aftermath of its 2001-2 financial crisis. In those cases, particular tribunals were prepared to find that the adverse societal effects of financial crisis might engage a state's "essential security interests". On the whole though, it is unlikely that the current measures will fall within the exemption. In particular, it will be difficult to make the argument that discrimination directed against foreign bank institutions (with domestic depositors) was indeed "necessary" to protect those "essential security interests". Argentina has also been unable to escape its treaty obligations by invoking the customary plea of a state of necessity. We therefore expect similar legal treatment of the current measures.

*Conclusion*

We draw two tentative conclusions, implicated in our analysis of potential liability under international investment treaties. First, there is clear evidence of widespread discrimination directed at foreign actors in the laws we have surveyed despite the public commitment of state parties to free market principles, including the rule of law, respect for private property, open trade and investment and competitive markets, expressed at the G-20 meetings. This is not confined to any individual state or select grouping; it is a marked characteristic of emergency responses to the financial crisis across a significant proportion of the globe. This then is a timely reminder to revisit the lessons associated with the outbreak of protectionism leading to the Great Depression in the inter-war period. Protectionism is the result of a prisoner's dilemma understood in game theory terms. Cooperation would make every state better off, but it is individually rational for states to pursue their self-interest (and protect domestic industry) at least in the short term. While protectionist instincts are now more nuanced, it is difficult to escape the conclusion that states are failing to cooperate in the current crisis, with possible cascading consequences.

This leads to our second, tentative concern, namely whether international law will fulfill a key function in the contemporary period. The framers of the post-Second World War architecture of international economic law were deeply influenced by the lessons of the inter-war period. They had drafted rules hoping to embed a loose form of cooperation and constrain the freedom of states to resort to short-term protectionist measures. The preparedness and rapidity by which states are now moving in that direction raise serious questions of whether our existing system is a sufficient check against these problematic tendencies.

Ultimately, these sensitive issues may be addressed – in less than optimal ways – in legal rather than diplomatic *fora*. The 2001 Argentine financial crisis triggered a wave of international litigation against that state. If current trends continue, there is no reason to expect any different on existing state responses to the Global Financial Crisis.

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