States take the BIT between the teeth

Tom Moore - 19 November, 2013

Governments are clamping down on international corporations using shell companies to sue them under investment treaties.

Treaty shopping, the process of finding an existing subsidiary or registering a new one to funnel foreign investment, is common practice among large corporations.

These extra layers can offer tax benefits – often through a matrix of loans and tax reliefs – as well as protect a company's investment through bilateral investment treaties.

Foreign investors not covered by a bilateral investment treaty will often create an intermediary company so it can sue the host nation if relations turn sour and its investment compromised.

"There are so many indirect ways a country can disturb an investment," says **Richard Winston**, a Miami-based partner at **K&L Gates**.
He explains: "What would happen if a claim had to go through a jurisdiction as the investment was made without a BIT? The company would either lose its case because of bias, or it would be undercompensated. Treaty shopping is just interposing an entity to get benefits where you would otherwise not get those benefits."

Layer Cake

Oil and gas majors entering Venezuela have long gained adoption from the Netherlands, which had a BIT in place with the South American country, to secure fair and equitable treatment.

Having a Dutch mailbox became the norm for US companies operating in Venezuela, given the pro-nationalisation policies of late president Hugo Chavez. Indeed, **Conocco-Philips** and **Exxon-Mobil** both invoked the Dutch BIT to lodge multibillion dollar claims against the country, while Italian oil major **Eni** used the same treaty.
"[Companies use] very complex corporate structures to benefit from tax and investment protection because there is no investment treaty between the US and Venezuela", says **Luis Gonzalez Garcia** of **Matrix Chambers** in the UK.
A weak environment for industrial success in the Netherlands and Spain has led to a long tax and bilateral treaty battle between the countries to attract shell companies.

But aggrieved with the volume of companies using the Netherland-Venezuela BIT to file disputes against the country, Venezuela attempted to amend the treaty and restrict rules on the nationality of investors. Talks collapsed but the South American country held its ground and denounced the treaty, which entered force in 1993.

Passport patrol

“Countries are looking to clamp down,” says Garcia. “New treaties are being negotiated where the place of incorporation is no longer the test,” he adds.

“Bangladesh, South Africa and Ghana have all reacted against providing investment protection to mailbox companies and all the Latin American countries are doing the same.”

South Africa tore up its Benelux Treaty with Luxemburg and Belgium, as well as its BIT with Spain, to stop shell companies in those countries making claims against the government. Meanwhile, Ghana renegotiated its BIT with Austria to prevent treaty shoppers benefiting from the protections afforded in the treaty.

ICSID judgments have been inconsistent in defining nationality. Changes to corporate structures years after a company’s entry to a foreign market have even been accepted by tribunals.

The freedom of finance and the competition between countries to attract business has meant that the place of incorporation is typically accepted as long as the government is not misled about the corporate structure, no laws and regulations are violated and the nationality of the investment is made clear in the preamble of the contract.

The cat and mouse of countries seeking to avoid being sued and companies seeking treaties to sue will continue to be played out.

Since Venezuela scrapped its BIT with the Netherlands, Winston says that “corporations have been inserting Spanish intermediaries” to gain investment protection from the Venezuela-Spain BIT. (The South American country has since denounced the ICSID Convention, stating in January 2012 that it is the right of the Venezuelan people to freely choose their strategic economic and social orientations.)

Where the heart is

But more and more states are changing their foreign investment policies so that shell companies don’t get these benefits.

Speaking at Kiev Arbitration Days 2013, **Sabine Konrad**, a Frankfurt-based partner at **McDermott Will & Emery**, said that while residency can be defined in several ways, most treaties don’t have a substance requirement, whereby a country requires a minimum amount of business activity in said country before an investor can claim that nationality.
But Konrad says that there have been “recent discussions in the Dutch parliament about whether substance requirements should be introduced into BITs and tax treaties”.

While in some jurisdictions substance requirements are not “a hard threshold to overcome”, other countries have much stronger substance requirements. For Germany, you need to consider corporate law in addition to the BIT as to what constitutes a valid company.

Winston says he is now urging clients to field stronger business activity in intermediaries to ensure full treaty protection is given. He reasons that wages for 10 or more employees fills the shell and is thus worth paying for, as it can protect a company’s foreign investment that could run into billions of dollars.

Even western European countries that have traditionally accepted the test of place of incorporation in their BITs as the only criteria for a claim, such as the UK and Spain, have recently changed their policy of in their latest BITs.

Indeed, companies are now required to have substantial business activities in the country the company is incorporated in BITs between the UK and Mexico, the UK and Colombia and Spain and Mexico.

Jus sanguinis

What’s really got governments riled are domestic companies using foreign shells to protect investments at home. After all, bilateral investment treaties were designed to encourage foreign direct investment.

In *Tokios v Ukraine*, a decision that was rendered by an ICSID tribunal in 2007, the state argued that the business was Ukrainian but a mailbox company in Lithuania entitled it to make a claim against the government.
Garcia says arguments that Tokios lacked substantial business activity in Lithuania were irrelevant, as this was not a criterion for nationality under the BIT. He adds that claims from what governments perceive to be domestic companies, which have used overseas mailboxes to bring claims invoking a bilateral investment treaty, “is one of the situations governments want to avoid”.

There is a clear rebalancing of the investor-state scales of justice towards governments, the most recent example being Venezuela’s successful disqualification of arbitrator **José Maria Alonso** in a case brought by **Blue Bank**.
That was just the second time that the World Bank’s arbitral body has upheld such a challenge, and a better playing field for states may be necessary to ensure the global use of ICSID and prevent further denouncements.

The increased use of ICSID and other forums to sue governments has kicked states into action. Complex corporate structures to shop for the perfect BIT remain, but governments are closing some of the tills.