



## Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues by  
the Vale Columbia Center on Sustainable International Investment

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Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Editor: Lisa Sachs (Lsachs1@law.columbia.edu)

Managing Editor: Rex Chatterjee (rchatt@law.columbia.edu)

### U.S. BITs and financial stability

by

**Kevin P. Gallagher\***

Almost immediately after taking office, the Obama administration charged the U.S. Department of State's Advisory Committee on International Economic Policy with reviewing the U.S. Model bilateral investment treaty (BIT). The group established a sub-committee of business groups, labor and environmental organizations, and a handful of academic experts and tasked it to make official recommendations for reforming U.S. investment treaties. When completed, the Obama Administration hopes to proceed with official negotiations with China, India, Vietnam, and possibly Brazil.

In light of the global financial crisis, one of the specific issues that the administration asked the subcommittee to address was the potential impact of BIT provisions on the ability of governments to prevent and mitigate financial crises. Financial stability was one of the few areas in which a consensus recommendation was reached—the subcommittee asked the administration to undertake a legal review of the prudential measures exception (Article 20 of the U.S. Model BIT).<sup>1</sup> In most recent U.S. treaties that exception states that parties to the treaty should “not be prevented from adopting or maintaining measures ... to ensure the integrity and stability of the financial system.” However, the paragraph ends with the following sentence: “Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Treaty.” Some on the subcommittee

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\* The author is an Associate Professor in the Department of International Relations at Boston University. His books include *The Dragon in the Room: China and the Future of Latin American* and *The Enclave Economy: Foreign Investment and Sustainable Development in Mexico's Silicon Valley*. He served on the investment subcommittee of the U.S. Department of State's Advisory Committee on International Economic Policy in 2009. The author wishes to thank Stephen Canner, Thea Lee and Theodore Posner for their helpful comments on this *Perspective*. **The views expressed by the individual author of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* is a peer-reviewed series.**

<sup>1</sup> Advisory Committee on International Economic Policy, *Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty*, September, 2009: <http://www.state.gov/e/eeb/rls/othr/2009/131098.htm> (see annexes for individual comments).

thought the language was vague and in need of clarification. Others echoed the concerns of legal scholars<sup>2</sup> who argue that the sentences were self-canceling and in need of deletion.

Given the high degree of contention among committee members, the report includes an annex in which individual members or subgroups provided additional arguments. A group of sub-committee members (that included myself) recommended that the Administration conduct a legal review of the potential that any of the measures implemented or under consideration in response to the financial crisis might be inconsistent with the 2004 Model BIT, and made three specific recommendations that should be implemented by the U.S. in a revised Model BIT:

**1. Codify the State Department’s position in *Glamis Gold Ltd. v. United States* regarding the standard of proof for identifying principles of customary international law and the minimum standard of treatment.**

Financial bailout measures, or future preventative measures that create “too big too fail” regulations, could be challenged under the 2004 BIT on the grounds that they deny a foreign investor’s right to fair and equitable treatment and a minimum standard of treatment. Indeed, a Dutch subsidiary of a Japanese bank recently argued that the Czech Republic had violated its rights by extending its bailout program only to “too big to fail” Czech banks, excluding a small bank in which the Dutch subsidiary had invested.<sup>3</sup> In addition to ensuring that the prudential exception is broad enough, codifying the *Glamis* position, which prevailed with a narrow interpretation of customary international law and minimum standard of treatment, will set a better standard for preventing and mitigating crises.

**2. Include a safeguard provision for balance-of-payments crises that is not subject to investor-state dispute settlement.**

U.S. investment treaties essentially force nations to liberalize their capital accounts, regardless of their institutional capacity -- or be prepared literally to pay the consequences. This stands in stark contrast with economic science and most other global treaties. Ayhan Kose of the IMF, Eswar Prasad of Cornell University and Ashley Taylor of the World Bank confirm that capital account liberalization is not correlated with economic growth in developing countries. These authors expand such findings to show that capital account liberalization only works for those nations above a certain threshold of economic and institutional development.<sup>4</sup> Capital controls have been shown to be an effective measure to prevent or mitigate a crisis and such a safeguard mechanism leaving governments room to impose capital controls under certain circumstances can be found in virtually every other form of international economic law, such as the WTO, OECD codes (and the draft MAI), and the BITs of most other capital exporting nations.

**3. Exclude “sovereign debt” from “definitions” of an investment.**

The U.S. Model BIT does not explicitly exclude sovereign debt from the definition of covered investments, as NAFTA does. It should. The U.S. government is the largest issuer of

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<sup>2</sup> See Congressional testimony by Georgetown Law Professor Robert Stumberg: <http://waysandmeans.house.gov/Hearings/Testimony.aspx?TID=2163>

<sup>3</sup> See *Saluka Investments BV v. The Czech Republic*, UNCITRAL, Award (Mar. 17, 2006), available at <http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf>

<sup>4</sup> See Ayhan Kose, Anwar Prasad and Ashley Taylor, “Thresholds in the process of international financial integration,” NBER Working Paper No. 14916, April 2009. <http://www.nber.org/papers/w14916.pdf>

sovereign debt, and countries across the world have taken on much debt to get out of the financial crises and could risk default. As noted in the full subcommittee report, the IMF and others have raised concerns that efforts to restructure sovereign debt may give rise to investor-state claims. New model investment provisions should not obstruct global efforts to set up adequate facilities for sovereign debt restructuring that could be undermined if bondholders are able to circumvent such mechanisms by filing claims under BITs. At minimum, the model BIT should codify U.S.-Peru FTA- like provisions that limit an investor's ability to bring an investor-State claim based on a debt restructuring where holders of 75% or more of the outstanding debt have agreed to the restructuring.

Ensuring that the U.S. model is in tune with global efforts to prevent and mitigate financial crises benefits both the U.S. and its investment partners. Making sure that ample prudential exceptions exist can buffer the U.S. from liabilities for prudential regulations. What's more, stability among our investment partners helps U.S. investors and exporters have more certainty for markets. Crises could lead to defaults and large losses to U.S. assets and export markets. And, crises can cause contagion that spreads to other U.S. investment and export destinations. Trade and investment treaties should not prevail over regulations for financial stability in the U.S. and abroad.

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*A copy should kindly be sent to the Vale Columbia Center at [vcc@law.columbia.edu](mailto:vcc@law.columbia.edu).*

For further information please contact: Vale Columbia Center on Sustainable International Investment, Lisa Sachs, Assistant Director, (212) 854-0691, [Lsachs1@law.columbia.edu](mailto:Lsachs1@law.columbia.edu).

The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

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