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Foreign Investments under NAFTA: Implications for Chile*

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Chile is a country with a peculiar geography : a narrow strip of land with a desert rich in minerals in the North, agricultural lands in the center valley, forests, lakes and volcanoes in the South, the Antarctic in the extreme South. The Chilean people, on the other hand, is a blend of mainly Spanish and Indian blood, that have lived in a peaceful integration, with no discriminations. But what is more remarkable and for what Chile is more internationally known, is its solid form of constitutional and legal organization reflected in (i) a juridical order and respect to law, (ii) political stability, and (iii) a civic and democratic maturity.

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The present Constitution was approved in 1980 and amended in 1989 with the support of the main political forces, as part of the transition to democracy. The executive branch is headed by the President of the Republic with strong powers, the legislative power is vested in the Congress composed of the Senate and the Chamber of Deputies, the judiciary is independent and its members are elected within the judicial career.

The Constitution provides for specific constitutional protection of economic rights. It guarantees the protection of the proprietary rights and provides that private property shall not be expropriated unless a just compensation is paid in advance. It also guarantees the freedom of enterprise and the right of equal treatment and not to be discriminated in economic matters by the State or its agencies.

I. CHARACTERISTICS OF THE FOREIGN INVESTMENT LAW

Since 1953 foreign investments have been regulated by comprehensive special statutes. The present Foreign Investment Law is contained in Decree Law 600 of 1974 which has had two major amendments. One in 1977, when Chile withdrew from the Andean Pact and was able to liberalize the system. And the second in 1985, when the government introduced certain special foreign exchange and tax benefits for projects over 50 million dollars of industrial or extractive nature that export its production. Among those special benefits is the authorization of an off-shore account to maintain the proceeds of the exports abroad, which is an important exception to our foreign exchange control.

The basic rule in the system is the registration of the investment. This is mandatory for remittance of capital and profits as well as the use of the formal exchange market to bring in and take out the foreign currency. But in exchange for the registration, a contractual relationship is created with the Chilean State regarding foreign exchange and tax rules.

Which are, in our opinion, the main characteristics of the law on foreign investments?

- 1) It is a system with a long experience and exposure, applied for more than 40 years, and by different governments (center, right and left), accepted by the public opinion, by the political parties and what is even more important, by our courts.
- 2) It is a general system, regulated by law, with a non-discriminatory treatment, with almost no space to negotiate. There are extremely few restrictions to the foreign investors and two can be mentioned: the necessity of using the formal exchange market and the waiting period of one year to repatriate capital.
- 3) It is a simple and short process, except for projects over 50 millions which have to be approved by the Central Bank, with non-discretionary processing.
- 4) It is a legislation that grants special benefits to the foreign investors, of a foreign exchange and tax nature, basically to fix the rules of the game for a certain period, but with no arbitrary discrimination, which by the way is prohibited by our Constitution.
- 5) Last but not least, it is a system that is protected with a contract with the State of Chile. The Supreme Court has held that there exists a right of ownership on the rights created in the contract in favor of the foreign investor. Said right is regulated in the Constitution and cannot be expropriated unless a fair compensation is paid.

II. THREE OUTSTANDING MATTERS

Of the above characteristics, I would like to expand further on three points: the non-discrimination, the contractual arrangement and the submission to local jurisdiction.

Let us first analyze the non-discriminatory treatment. DL 600 (arts. 8 and 9) provides first, that both the foreign investor and the recipient company shall be subject to the indirect tax regime (VAT) and to the tariff regime applicable to local investments and second, that they will be subject to the regular legal regime that applies to national investments.

On the other hand DL 600 (art. 9) provides that the foreign investor and the recipient company cannot be discriminated against, either directly or indirectly. There is only one exception to this non-discrimination rule, contained in article 11 of DL 600. Said provision permits restrictions to local credit, which has been applied in the mega-projects over 50 million dollars which obtain special foreign exchange and tax benefits. The law continues specifying that there is discrimination if the rules of a given activity exclude foreign investments or the rules of special or exceptional regimes do not permit foreign investments to have access to them.

What happens if a rule of law is enacted that according to the foreign investor is discriminatory? Pursuant to article 10 the foreign investor can request the discrimination be eliminated: "The Foreign Investment Committee shall, within not more than 60 days after the date of presentation of the request, issue a decision rejecting the request or taking the appropriate administrative measures to eliminate the discrimination, or requiring the competent authorities to take such measures if they are beyond the powers of the Committee. If the Committee fails to issue a timely decision, or issues a decision rejecting the request, or if it is not possible to eliminate the discrimination administratively, the holders of the foreign investment or the enterprises in whose capital they hold an interest may resort to the ordinary justice system for a ruling on whether discrimination exists or not, and, in the affirmative case, that general legislation should apply".

And now let's turn to the foreign investment agreement. DL 600 (art. 3) provides that the authorizations for foreign investments will be inserted in a contract to be executed by public deed before a notary public. What is the nature of this foreign investment contract? In doctrine it is called in our legal system a *contrato-ley* (contract-law, under a literal translation). Why? Because it is an agreement entered into by the State and the investor, on matters that must be regulated pursuant to the Constitution by statutes — such as tax and foreign exchange. This is not the only case of contract-law. There also exists for construction of houses, foreign exchange matters and for certain regional benefits.

There has been a long legal discussion, first, on the validity of the *contrato-ley* and, two, on its effects. One line of thinking opines that it is an agreement which cannot be changed or amended unilaterally, a second one says that they are illegal because the sovereign rights cannot be limited and a third — which is dominant — affirms that they are valid agreements but if amended by the State, for example by a new statute, the investor must be indemnified.

We personally adhere to the third position, although we must recognize that the Supreme Court has accepted the first position, that is to say, that the contract-law cannot be changed by future legislation.

Thirdly, it is important to consider that the foreign investment agreement is governed by Chilean law and the parties submit to the jurisdiction of the

Chilean courts. As you may know, Chile is rather unique in Latin America for having a Sovereign Immunity Act. In 1978 Chile enacted Decree Law 2349 that determines rules for international contracts of the public sector. Said law in article 1 states the following: "Stipulations intended to subject to foreign law international contracts whose main objective concerns transactions or operations of an economic or financial nature, executed or to be executed by international or foreign entities, institutions, or enterprises whose main center of operations is located abroad with the Chilean State or with its entities, institutions or enterprises, are declared to be valid. Stipulations by which disputes arising out of such contracts have been or are submitted to the jurisdiction of foreign courts, including courts of arbitration contemplated in pre-established mechanisms of arbitration or in the respective contract, as well as stipulations by which special domiciles have been or are established and agents abroad have been or are designated for purposes of the contract, are likewise valid". And in article 2 the law permits the State of Chile and its enterprises to waive immunity from execution in international contracts. However, article 7 of the same law expresses that the provisions contained in articles 1 and 2 may not be included in contracts executed under DL 600. The same prohibition is applicable in concessions of property of public use or of fiscal assets.

III. JUDICIAL DECISIONS ON FOREIGN INVESTMENTS

Since DL 600 was enacted in 1974 we have had only four judicial cases related to foreign investments. Let us explain briefly the facts and the position taken by the Courts.

- Case 1 : an Australian company wanted to repatriate its capital. The Foreign Investment Committee argued that the period of 3 years required at that time by DL 600 should be counted since the foreign investor made the investment in the assets that were being sold to repatriate the capital. The Supreme Court (1986) determined that the period should be counted since the capital was brought into the country, that no new conditions can be added to what the law requires, and supported the decision in the theory of the contract-law.
- Case 2 : a Brazilian company requested that VAT paid for an import be returned because it was not subject to said tax based on a special exemption of the VAT law in conjunction with DL 600. The Supreme Court (1988) held that the exemption was granted only to the recipient company and therefore the foreign investor did not have the benefit of the exemption.
- Case 3 : Carter Holt, a company of New Zealand requested the Foreign Investment Committee to take a position regarding a discrimination against foreigners existing in the Fishing Law. The Committee did not declare if there was or not a discrimination. The Court of Appeals (1991) determined that the Committee made an illegal omission and did not comply with article 10 of DL 600.
- Case 4 : an American company — Exxon — argued that a reserve requirement established by the Central Bank to all foreign loans established a new condition to loans associated to its foreign investments and infringed the contract-law entered into with the State of Chile. The Court of Appeals decided that the contract did not protect the foreign investor against rules applied to loans. The Supreme Court (1992) rejected the appeal for procedural reasons.

IV. ACTIVITIES RESTRICTED TO FOREIGNERS UNDER CHILEAN LAW

A. ACTIVITIES RESERVED TO THE STATE OF CHILE

Under the Constitution of 1980, activities related to the exploration and exploitation of hydrocarbons are to be undertaken exclusively by the State of Chile or state enterprises. However, local and foreign investors can enter into these activities through “risk-contracts” or administrative concessions.

Uranium activities are subject to similar restrictions.

B. ACTIVITIES OR ASSETS WHERE THE PARTICIPATION OF FOREIGN PARTIES IS RESTRICTED

1. Fishing Activities

The Fishing Law 18,892 of 1989, which restated text is contained in the Supreme Decree 430 of 1991, expressly states that to carry out fishing activities within the national seas, a foreign individual must obtain a permanent resident visa. (Section 17, first paragraph).

In the case of legal entities, they must be organized in Chile. If the respective legal entity, even though incorporated in Chile, has foreign participation in its capital, the investment made by the foreign party must be duly authorized by the Chilean authorities and registered in the country in accordance with Chilean law. (Section 17, second paragraph).

2. Transportation of Passengers and Freight

In accordance with the Navigation Law contained in the Decree Law 2,222 of 1978 and Decree Law 3,059 of 1979, the transportation of passengers and freight within the national territory is reserved to ships registered in Chile. To register a ship in Chile, its owner must be a Chilean citizen in case of individuals. If the owner of the ship is a legal entity, it must be domiciled in Chile and have its main business operation within the country. Also, its directors, managers and representatives must be Chileans and its capital must be majority owned by Chilean individuals or Chilean legal entities.

Nevertheless, on the basis of reciprocity, this restriction can be waived to nationals from countries which provide the same privilege to Chilean nationals. (Section 11 et seq).

3. Ownership of National Airlines

National airlines (“Flag Carriers”) cannot be owned by foreigners in more than 49% because it would produce the loss of traffic routes in accordance with the treaties executed by Chile with other nations in which the air routes are reserved to the flag carrier airlines.

4. Managing Positions in Telecommunication Companies

In accordance with the General Telecommunications Law 18, 168, sections 21 and 22, the directors, managers and legal representatives of television

companies must be Chilean citizens and the respective company must be organized and domiciled in Chile.

In the case of radio companies, the president of the board, managers and legal representatives must be Chileans, but the directors can be foreigners as long as they do not constitute a majority of the board. Also, the respective companies must be organized and domiciled in Chile.

5. Ownership of Real Estate

Decree Law 1,939 of 1977, as amended, imposed several restrictions to the transfer and acquisition of real estate located in border zones defined by the law. Section 7 of the law says that, for reasons of national interest, it is prohibited to the nationals of neighbor countries to acquire the ownership or even lease real estate totally or partially located in zones declared by the law as "border zones", if such countries contemplate the same prohibition to Chilean nationals. The same restriction is applicable to legal entities not domiciled in Chile or in case that 20% or more of its capital is owned by foreigners. However, the President of the Republic may authorize said transfers in special cases.

V. MULTILATERAL AND BILATERAL TREATIES REGARDING PROTECTION TO INVESTMENTS

Chile is a party to the Convention of the Multilateral Investment Guaranty Agency (MIGA) of the World Bank published in the *Official Gazette* of June 11, 1988. Its purpose is to support the flow of international investments, granting protection against non commercial risks (transfer of funds, expropriation, breach of contract, war). The investor is subrogated by the Agency and the matter can be taken to arbitration under the ICSID rules.

Chile is also a party to the Convention of the International Centre for Settlements of International Disputes (ICSID) published in the *Official Gazette* of January 9, 1992. Conciliation and arbitration can only refer to matters of legal nature between an investor and a member State excluding therefore purely political or economic matters. The parties must expressly submit to the ICSID settlement's system.

On the other hand, the Chilean Government has been negotiating since 1991 several bilateral conventions on protection of investments. The Conventions with Argentina and Spain signed in 1991 have already been ratified by Congress and the same is true with the Convention with Venezuela signed in 1993. The Government of Chile has also signed the following additional conventions : Germany and Switzerland in 1991, both in the process of being reviewed; Belgium, France and Malaysia in 1992; Ecuador, Denmark, Finland, Italy, Norway and Sweden in 1993; Brazil and China in 1994.

The above treaties contain certain basic principles for the protection of investments :

- a) National treatment, no less favourable than that accorded to its own investors.
- b) Most-favoured-nation clause, treatment not less favourable than that accorded to investors of a third State.
- c) Expropriation subject to due process of law, non discriminatory, with a prompt, adequate and effective compensation, and

d) Repatriation of investment, free transferability.

In connection with the settlement of disputes the treaties make the following distinction : a) between the Contracting Parties, establishing an arbitral tribunal and b) between an investor and a Contracting Party, the investor having the choice of the local courts or international arbitration and in the latter case according to the ICSID rules or to the UNCITRAL rules of the United Nations.

It is important to note that the provisions of the above agreements are not exactly the same and therefore any party invoking the most-favoured-nation clause could pretend the best position.

VI. THE INVESTMENT PROVISIONS OF NAFTA AND CHILEAN LEGISLATION

Chapter 11 of NAFTA deals with investments and Section A refers to substantive rules and principles.

- a) Article 1102 deals with National and Most-favoured-Nation Treatment : each Party must treat other NAFTA investors and their investments no less favourably than it treats, in like circumstances, its own and third parties investors and their investments. The terms investor and investments are defined very broadly. Additionally, it prohibits that a minimum level of equity be held by local nationals (1102.4) and that senior management positions be in hands of local nationals (1107).

In this respect the short list of restrictions to foreigners in Chile enumerated above are exceptions to these principles. To this list we should add the reserve requirement applicable to foreign loans. Loans are subject to a 30% cash reserve that must be deposited in foreign currency in the Central Bank for 90 days, if the term of the loan is 90 days or less, or for the average term of the loan if such term is over 90 days but less than a year or for a year if the average term of the loan is equal to or exceeds a year. This deposit is not interest bearing. In lieu of the deposit, borrowers are entitled to pay a flat fee to the Central Bank that is equal to the six-month Libor rate over the amount of the deposit and for the term of it. The fee is paid through a rather complex mechanism whereby the borrower purchases a non-bearing interest note issued by the Central Bank, which, in turn, repurchases that same note at a discount.

- b) Article 1106 establishes a second important principle : the prohibition on performance requirements. No NAFTA country can impose requirements on investors that they export a certain percentage of the production, give preferences for domestic sourcing, achieve domestic content, mandatory transfer of technology, etc.

It is important to note that Chile does not have performance requirements for foreign investors.

- c) Article 1109 determines a third principle : free transfer of profits and dividends, of principal and interest of loans, royalty and management fees, proceeds from the liquidation of an investment. The Agreement refers to the market rate of exchange.

In this point we must consider (i) that foreign capital contributions and foreign loans brought into Chile must be converted to local currency under the Formal Exchange Market and payments abroad must be made in the same market and (ii) that foreign capital registered under DL 600 must remain in the country at least one year before repatriation.

d) Article 1110 establishes a fourth fundamental principle : no party may directly or indirectly nationalize or expropriate an investment of an investor of another Party except if certain requirements are met. The compensation shall be the fair market value; valuation criteria shall include going concern value and asset value; it must be paid without delay.

Our Constitution reflects the above requirements. Expropriation can only be justified by public need or national interest, as determined by Congress; must be on a non-discriminatory basis, in accordance with due process of law; payment must be made in cash. The Organic Mining Law (Law 18097 of 1982) establishes that the owner of a concession has the right to be indemnified if expropriated considering his effective loss, which is the commercial value of his rights; in case of disagreement the judge determines the commercial value considering the net cash flow of the concession based on the reserves the holder can prove to exist.

As a conclusion we can express (1) that there is a great similarity between the investment principles of NAFTA and Chilean legislation and (2) that the inconsistencies that exists are clearly not significant and in any case are minor in number and importance if compared with the long and substantial list appearing in the annexes to Chapter 11, which contain the exceptions of the three parties to NAFTA.

VII. THE PROVISIONS OF NAFTA ON SETTLEMENT OF DISPUTES AND CHILEAN LEGISLATION

Section B of Chapter 11 of NAFTA refers to settlement of disputes. It establishes a mechanism for disputes between a NAFTA country and an investor of another NAFTA country through international arbitration.

After a waiting period of six months since the events occurred, an investor may submit a claim to arbitration under the ICSID Convention or the UNCITRAL Arbitration Rules.

The investor must consent to arbitration and waive to initiate or continue any proceeding before a court or an administrative tribunal.

An arbitration tribunal must decide the dispute in accordance with the applicable rules of international law.

Turning now to Chilean legislation and as discussed above, a dispute under the foreign investment agreement — DL 600 — between the Chilean State and a foreign investor will be governed by Chilean law and submitted to Chilean courts. A risk contract between the Chilean State and a contractor to explore and exploit hydrocarbons is also governed by Chilean law and subject to Chilean courts. The same is true of concessions granted by the State of Chile to private investors for the performance of public works.

The above rules are clearly not consistent with the Agreements on the Protection of Investments to which we referred above and they are also inconsistent with the rules on settlement of disputes contained in Chapter 11 of NAFTA, because in both cases they provide for international arbitration.

This is an important discrepancy, from a legal standpoint, between NAFTA and present Chilean legislation. However, once the treaties are ratified by Chile, they will become part of the Chilean legal system and therefore the present restrictions above mentioned in connection with international arbitration and governing law, will not apply.