Real Estate Development Project in Chile by a Private Entrepreneur of Malaysia

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Executive Summary

This case focuses on an urban development project that a private corporation organized in Malaysia attempted to carry out in Central Chile between 1996 and 1997. The project intended to build a satellite town on 600 hectares of rural property with an initial investment estimated at US$ 17.136 million. The prospective investor submitted to the Foreign Investment Committee of Chile (CIE) the required investment application, which was approved by the agency on 3 March 1997.

Notwithstanding the CIE approval, the foreign investor still faced a number of administrative obstacles at the beginning of the project due to some urban regulations in effect in the chosen project area. This situation ended in the official rejection of the project by the Chilean Ministry of Housing and Urban Development owing to the conflict between the project and the urban development plan for the project site.

As a result, the foreign investor resorted to the International Centre for Settlement of Investment Disputes (ICSID), on the basis of the Bilateral Investment Treaty for Investment Promotion and Protection executed by Chile and Malaysia in 1992, which provided for this type of intervention.

The ensuing controversy gave rise to an interesting analysis by ICSID of the importance and necessity of making compatible the rights of a member economy to adopt any sovereign decision in affairs of economic policy as it may see fit, with strict adherence to international treaties that it may have entered into with third economies, with the exclusion of possibly discriminatory measures against a foreign investor.

The case highlights the inordinate duration of the arbitration proceedings which ensued. The proceedings had been going on for close to seven years and the issues were still unresolved. This condition was inconsistent with the expeditious decision-making process that international trade required in order to accelerate the development of the economies involved.

The background and conclusions contained in this case will help to further the aims of the APEC Project, i.e., to promote and facilitate foreign investment processes among the entrepreneurs of APEC member economies.

The Historic Evolution of the Chilean Juridical Framework in the Context of Foreign Investment Promotion and Protection

Until the mid-1960s Latin America was favorably disposed towards foreign investment and regarded this type of investment in much the same manner that it did domestic investment. Chile was no exception to this rule and during the same period the economy enacted major legal provisions designed to encourage the inflow of foreign capital.

In 1954, Chile created the Foreign Investment Committee (*Comité de Inversiones Extranjeras)* and in 1960 it established the Foreign Investment Statute *(Estatuto de la Inversión Extranjera*), thus providing substantial benefits in favor of foreign investment, a move which at that time was a highly significant step forward in this area.

At the end of the decade the above liberal scenario changed abruptly and an open “economic xenophobia” arose against the admission of foreign capital to the Latin American Region, characterized by strict controls on foreign currency operations and a number of restrictions

on imports of various items other than essential goods. One of the clearest instances of the situation described was the approval in 1971 by Bolivia, Chile, Colombia, Ecuador and Peru (all at the time members of the Cartagena Agreement), of Decision 24 of the Andean Agreement, which, among other restrictions, strictly limited the participation of foreign capital in the assets of domestic corporations of the members, and further restricted remittance of profits abroad, import of technology, or use of foreign trademarks and patents.

With the advent of a military administration in Chile (1973-1990), the above inordinate protectionist position was reversed and a new Foreign Investment Statute was adopted in 1974 with the stated objective of promoting foreign investment. A number of restrictions that hampered foreign investment were lifted, which led to the withdrawal of Chile in 1976 from the Cartagena Agreement as well as from the Andean Agreement.

From that time on, a solid legal system tending to foster free trade and foreign investment and guarantee the security and freedom to export the capital invested and the profits obtained, had taken shape in Chile. It was implemented with the enactment of various economic laws designed to protect the ownership of foreign investors in the event of abusive or illegal expropriatory acts by the Authorities.

In contrast with the protectionist attitude that prevailed in Latin America, the more highly developed economies—principally Europe and the USA—endeavored to structure the bases of an international protection system in favor of their corporate nationals' investments abroad. This was done to ensure the remittance of capital and profits, and to protect them from risks of a nationalist nature, whether in the form of expropriations or restrictions to the free exercise of their business operations.

Such concern took shape in various international agreements, namely, the bilateral free trade agreements, investment promotion and protection agreements, conventions to avoid double taxation, multilateral instruments for settlement of international controversies, and in diverse institutions designed to insure the nationalist risks described above.

Many Latin American economies, particularly Chile—a pioneer in this regard, including the unilateral opening of its economy—successively adhered to the new attitude, as shown by countless bilateral or multilateral treaties executed to strengthen free trade and protect foreign investment, in the event of threats from arbitrary acts of the administration of the host economy.

It is worth stressing that as of August 2008, Chile has executed with sundry third economies more than 50 Investment Promotion and Protection Agreements (APPIs) and more than ten Conventions, including one with Malaysia, to avoid double taxation. In addition, Chile was a party to a number of free trade agreements, i.e., with Canada, Central America, the European Union, Korea, Mexico, the United States, and the European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland), Chile being also a member of the International Center for Settlement of Investment Disputes (ICSID) and of the Multilateral Investment Guarantee Agency (MIGA).

Features common to most of these international agreements included foreign investor protection, assurance of fair and equitable treatment, non-discrimination *vis-à-vis* domestic enterprise, authority to invoke the most favored nation clause that Chile applied to third economies, and provision for a regime governing settlement of controversies with the administration of the host economy, in a technical, impartial and expeditious manner.

The above description illustrates the protection system in force in Chile regarding foreign investments as embodied in the above domestic laws and international treaties, which formed

part of its legal system. This was a major consideration on the part of the investor from Malaysia in deciding to undertake its capital project in Chile.

The Agreement for Promotion and Protection of Investments (APPI) Executed by the Governments of Chile and Malaysia

As discussed previously, there had been substantial effort on the part of Chile favoring the inclusion under the international legal framework of a number of regulations designed to foster foreign investment in the economy through such mechanisms as, *inter alia,* insurance against non-commercial risks whether of political or expropriatory character, and the execution of various agreements designed to protect such investments and avoid double taxation.

To pursue this direction, the Governments of Chile and Malaysia executed an Agreement on Promotion and Protection of Investments (APPI) in November 1992. Owing to the prolonged constitutional ratification formalities surrounding international agreements of this nature, the APPI took effect only on 4 August 1995. This international agreement contained some provisions which later on proved to be relevant to the Malaysian project in Chile.

For instance, the introductory statement declared that one of the objectives of the Agreement was to create *"favorable conditions for the investments made by investors from one Contracting Party in the territory of the other Contracting Party"* and recognized *"the need to protect the investments of investors from both Contracting Parties..."*

Then, Article 2 para. 2 stated that *"the investments of investors from either Contracting Party shall be granted at all times fair and equitable treatment and shall enjoy full protection and security within the territory of such other Contracting Party."*

Attention should also be given to Article 3 on the Most Favored Nation Clause, which read as follows: *"the investments of investors from either Contracting Party within the territory of the other Contracting Party shall be given at all times fair and equitable treatment, no less favorable than that granted to the investments made by investors from any other third State."*

Competent Jurisdiction to Hear a Controversy Arising between an Investor from Malaysia and the Republic of Chile

Article 6 of the Agreement between Chile and Malaysia dealt with a system for "Settlement of Investment Controversies between one Contracting Party and an Investor from the other Contracting Party", and for such purpose provided that *"... any controversy arising between one Contracting Party and an investor from another Contracting Party involving: an obligation entered into by such Contracting Party with such investor from such other Contracting Party in respect of an investment made by such investor; or an alleged breach of any right granted or created hereunder in respect of an investment by such investor, shall be submitted to the International Centre for Settlement of Investment Controversies through reconciliation or arbitration."*

This provision was based on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States 1965, otherwise known as the IBRD

Washington Convention, open to execution by the members of the International Bank for Reconstruction and Development and effective as of 14 October 1966. The Republic of Chile executed this Convention in 1991 and the Chilean National Congress gave its official approval in January 1992.

Since then the ICSID had been providing foreign investors with arbitration and reconciliation procedures for settling the disputes with the host economies receiving the investment in question. The process involved specialized competence, given that it could hear only juridical disputes arising from a foreign investment. Furthermore, and more importantly, the parties were bound to recognize such arbitration awards as though issued as definitive rulings of their own courts, without requiring *exequatur* procedure for compliance.

Pre-Investment Formalities Entered into by MTD Equity, Initial Approval of its Investment Application, and Subsequent Rejection by the Competent Authority of the Construction Project

Amidst the favorable and friendly environment enacted in the framework of Chilean public policy, a foreign investor, MTD Equity Sdn (MTD Equity), a corporation organized in Malaysia, attempted to carry out an urban development project in Chile between 1996 and 1997 with the objective of building a town on 600 hectares of rural land located in Central Chile, and involving a planned investment estimated at US$ 17.136 million.

Beginning in 1994, the representatives of MTD Equity and certain officials of the Malaysian government held meetings with various authorities and business leaders of Chile, particularly with a representative of the company owning the above-mentioned rural land, to coordinate and implement the project.

As a result, the MTD Equity submitted to the Chilean Foreign Investment Committee (CIE) the required investment application, which was approved by the agency on 3 March 1997. The approval expressly stated that the MTD Equity would develop a capital project on rural land located in Central Chile for the "construction of a self-sufficient satellite town including houses, apartment buildings, schools, hospitals, shops, utilities, etc." The appropriate Foreign Investment Agreement was executed by the CIE for the Chilean government, and the foreign investor on 18 March of that year.

It should be noted that the CIE was a juridical person subject to public law, decentralized as to functions, and was the sole body with authority, for and on behalf of the Republic of Chile, to accept the entry of capital from abroad opting for the benefits provided under the Foreign Investment Statute. The CIE was composed of the Ministers of Economics, Development, and Reconstruction; Finance; Foreign Affairs; Planning and Cooperation; the president of the Central Bank of Chile; and the Minister of the area concerned, in the event of investments in areas other than those already represented in the Committee by a Minister.

Notwithstanding the approval given by the CIE, implementation of the project by MTD Equity faced a number of administrative difficulties right from the start mainly because earlier urban regulations designated the property selected for locating the above project as an agricultural zone only, and therefore incompatible with the project that MTD Equity was seeking to carry out. Nevertheless, both public and private sources appeared to have assured MTD Equity that rezoning of the property for urban purposes might be easily obtained if a major foreign capital project were submitted to the Authorities promoting the development

of such area. In fact, the property appraisal conducted by foreign experts retained by MTD Equity was based on the assumption that the land might be developed as an upscale community once the current zoning for agricultural use had been changed.

Despite the seeming obstacle, MTD Equity proceeded to acquire the rights to ownership of the property where the investment was to be located, under the terms and conditions previously agreed with the owners. The company also injected capital into MTD Chile S.A through which the project was to be developed. Simultaneously, MTD Equity proceeded to retain the necessary professional advisory services and apply for the zoning change on the property where the project was to be located which would require an amendment to the Metropolitan Regional Plan of Santiago (PRMS).

Countless meetings were held from April 1997 to November 1998 among MTD Equity and the Minister of Housing and Urban Development, the Minister of Foreign Affairs, the Executive Vice Chairman of the Foreign Investment Committee, other high-ranking officials of these agencies, and the Mayor of Pirque to pursue the rezoning of the property to urban purposes. These steps however proved to be unsuccessful owing to opposition from the administrative authorities responsible for decisions of this nature, and who stated that such a decision was not contemplated in the plan for future development of the area where the MTD Equity project was to be located.

On 4 November 1998, the Minister of Housing and Urban Development definitively rejected the project, officially supporting his decision by citing that the project *"countered the prevailing urban development policy because it is incompatible with the zoning regulations in force for the place where the property of interest to the foreign investor is located."*

Notwithstanding the above rejection, a third Foreign Investment Contract was executed in September 1999 by the Foreign Investment Committee for and on behalf of the Republic of Chile and MTD Equity in the amount of less than US$ 100,000 to provide additional capital to the company organized in Chile for the development and management of the project. The minor additional investment was believed to have sprung from the desire of MTD Equity to increase the amount of cash funds available to the corporation already organized in Chile, for payment of miscellaneous administrative expenses associated with the project. The further approval from the CIE, albeit the official objections already raised against the development of the project by the Malaysian investor, was subsequently justified in the course of the ICSID arbitration by the officers of the CIE, who stated that the role of the Committee *"was strictly limited to approving the inflow of foreign investment funds into Chile, without prejudice to other obligations of the foreign investor to obtain any other approvals necessary for developing its project."*

Because of what transpired, MTD Equity advised the Chilean Authorities in October 1999, that it proposed to file a request with ICSID to resolve the difficulties it was encountering in the context of its project. In June 2001 MTD Equity filed the requisite papers.

Allegations of the Foreign Investor before the Arbitral Tribunal in Support of its Claim and Allegations of the Host Government Receiving the Investment

In its presentation to ICSID, MTD Equity ("Claimants") held that the Republic of Chile had failed to honor its obligation to grant the permits necessary for the MTD Equity investment in Chile to materialize, although Chile, in their own words, *"created and encouraged strong*

expectations that the Project, which was the object of the investment, could be built in the specific proposed location and entered into a contract confirming that location, but then disapproved that location as a matter of policy after MTD irrevocably committed its investment to build the Project in that location."

MTD Equity argued that such non-compliance by the host government should be considered in the framework of international law, primarily the provisions contained in the APPI executed by Malaysia and the Republic of Chile, the main points of which are presented in the earlier section of this case.

It is worth emphasizing that MTD Equity invoked the statement made in the treaty with reference to the *"fair and equitable treatment"* due to a foreign investor, and this treatment might not be less favorable than the treatment given to investors from other economies, thus alluding to the Bilateral Investment Agreements (BITs) executed by Chile and Denmark (effective since 1995) and by Chile and Croatia (effective since 1996), which in the opinion of MTD Equity upheld the obligation of the receiving Party to grant the necessary permits, once such investment had been approved.

A particularly enlightening reference to the latter statement was the provision embodied under Article 3 para. 2 of the international treaty between Chile and Croatia, which read as follows: *"2. When a Contracting Party has admitted an investment into the territory thereof, the latter shall grant the necessary permits pursuant to the laws and regulations thereof."*

The above allegation ended with the statement that the foreign investment concerned was not given fair and equitable treatment by the Republic of Chile because the latter *"impaired with unreasonable and discriminatory measures the use and enjoyment of the Claimants' investment by failing to grant the necessary permits to realize an investment already authorized."*

This attitude of such Party is a breach of the obligations entered into under the Foreign Investment Agreement executed by both parties, adding that the Most Favored Nation (MFN) Clause, contained under clause 3 of the treaty executed by Chile and Malaysia was also breached by such procedure. This last statement referred to the obligations of Chile under the Agreements known as APPIs executed earlier by Chile with Denmark and with Croatia, which if breached would constitute an expropriation of the Claimants' foreign investment, an action expressly prohibited under Article 4 of the treaty executed between Chile and Malaysia.

In turn, the government of the Republic of Chile ("Respondent") disagreed with the plaintiff over the meaning the latter attributed to the approval of their investment by the Foreign Investment Committee, insisting that this body, pursuant to its organic text, simply approved the capital transfer without going into the project details. This accounted for the limited description of the objective of the investment that was required from a foreign party seeking to begin a foreign investment project in Chile and applying for such benefits as the Foreign Investment Committee granted in such cases.

The Respondent added that in the course of various meetings held with the Claimants, there was occasion to advise them that their project was opposed to the objectives of the Metropolitan Regional Plan, *"one of which was to promote urban densification."* In its view, MTD Equity ought to have displayed due diligence prior to investing money and executing various agreements with prospective national partners.

The Respondent reiterated its position regarding the mission pertaining to the CIE to the effect that, pursuant to the terms of the CIE organic text, such mission was solely to *"perform information, registration, statistics, and coordination functions in regard to foreign*

investments" and that neither such organic text nor any other law in force in Chile contained any provision binding the CIE to seek from any other authority a report or prior approval of a real estate project such as the one that MTD Equity had proposed.

In addition, the Respondent argued that the foregoing was supported by national jurisprudence, which had regularly recognized the limited competence of the CIE and the limited scope of Investment Contracts. The Respondent's allegations ended with the statement that, contrary to the Claimants' allegation, the Republic of Chile was under no obligation to advise MTD Equity regarding the feasibility of the project before they commenced the investment.

Decision and Grounds of the Arbitral Tribunal on the Controversy

In the award forwarded to the parties on 25 May 2004, the Arbitral Tribunal designated in accordance with ICSID rules found that the Republic of Chile had breached its obligations under Article 3 of the Bilateral International Treaty (BIT) entered into with Malaysia, which laid down the well-established point of international doctrine known as "fair and equitable treatment." Nevertheless, it also found that the Claimants, MTD Equity, which ought to have obtained due protection from business risks inherent to their investment in Chile, had failed to present adequate proof of having done so.

Based on the above considerations, it sentenced the Republic of Chile to pay the foreign investor the amount of US$ 5,871,322.42, equivalent to half the amount requested by MTD Equity, in damages.

Thereupon, the Respondent appealed for annulment of the sentence, which was denied on 21 March 2007 by an ad hoc Committee composed of three members designated by ICSID. With its ruling, the Committee stated that its role in hearing such appeal for annulment was limited, for it had no power to amend the merits of the decision adopted by the Arbitral Tribunal against which such appeal was raised.

A brief description is given below of the most important decisions and associated motivations contained in the above award, which will provide food for thought to member governments receiving foreign investments in the future, as well as to businessmen electing to invest abroad.

The most important of this was the application by the Arbitral Tribunal of the Most Favored Nation (MFN) Clause, which was provided under Article 3 of the Chile-Malaysia BIT. In this regard, the Tribunal concluded that, under the BIT, *"the fair and equitable standard of treatment has to be interpreted in the manner most conducive to fulfill the objective of the BIT to protect investments and create conditions favorable to investments...",* and further considered to include as part of the protections of the BIT those included in the Denmark BIT and the Croatia BIT *"is in consonance with this purpose."*

On this issue, the Tribunal particularly referred to the Chile-Croatia BIT, which provided that *"the right to fair and equitable treatment* '*shall not be hindered in practice'."* In the same context, the Tribunal further referred to the Commission of the North American Free Trade Agreement (NAFTA), which *"interpreted 'fair and equitable treatment' as not requiring treatment in addition to or beyond that which is required by the international law minimum standard."*

In view of the foregoing considerations, the Arbitral Tribunal declared that it was *"obliged to apply the provisions of the [Chile-Malaysia] APPI and interpret them in accordance with the norms of interpretation established by the Vienna Convention on the Law of the Treaties, which [...] requires that a treaty be 'interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.'"* The conclusion of the Tribunal was that *"fair and equitable treatment should be understood to mean treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment."*

In the same context, the Tribunal agreed with the Claimants' position that Chile, having approved their investment, was bound to grant them the necessary permits for adequate development of their project. The foregoing was based on the Chile-Croatia APPI, which provided that *"[w]hen one of the Contracting Parties has admitted an investment in its territory, it shall grant the necessary permits subject to its laws and regulations."* The Tribunal concluded that such position was fully applicable to the controversy under discussion and had valid juridical support, given the wide scope of the MFN Clause under the BIT.

On the issue of diligence shown by MTD Equity in the planning and development of their Project, the Tribunal considered that Chile was not *"responsible for the consequences of unwise business decisions nor the lack of diligence of the investor",* and specified that *"BITs are not insurance against business risk."* Nevertheless, it pointed out that Chile was responsible *"for the consequence of its own actions"* to the extent that it failed to give the investor *"fair and equitable treatment."*

Regarding the Claimants' complaint that Chile had applied unreasonable and discriminatory measures against them, the Tribunal based its decision on Article 3 of the Chile-Croatia BIT, which provided that *"[e]ach Contracting Party shall protect within its territory investments made in accordance with its laws and regulations by investors of the other Contracting Party and shall not impair by unreasonable or discriminatory measures the management, maintenance, use, enjoyment, extension, sale and liquidation of such investments."* It further concluded that the approval by a host government of an investment against its own urban policy could be considered unreasonable.

It is interesting to note the MTD Equity's claim of indirect expropriation of its investment, based on Article 4 of the BIT and a number of facts: that it made its investment after having been authorized to do so by Chile; that it was forced to halt execution of the project because it was told that it lacked a necessary permit; and that it attempted to obtain such permit but its attempts were rebuffed and as a result it was unable to continue its Project and essentially lost the value of its investment. The MTD Equity alleged indirect expropriation resulting from actions and failure to act by Chile, irrespective of whether the latter intended or did not intend to cause indirect expropriation.

Although the Tribunal was cognizant of such circumstances, the situation was not one of expropriation but an instance of unfair treatment dealt to the investor by Chile by approving an investment that was incompatible with its own policy and ought to have been rejected by reason of internal policies.

Final Comments on the Discussion of a Real Case of Foreign Investment Dealt within the Preceding Sections

Chile has set up a powerful institutional framework of both national and international scope, designed to foster foreign investment in its territory, while protecting the investment from excessive regulations that might hinder the legitimate right of ownership of the proprietor of the investment concerned, and from illegal expropriation.

The successful achievements of Chile in this respect are widely known, as shown by the number of foreign businesses that have completed investments under the legal franchise provisions discussed above as well as the amounts invested. The differences arising between Chile and foreign investors have been minimal and invariably settled through the legal channels agreed with and accepted by the host government of these foreign investments.

The Arbitral Tribunal hearing the controversy discussed in this case recognized as much in its award, noting *"the success of the Respondent in attracting foreign investment",* while recording its *"understanding that a dispute before an ICSID Tribunal is not necessarily a black mark on the record of a country or an investor",* adding that *"[b]ilateral investment treaties are relatively new and it is not unreasonable that their application and the many factors that affect foreign investment be a source of disagreement."*

The case writer shares this objective and impartial outlook, and in a constructive frame of mind one must agree with the principles adopted by the award and that the responsibility of the various member economies is not over by the sole fact of approving a foreign investment and materially receiving it. The host economy must take up additional responsibilities relative to the possibility that a foreign investor might claim that the host economy had the responsibility to grant the foreign investor the permits necessary to implement the project as provided under the Treaty executed by Chile and Croatia. Thus, it is advisable for the Authorities to require first the foreign investor to show or to make sure that such permits would be granted as appropriate. This procedure would further achieve greater coordination among all the administrative authorities concerned.

This is the true meaning and scope of the obligations arising from the international investment treaties that Chile has executed, and also the spirit of its current Constitution regarding freedom to undertake any legitimate activity and assurance of the right of property over such investment.

Hence one has to agree in general with the reasoning of the ICSID Arbitral Tribunal that *"approval by the CIE of a foreign investment for a project that counters the urban policy of the Government is a breach of the duty to dispense to a foreign investor fair and equitable treatment."* Such treatment may not be less favorable than that afforded to investments by investors from any third economy, as in the case of the International Treaty between the Chilean and Croatian Governments.

In conclusion, it is worthwhile noting the operation of the ICSID system for settling disputes, from the standpoint of the case of MTD Equity.

The complaint addressed by MTD Equity from Malaysia had been going on for almost seven years, with no concrete results as of June 2008 regarding recovery of the damages that the Tribunal decided should be paid. This was a result of lengthy procedures to deal with issues such as the resignation of judges and presentation of a recourse for annulment of the award.

There has been a substantial increase in the number of cases brought before ICSID lately, in spite of the relatively scant jurisprudence that might be derived from such cases. The legal

costs incurred by the parties in defense of their interests had been high, including the costs of retaining highly competent foreign law firms, mostly from Europe and the USA. It is suggested that Latin American economies such as Chile make efforts to train teams of young professionals who might participate and cooperate on issues of this nature with more experienced persons. It is commendable that ICSID for its part continues to discuss its own procedures and promote the needed reform whenever advisable and arrived at by consensus.