



Natural Resources Journal

14 Nat Resources J. 2 (Spring 1974)

Spring 1974

One Problem with Using an Escrow to Deter Nationalization of Foreign Investment

William Darling

Recommended Citation

William Darling, *One Problem with Using an Escrow to Deter Nationalization of Foreign Investment*, 14 NAT. RESOURCES J. 271 (1974).
Available at: <https://digitalrepository.unm.edu/nrj/vol14/iss2/8>

This Comment is brought to you for free and open access by the Law Journals at UNM Digital Repository. It has been accepted for inclusion in Natural Resources Journal by an authorized editor of UNM Digital Repository. For more information, please contact disc@unm.edu.

COMMENTS

ONE PROBLEM WITH USING AN ESCROW TO DETER NATIONALIZATION OF FOREIGN INVESTMENT

In their article, "Escrow: a Private Law Device Adapted for the Protection of Foreign Investment,"¹ Michael Kitay and Robert Trout attempt to formulate a method of protecting investments in the less developed countries from nationalization.²

There are three basic considerations involved in any attempt to deal with nationalizations: compensating the investor, deterring the host country from nationalizing, and making the scheme acceptable to the parties involved. Kitay and Trout devote most of their discussion and analysis to setting up the escrow fund in such a way as to compensate the investor for any nationalization and with making the escrow attractive, or at least acceptable to the investor, the escrow agent, and the host country. They give relatively little consideration to the deterrent effect which the device might have.

This comment will deal with one aspect of making the escrow an effective deterrent to nationalization. Unless the escrow fund is set up with care it may become an incentive rather than a deterrent to nationalization.

According to the plan which Kitay and Trout have devised, the prospective investor would negotiate an escrow agreement with the host country. The agreement would set up an escrow fund with a mutually acceptable agent³—an international bank or monetary agency or possibly a regional development bank of the region in which the host country is located.⁴ Each year the investor would deposit a percentage of the host country's share of the profits from the enterprise and a percentage of the taxes owed by the enterprise to the host country into the escrow fund. Each year's contribution to the fund would remain there for a number of years set by the escrow agreement and would then be released to the host country.⁵

1. 13 Va.J. Int'l L. 48 (1972).

2. Throughout this Comment I have used the term "nationalization" instead of "expropriation" or "confiscation." Expropriation implies that effective compensation for the enterprise was made to the investor. Confiscation implies that it was not. Since this Comment envisions a situation in which the issue of effective compensation is not yet raised, neither word is appropriate. I have therefore used nationalization to mean a taking by the host country without any implication that compensation was or was not adequate.

3. Kitay and Trout, *supra* note 1, at 51-53.

4. *Id.* at 53-54. See Knop, *Regional Development Banks*, 4 J. Law & Econ. Dev. 93 (1969), for a comparison of several of the regional development banks.

5. Kitay and Trout, *supra* note 1, at 51-52.

For instance, if the fund were set up for five years, after the fund had been in operation for a complete cycle, there would be five years' contributions in the fund at any one time. If the host country expropriated the enterprise, this fund would go to compensate the investor.⁶

The period of the fund and the percentage of the host country's share of the profits and taxes to be contributed would be fixed in such a way as to provide adequate compensation to the investor.

The main attraction of the escrow fund, however, is not its ability to compensate the investor—Overseas Private Investment Corporation (OPIC) insurance can also do that⁷—its main attraction is its possible ability to deter the host country from nationalizing the enterprise. After all, the investor does not make investments so that he can be compensated at some later date. He invests in order to make money. Therefore he has a primary interest in avoiding or deterring nationalization.

Absent OPIC insurance or the escrow device, what does the nationalizing state lose when it nationalizes property of an American citizen without prompt or effective compensation? It will lose its reputation, if it has one, of being a safe place to invest. It will be subject to more or less pressure from the United States State Department. It may even be threatened with loss of aid under the Hickenlooper Amendment.⁸ Directly, it will lose nothing by nationalizing. The investor receives nothing from the host country unless the State Department can negotiate a settlement.

One of the main deficiencies of OPIC is that the consequences for the nationalizing state are almost the same as if there were no OPIC at all. The United States government takes over the rights of the investor in return for OPIC compensation. The State Department may therefore exert more pressure on the nationalizing state than if it were merely asserting the rights of the investor. Again, however, the host country suffers no direct loss from nationalizing. The deterrent effect of the actions which are taken by the United States government is probably minimal.

In the case where the host country nationalizes an enterprise pro-

6. *Id.*

7. 22 U.S.C.A. §§ 2194-2198 (Supp. 1973). See J. Loomis, *Public Money Sources for Overseas Trade and Investment* (1963), for a discussion of the availability and coverage of OPIC insurance. However, see Adams, *The Emerging Law of Dispute Settlement under the United States Investment Insurance Program*, 3 *Law & Policy in Int'l Bus.* 101 (1971), for a survey of the problems in obtaining compensation under OPIC insurance.

8. 22 U.S.C.A. § 2370(e) (1964). Eder, *Expropriation: Hickenlooper and Hereafter*, 4 *Int'l Lawyer* 611 (1970), discusses the application and effect of the Hickenlooper Amendment.

tected by an escrow agreement, the loss to the host country is theoretically immediate. It loses a significant amount of hard currency. If the nationalizing government is radical or revolutionary, even this direct loss will probably be no deterrent. To a more moderate government, however, especially if it is having balance of payments problems and *if it has used the money in the fund as collateral for loans*, loss of the fund should act as a strong deterrent. If it does not have an immediate interest in the fund, though, the fund will not act as a deterrent, but as an incentive to nationalize. A simple hypothetical will illustrate this point. If the term of the escrow is five years; the net worth of the enterprise is \$1,000,000; the average annual net profits are \$300,000; the host country's share in the profits and taxes is 75% or \$225,000; and 75% of that or \$180,000 is deposited in the escrow each year; then the escrow will contain \$900,000 at any time after the agreement has been in operation for at least five years. Beginning in the sixth year and every year thereafter, the host country will receive its usual 25% of its share or \$45,000 plus the \$180,000 released from the escrow for a total of \$225,000. If the host country were to nationalize, however, and if it could continue to run the enterprise by itself, its annual income from the enterprise would immediately jump to \$300,000. It would therefore gain \$75,000 annually by nationalizing, the investor would be substantially compensated, and the host country would not be an international outcast for not compensating. In such a case the escrow would really be a prepayment plan for nationalization. The host country does not lose anything by forfeiture of the fund since the fund is perpetual. The only way that the host country could ever get the fund would be if the enterprise were dissolved. In that case the original investment would be repatriated and the host country would lose it in any case.

Therefore, unless the host country has an immediate interest in the fund, some benefit immediately derived from the fund that would be lost if the fund were forfeit, the fund is no deterrent to nationalization. Under an escrow agreement, then, the host country must have the right to use the fund as collateral for loans or in some similar way. The host country must have something substantial to lose if it forfeits the fund by nationalizing the enterprise. Only then will the fund be a deterrent.

WILLIAM DARLING