Collateral in Eastern Europe: Problems and Solutions

I. Introduction
A. BACKGROUND

The U.S. commercial real estate market reached its peak in the late seventies to early eighties. Favorable tax laws and aggressive lenders combined to fuel many new projects. Today, lenders are setting different kinds of records. Foreclosure rates are surging nationwide. The cost of bailing out the savings and loan industry continues to soar. In these tough times lenders meticulously scrutinize each new loan application and finance only the most solid proposals.

The lenders' cautious attitude has international implications. Today's opportu-
nities are overseas. Recent political changes in Europe have created unprecedented opportunities for foreign investors. Unfortunately, domestic lenders are hesitant to finance projects in other nations.\(^7\)

This comment explores opportunities available to foreign investors because of the privatization of Eastern Europe, specifically in the area of land ownership. It also investigates possible problems investors can expect to encounter when purchasing land in Eastern Europe, such as the sufficiency of realty as collateral for a mortgage loan. Finally, it proposes solutions to overcome the problems associated with financing land purchases in Eastern Europe.

### B. Political Changes in Eastern Europe

The cold war is over, and the race for profits has begun. For corporate America Eastern Europe represents a new frontier of opportunity. Poland, Hungary, the Czech Republic, and Slovakia lead the campaign to attract foreign enterprise to the former Communist bloc.\(^8\) For American companies doing business in these countries, uncertainty accompanies opportunity.\(^9\)

Political changes in Eastern Europe provide the backdrop for corporate opportunities. As democracy gradually replaces communism, capitalism gradually replaces socialism. The Czech Republic, Slovakia, Hungary, and Poland are moving toward a market economy.\(^10\)

From 1948 to 1989 the Communist party dominated the country then known as Czechoslovakia.\(^11\) In November 1989 the “Velvet Revolution” broke the grip of hard-line communism,\(^12\) and Czechoslovakia held free elections for the first time.\(^13\) On January 1, 1993, two sovereign states, the Czech Republic and Slovakia, replaced Czechoslovakia.\(^14\) With their new political structures the Czech

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8. See infra notes 37-60 and accompanying text.
9. See infra notes 80-277 and accompanying text.
13. Doing Business in the Czech Republic and Slovakia, supra note 11, § 1.2.
14. Id. § 1.1. Both states agreed to adopt all legislation and honor all treaties of former Czechoslovakia. Id.
Republic and Slovakia abandoned former Czechoslovakia's inefficient system of central market planning and reintroduced a market economy. Although Poland and Hungary have privatized state-owned industries at a faster rate than the Czech Republic and Slovakia, the better macroeconomic conditions of these new nations provide a stronger foundation for further privatization.

Hungary, like former Czechoslovakia, saw the fall of communism in 1989. In October of that year the Hungarian Parliament adopted a package of democratic legislation that made Hungary a multiparty parliamentary republic. Although private companies have existed on a small scale in Hungary since 1968, experts expect their numbers to mushroom in response to the political changes.

Recently, to ease the transition into a market economy, the Hungarian Parliament passed key legislation concerning privatization and deregulation. To its advantage, Hungary's business framework is more advanced than those of its Eastern bloc neighbors. For this reason Hungary has attracted more direct foreign investment than any other country in Eastern Europe. Yet, with unemployment on the rise, analysts question whether the Hungarian people will continue to support the measures necessary to establish a market economy.

In 1989 voters rejected Communist rule in Poland. Soon after, the Polish Sejm passed legislation aimed at establishing a market-based economy through private enterprise. Poland leads the transition of the Eastern bloc to a market-

15. Id. § 1.4. The former Czechoslovak Ministry of Privatization had planned to eventually privatize all state-owned industries, except those concerning infrastructure operations. Sumann, supra note 12, at 372. As of 1992 market forces determined 85% of Czechoslovak prices. Id. at 370.


19. Doing Business in Hungary, supra note 18, § 2.3.


22. Id. at 680.

23. Coopers & Lybrand, Hungary, supra note 20, § 3.1.


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based economy. Poland was the first Eastern European country to make its currency internally convertible. In 1992 Polish investors established 300,000 new private businesses, most of them in trade and services. While progress is underway throughout Eastern Europe, Poland has made the greatest stride toward emulating the political and economic structures of the west. The current structure of government in Poland closely resembles decentralized western systems of governance. Polish law now recognizes municipalities as legal entities separate from the state. These municipalities control all matters of local importance, including private and public property rights. Often, municipalities hold public property formerly under centralized state control.

The leaders of the Czech Republic, Slovakia, Hungary, and Poland realize that their new political and economic systems will not survive unless fortified by western investment. As a result almost all legislation targeted at privatization includes provisions for foreign investment. Government officials hope that many western businesses will take advantage of these provisions and invest in the new markets of Eastern Europe. Some businesses already have established offices in Eastern Europe, and most of them report initial success.

26. Id. § 2.4. In 1989 market forces determined approximately 50% of prices in the Polish economy. Philip D. Beck, Investors Benefit from New Polish Laws, Nat'1 L.J., Aug. 17, 1992, at 17, col. 1. In 1990 this figure increased to 90%. Id. Presently, market forces determine nearly 100% of Polish prices. Id.

27. Coopers & Lybrand, Poland, supra note 25, § 3.5.

28. Id. § 3.7.

29. See generally id.


31. Id.

32. Id.

33. Id. Prior to the Local Government Law, the People's Council controlled public land held by the state. Id.

34. Total gross debt outstanding in former Czechoslovakia, Hungary, and Poland averaged $150 billion in 1992. Mihaly Simai, The Emerging New Market Economies and the Evolving New Democracy in Central and Eastern Europe, in 1 Change: Threat or Opportunity for Human Progress: Political Change 227 (1992). The Czech Republic, Slovakia, Hungary, and Poland must depend on investment from western nations in order to service their debts. Id. Mihaly Simai believes that the success of the sweeping changes in Eastern Europe depends on active political, moral, intellectual, and financial support from the western countries. Id. at 234, 236.


C. PRIVATIZATION AND THE ENCOURAGEMENT OF INVESTMENT IN EASTERN EUROPE

The governments of the Czech Republic, Slovakia, Hungary, and Poland have all drafted laws to stimulate foreign investment. While these laws vary from country to country, their premise is the same: encouragement of western investment. Eastern European leaders recognize the important role of foreign investment in a market economy.

Before the Velvet Revolution in former Czechoslovakia foreign investors could enter a joint venture with Czechoslovak partners for the purpose of producing or selling goods within the country. Initially, few foreign firms took advantage of joint ventures because the weak economy created unavoidable obstacles. Investors also were concerned about the Ministry of Finance's tight regulation of joint ventures. All joint ventures had to be founded on the basis and within the limits of a permit issued by the ministry. Finally, the then Czechoslovak government, recognizing the limitations of this rule, modified its joint venture law.

In November 1990 the Czechoslovak government excluded the following types of joint ventures from the requirement of obtaining a permit before doing business in Czechoslovakia: (1) joint ventures with a Czechoslovak partner; (2) joint ventures where the Czechoslovak partner was a cooperative, if the parties established the joint venture after July 1, 1988; and (3) a 100 percent foreign-owned company. Although these changes made the establishment of foreign-owned businesses much easier, foreign business owners in the Czech Republic and Slovakia must still tolerate the growing pains of a new market economy. Resources are scarce. Nevertheless, the Czech Republic and Slovakia remain attractive locations for foreign investors because of their favorable laws concerning expropriation, repatriation of profits, and corporate tax.
The situation in Hungary resembles that of former Czechoslovakia. The Hungarian Parliament relaxed its laws governing foreign investments shortly after the fall of hard-line communism.\(^4\) In 1988 the Hungarian Government passed the Foreign Investment Act.\(^4\) Among other things, this act provides compensation for foreign investors if the government expropriates their assets.\(^4\) It also guarantees foreigners the same treatment as Hungarian nationals when setting up and running a business.\(^5\) Like the Czech Republic and Slovakia, Hungary gives foreign investors favorable treatment.\(^5\)

Poland, following the lead of Hungary and former Czechoslovakia, relaxed its laws concerning foreign investment.\(^5\) Before the Communist Party's fall from power, the law required foreign investors who wanted to do business in Poland to enter a joint venture with a Polish partner.\(^5\) The Polish partner had to be the majority shareholder in the joint venture.\(^5\) Now, foreign investors interested in doing business in Poland can choose one of several corporate forms.\(^5\) They may establish a wholly owned limited liability or joint-stock company, or they may enter a joint venture with a Polish partner.\(^5\) The Polish partner no longer needs to be the majority owner of the venture's equity.\(^5\) Poland, like the Czech Republic, Slovakia, and Hungary, has enacted favorable laws concerning repatriation of profits and expropriation.\(^5\)

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50. *Doing Business in Hungary*, supra note 17, § 2.5.2.
51. *Id.* Tax breaks awarded to foreigners have succeeded in drawing over $1.5 billion in foreign investment. *Id.* § 4.1.1. As expected, however, these tax breaks have always been a point of contention among domestic businesses. *Id.*
54. *Id.*
56. Participation Law, supra note 55, art. 1; Coopers & Lybrand, *Poland*, supra note 25, § 4.2.
57. Participation Law, supra note 55, art. 1; Coopers & Lybrand, *Poland*, supra note 25, § 4.2; Beck, *supra* note 26, at 17, cols. 1, 2. State-owned enterprises are an exception to this rule. Foreign investors must obtain a permit from the Foreign Investment Agency if they wish to purchase more than a 10% share in a corporation formed from the privatization of a state-owned enterprise. Law on Privatization of State-owned Enterprises, art. 19(2), *reprinted in* 29 I.L.M. 1226, 1235 (1990). Although a Polish partner no longer needs to be the majority owner of the venture's equity, the Polish partner may not contribute more than 80% of the equity upon formation of the joint venture. Matthew W. Sanidas, *The Economic Evolution of Polish Joint Venture Laws*, 19 *DENV. J. INT'L L. & POL'Y* 641, 655 (1991). Further, the value of the U.S. partner's contribution must be at least 25 million zlotys (about $2,600). *Id.* Foreign investors must be seriously committed to the success of their ventures in Poland in order to comply with this rule. *Id.*
changes provide considerable flexibility and opportunity for businesses establishing offices in Poland.59

By changing their laws the Czech Republic, Slovakia, Hungary, and Poland have shown a commitment to foreign investment. Perhaps the most striking change is in the area of land ownership. Until recently even nationals had difficulty acquiring real estate in their home countries.60 Today, most Eastern European countries allow foreign investors to purchase real estate.

D. FOREIGN OWNERSHIP OF LAND IN EASTERN EUROPE

In the Czech Republic and Slovakia prospective investors must obtain government permission before purchasing real estate.61 So far, authorities have been hesitant to allow foreigners to purchase real estate in these countries.62 Joint ventures, on the other hand, have had more success buying and selling real estate because Czech and Slovak law views foreign-owned joint ventures as Czech or Slovak legal persons.63

Until January 1, 1989, Hungarian companies with foreign participation needed permission from the foreign exchange authorities to purchase real estate.64 The foreign exchange authorities refused permission more often than they granted it.65 Today, foreign companies enjoy the same treatment as Hungarian enterprises,66 except these companies still must seek permission from the Hungarian Government if they wish to acquire real estate.67 The government conditions permission to purchase real property on the business activities of a company.68 To own real

59. See Participation Law, supra note 55. Poland’s foreign investment law is the most liberal in Eastern Europe. Cole, supra note 16, at 688. The new law removes nearly all impediments to foreign investment. Id.

60. The former Czechoslovak government modified the constitution to provide for the protection of private property rights. Coopers & Lybrand, Czechoslovakia, supra note 35, § 3.2. The state has begun returning land seized during the 1950s to its former owners. Doing Business in the Czech Republic and Slovakia, supra note 11, § 4.2.2.

In Hungary, like the Czech Republic and Slovakia, the state has begun returning land nationalized during the 1950s. Doing Business In Hungary, supra note 17, § 4.2.1. Hungary again recognizes private land ownership. Id.

In Poland the Communist government never succeeded in nationalizing all of the land. Zbigniew M. Slupinski, Foreign Investment and Ownership Problems in Poland § 1, in JOINT VENTURES AND PRIVATIZATION IN EASTERN EUROPE (PLI Com. L. & Prac. Course Handbook Series No. A4-4331, 1991). Today, few restrictions on land transfer are still in place, and freedom of contract between buyers and sellers is being reintroduced. Id.

61. Doing Business in the Czech Republic and Slovakia, supra note 11, § 4.2.2.

62. Id.

63. Id. Nevertheless, joint ventures with foreign participation can only purchase land necessary to fulfill the venture’s corporate needs. Sumann, supra note 12, at 375. The law prohibits purchasing land for investment. Id.

64. Doing Business in Hungary, supra note 17, § 4.2.1.

65. Id.

66. See supra note 50.

67. Id.

68. Id.

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estate foreign investors must prove that property ownership is necessary for their business. The government prohibits the purchase of real estate for speculation.

Until 1932 Poland severely restricted the rights of foreign investors to purchase real estate. Today, foreign investors may purchase land and property from all types of owners. Although the Ministry of the Interior requires joint ventures with less than 50 percent Polish ownership to obtain permission to purchase land, the Ministry only refuses permission in exceptional circumstances.

In practice, the feasibility of purchasing land in Poland depends on its location. Purchasing land in Warsaw is difficult because two postwar decrees have restricted the alienability of land within the city. Outside the city, however, an investor can fairly easily obtain a permit to purchase realty.

The governments of the Czech Republic, Slovakia, Hungary, and Poland have all made provisions to accommodate foreigners who wish to purchase real estate. In theory these provisions cleared the last political barriers that prevented western investors from purchasing land in Eastern Europe. In practice, however, many more obstacles exist. These practical challenges present problems that make purchasing land in Eastern Europe difficult, if not impossible.

In exploring the problems that limit a foreigner's ability to purchase land in Eastern Europe, this comment focuses on the relationship between mortgage lenders and borrowers. Although this comment explores many of these problems in the context of Poland, the same challenges apply equally in the Czech Republic, Slovakia, and Hungary. This comment uses the example of Poland because it

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70. Foreign Investment Act, *supra* note 20; *Doing Business in Hungary*, *supra* note 17, § 4.2.1.

71. *Doing Business in Poland*, *supra* note 24, § 4.3.2.

72. The Law on Acquisition of Property by Foreigners, 1991 Dz.U. No. 24, item 202 (amended), translated in 1990 WL 336648 (Polska); Coopers & Lybrand, *Poland*, *supra* note 25, § 4.2. In the case of real estate purchased from the state treasury, somewhat different rules apply. Banasinski, *supra* note 30, at 773. State officials must first offer state-owned land to the original owners from whom it was nationalized. *Id.* The land must be offered at fair market value. *Id.* If the original owner does not wish to repurchase the land, officials then offer the land to all qualified purchasers. *Id.*

73. Coopers & Lybrand, *Poland*, *supra* note 25, § 4.2. Foreigners do not need permission to enter into a lease agreement unless the law considers the lease perpetual (40-99 years). *Id.* Permission is not necessary if a Polish partner contributes real property to a joint venture with less than 50% Polish participation. Slupinski, *supra* note 60, § VI. Private partners may contribute full ownership of title of real estate to a joint venture. *Id.* § II(b). Until recently state partners were unable to contribute full ownership title to real property. *Id.* Now the law allows state partners to a joint venture, like private partners, to contribute full title to real property. *Id.*


75. *Id.*

76. *Id.*

77. *Id.*

78. Several factors make Poland attractive to foreign investors: (1) More than 1.5 million private concerns have been registered in Poland; (2) Poland now has a currency with a stable exchange rate; (3) hyperinflation has been conquered; and (4) foreign investors committed almost a billion dollars of investment capital to Poland last year alone. Jan Krzysztof Bieleck, *Poland: No Retreat From Democ-
is currently the most attractive Eastern European nation for foreign investment. First, however, before discussing reasons why lenders are hesitant to finance foreign real estate purchases, this comment reviews the mechanics of a traditional U.S. real estate transaction.

II. Possible Problems with Eastern European Property as Collateral

A. The Mechanics of Real Estate Transactions

Generally, American investors borrow money to purchase real estate and pledge the property as collateral for the loan. If the investor cannot repay the loan, the lender forecloses the collateral and holds the borrower liable for any deficiency between the unpaid loan balance and the amount received from the sale of the foreclosed property.

This method of borrowing money is usually low risk because the transaction is premised on the lender’s interest in the property. If the borrower defaults on an obligation, the lender can be made whole with proceeds from the sale of the property. In the United States a lender generally is not concerned about the security of realty pledged as collateral—the government will not foreclose the lender’s interest in the land. Moreover, the lender usually reasonably believes in the viability of the borrower’s financial well-being.

Overseas, the situation is much different. The unstable political and economic environment of many countries compromises the security of foreign collateral. Lenders must account for direct political risks such as expropriation and political violence; indirect political risks such as profit repatriation and income tax; environmental risks such as fires and natural disasters; and commercial risks such as currency devaluation, cost overruns, and inferior quality. Finally, and
perhaps most importantly, lenders must account for the legal risks associated with foreign collateral. 91

B. DIRECT POLITICAL RISKS

1. Problems

a. Expropriation

Because of direct political risks, lenders are hesitant to lend money to borrowers who pledge foreign property as collateral. 92 On a basic level, the market economies of Poland, the Czech Republic, Slovakia, and Hungary do not have a proven record of success. 93 If the standard of living in Eastern Europe continues to erode, these governments could possibly nationalize industries they had once privatized. 94 If this nationalization should happen, private owners of realty could be forced to relinquish their property to the government without recourse. The process of retaking privatized property is called expropriation. 95 Most industrialized nations view expropriation as an illegal act unless it serves a public purpose and prompt and adequate compensation follows. 96 Another concern for foreign investors is de facto, or "creeping," nationalization. 97 Political acts, such as discriminatory taxation and regulation, can effectively nationalize a business by making it impossible for the business to carry on profitably. 98 Expropriation especially troubles lenders. Conceivably, mortgaged realty could be nationalized and its owners—equitably the lenders—left without compensation. 99 Domestic lenders are unwilling to take this risk. 100

b. Political Violence

Another direct political risk, political violence, is also common. 101 Political violence can have the twofold effect of expropriating property and closing other-
wise profitable businesses. Lenders should always consider the possibility of political violence when evaluating the security of foreign collateral, especially in Eastern Europe, where new political parties are trying to take root.

2. Solutions

a. Treaties

In response to these concerns nations frequently negotiate bilateral investment treaties (BITs) with one another to eliminate international uncertainties. For example, to encourage American investment in Poland, the United States and Poland agreed to a bilateral treaty on business and economic relations. The U.S.-Poland BIT addresses several foreign investment issues, including the nationalization of private property.

The U.S.-Poland BIT does not eliminate the Polish Government’s ability to
nationalize private property owned by foreigners. Instead, it imposes four criteria that the government must satisfy before it can nationalize private property. First, the Polish Government must offer a legitimate public purpose for taking the property. Second, the nationalization must not discriminate among foreign and domestic owners. Third, the government must fairly compensate private owners for their nationalized property. Finally, the government must award compensation in a manner consistent with the principles of due process and treatment as set forth in the treaty.

The expropriation provisions of the U.S.-Poland BIT protect both borrowers and lenders. If the government expropriates a borrower’s property, it will fairly compensate the borrower. This compensation, in turn, could be credited directly to the outstanding balance of the borrower’s loan.

b. International Arbitration

Article II(7) of the U.S.-Poland BIT allows the parties to decide the terms for enforcement of the treaty’s provisions. The treaty suggests the parties choose international arbitration for enforcement. Mortgage lenders find this suggestion particularly attractive because the availability of international arbitration could

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107. Id.
108. U.S.-Poland BIT, supra note 104, art. VII.
109. Id.
110. Id. This provision leaves investors with unanswered questions. For example, the U.S.-Poland BIT uses the term “fair market value” as a measure of compensation for nationalized property. Id. As a practical matter the term “fair market value” would lose its meaning in the context of widespread nationalization because the concept of a market would be absent. Moreover, the U.S.-Poland BIT does not establish a method for determining fair market value. See id. Investors can only assume that the agency of nationalization establishes such a method. Offering investors the alternative of compensation based on historical value, if the fair market value of the property is less than historical value, would enhance the fairness of the treaty. With the addition of historical value investors would know with certainty the minimum amount of compensation they would receive in the event of expropriation.

111. Id. Article II(6) of the U.S.-Poland BIT provides that:

Investment(1) shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law. Neither Party shall in any way impair by arbitrary and discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of investments. Each Party shall observe any obligation it may have entered into with regard to investments.

112. Id. art. VII.
113. Id. Article II(7) of the U.S.-Poland BIT provides: “Each party shall provide effective means of asserting claims and enforcing rights with respect to investments under this Treaty and authorizations relating thereto, with the exception of denials thereof, and investment agreements.”

enhance the value of their international loan portfolios. Borrowers find international arbitration equally attractive because it increases the security of their foreign property interests.

To settle disputes between a host state and a foreign investor, a United Nation’s convention created the International Center for the Settlement of Investment Disputes (ICSID). United Nations delegates called for the convention to encourage or, more appropriately, not discourage foreign investment in developing countries. Under the provisions of the ICSID Convention a country and a foreign investor can agree to submit their investment disputes to an ICSID tribunal rather than their national courts.

The ICSID grants parties substantial freedom to tailor arbitration to their needs; however, some restrictions do apply. For example, the jurisdiction of the ICSID is limited to a state, its agencies, and a national of another contracting state. Also, annulments of decisions made by the ICSID tribunal must be based on defined grounds.

A complete arbitration clause contains: (1) an agreement to submit all disputes arising under the contract to arbitration; (2) an agreed place of arbitration; and (3) a direction on the appointment of arbitrators. Under the ICSID

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115. See infra note 137 and accompanying text.
116. Id.
119. Id. Article IX(3)(a) of the U.S.-Poland BIT provides: “At any time after six months from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by conciliation or binding arbitration to the International Centre for the Settlement of Investment Disputes.”

As of November 1993, Poland was not a signatory to the ICSID Convention, although it intends to sign the Convention in the near future. See Marian Nash Leich, Bilateral Investment Treaties, 84 AM. J. INT’L L. 895, 900 (1990).

As a background to this provision Poland wanted foreign investors to exhaust all remedies through local courts before proceeding to international arbitration. Lewis, supra note 104, at 541. The United States, on the other hand, wanted investors to have the option to initiate international arbitration at any time after six months from the date on which the dispute arose. Id. As a compromise the two countries decided on the purely advisory language that encourages the settlement of investment disputes in local courts, but does not take away from the investor’s right to initiate international arbitration after six months. Id.; U.S.-Poland BIT, supra note 104, art. IX(2).
120. Gaillard, supra note 117, para. 3.
121. Id. The ICSID Convention provides: “The purpose of the Centre shall be to provide facilities for conciliation and arbitration of investment disputes between Contracting States and nationals of other Contracting States in accordance with the provisions of this Convention.” ICSID Convention, supra note 117, art. 1.
122. Id. art. 52.
123. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 487 reporter’s notes (1987) [hereinafter RESTATEMENT (THIRD)].
Convention the parties can agree on the choice of law provisions the tribunal will apply. The parties may also adopt clauses concerning the enforcement of awards.

Countries that follow the Convention on the Recognition and Enforcement of Foreign Arbitral Awards will give deference to the awards of foreign arbitration proceedings. In the United States both federal and state courts have jurisdiction to enforce arbitral agreements under the Arbitral Awards Convention, despite citizenship or amount in controversy. The parties may remove actions brought to enforce arbitral awards to federal court any time before trial.

International awards not falling under the Arbitral Awards Convention may be enforced in state or federal court. However, most state arbitration statutes do not provide for the enforcement of international arbitral awards. Therefore, the claimant must seek enforcement in federal court on diversity of citizenship grounds. Typically, U.S. courts enforce foreign arbitration awards.

The ICSID provides valuable insurance for foreign investors. It is especially useful in the case of expropriation where treaties, such as the U.S.-Poland BIT, do not ensure that the government will appropriately compensate investors for the current value of their assets. Because a treaty cannot provide for all possible contingencies, the ICSID promotes certainty by providing investors with a fair and inexpensive way to resolve disputes over international contracts.

The availability of the ICSID enhances the attractiveness of foreign collateral. Under ICSID arbitration foreign purchasers of land know they will be fairly compensated in the event of expropriation. The availability of the ICSID in Poland, Hungary, the Czech Republic, and Slovakia should change lenders' attitudes toward real property pledged as collateral. The ICSID can protect both lenders and borrowers against loss.

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124. Id.; ICSID Convention, supra note 117, art. 42.
125. ICSID Convention, supra note 117, art. 54(1).
127. Id. art. III; RESTATEMENT (THIRD), supra note 123, § 487(1).
128. RESTATEMENT (THIRD), supra note 123, § 487 cmt. a.
130. RESTATEMENT (THIRD), supra note 123, § 487 cmt. a.
131. Id. reporter's note 8.
132. Id.
133. Id.
134. See generally Gaillard, supra note 117, comments.
135. Id.
137. The ICSID Convention allows for the predetermination of arbitrators' fees by express provision in the contract. ICSID Convention, supra note 117, art. 61(2).
In theory the ICSID provides an attractive alternative for investors concerned about receiving fair treatment in foreign courts. Economically, however, the ICSID is not as attractive. The problem centers on ICSID Convention article 52, which provides for the review and possible annulment of arbitral awards. Experts have interpreted article 52 to authorize re-arbitration of a tribunal's award in almost all cases. Losers are foolish not to appeal adverse awards because past review boards have given little deference to tribunal decisions. As a result, critics consider the ICSID Convention, in its current form, to be an uneconomical system for dispute resolution.

c. Overseas Private Investment Corporation Insurance

Although a reliable dispute resolution system is available, nothing guarantees that foreign investors will receive full satisfaction of their claims. To fully protect their investments against loss resulting from adverse political activity, investors must obtain international insurance. The United States Government and the World Bank have each established international insurance organizations. These organizations were created to insure foreign investors against political risks such as expropriation, currency inconvertibility, and war or political uprising. Commercial risks such as currency devaluation and default are not insurable under the charters of these organizations, but may be insured privately.

The United States Government established the Overseas Private Investment Corporation (OPIC) to encourage private investment in developing countries. OPIC insures U.S. investors against political risks in foreign countries. To be eligible for insurance, a prospective investor must meet specific criteria. First, the investor must be a U.S. citizen, natural or corporate. Second, the investor's
project must be located in a "developing friendly country." Third, the investor must rely on the availability of OPIC insurance in making a decision whether to undertake the project. Fourth, the project must be classified as a new investment. Fifth, a "satisfactory agreement" between OPIC and the host government must be in place. Finally, the investor's project must not result in a net loss of U.S. jobs or offset the U.S. balance of payments.

For eligible projects OPIC offers insurance for up to 90 percent of the project's value, provided it is not more than $100 million. The duration of OPIC coverage is long term, up to twenty years, and the full faith and credit of the United States Government support it. Like most international insurance organizations, OPIC covers all types of political risks, but excludes commercial risks.

OPIC insurance specifically covers the following political risks: expropriation, currency inconvertibility, and political violence. Expropriation encompasses all acts of expropriation, including acts by the host government that are outside its role as a regulatory authority and commercial participant. OPIC distinguishes currency inconvertibility from currency devaluation. The OPIC charter allows insured investors to enter currency inconvertibility claims if they cannot convert profits to U.S. dollars, but excludes claims for losses due to unfavorable conversion rates. Finally, OPIC insurance protects investors against losses from political violence. In general, political violence includes acts undertaken with the

151. Id. OPIC loosely defines a "developing friendly country" as a non-Communist country (subject to exceptions) having an average per capita income of less than $3,887 (real 1982 U.S. dollars). Id. The Czech Republic, Slovakia, Hungary, and Poland are all currently eligible for OPIC programs. East-West Trade: Poland Needs Foreign Capital to Meet Privatization Goals, Ambassador Says, 8 Int'l Trade Rep. (BNA) 830 (May 29, 1991). Currently, OPIC operates in more than 100 countries worldwide. Shanks, supra note 101, § III(D)(1)(b).

152. Shanks, supra note 101, § III(D)(1)(b). The organization intends this criteria to disqualify any investment that could go forward without the assistance of OPIC insurance. Id.

153. Id. "New," for purposes of the statute, includes modernization and expansion of existing facilities. Id.

154. Id. This agreement provides several things. Most importantly, it (1) provides OPIC with rights of subrogation for claims paid on behalf of its insured; and (2) requires that disputes be resolved through international arbitration in accordance with the international rules. Id.

155. Id.

156. Id. § III(D)(1)(a). Case-by-case exceptions can be made to extend coverage beyond the $100 million limit. Id. OPIC may insure up to 100% of loans by lending institutions. Id. § III(D)(1)(b).

157. Shanks, supra note 96, Managing Political Risks § B(1). While private risk insurance is available, its term of coverage is considerably shorter—one to three years—with rollover at the option of the insurer. Id. § B(3).

158. Id. § B(1). The distinction between political and commercial risks is often blurry. For instance, while the setting of currency exchange rates has a clear political element, OPIC treats currency devaluation as a commercial risk and will not insure against it. Shanks, supra note 101, § III(D)(1)(a).

159. Id.

160. Id. § III(D)(1)(c).

161. Shanks, supra note 101, § III(D)(1)(c). OPIC defines currency inconvertibility as the inability to readily convert foreign earnings or returns to U.S. dollars within a ninety-day period. Shanks, supra note 96, Types of Risk para. 3.

162. Shanks, supra note 96, Types of Risk para. 3.

163. Id. para. 5.

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primary intent of achieving a political objective. These acts include war, revolution, civil strife, terrorism, and sabotage.

OPIC insurance, like international arbitration, limits the risk of investing in a foreign country. By founding OPIC, the United States Government hoped to encourage investors to pursue foreign projects they would otherwise forgo because of unfavorable risk-reward ratios. For lenders who accept foreign realty as collateral, the availability of OPIC insurance provides added security. If a foreign government expropriates insured collateral, the borrower can recover from OPIC and repay the lender.

Although OPIC insurance has made several investments possible, it still has major drawbacks, the foremost being the exclusion of commercial risks from coverage. In the unstable economies of Eastern Europe, commercial risks are as much a concern as political risks. Commercial risks such as currency devaluation, cost overruns, unmarketable products, and inferior quality concern investors. Lenders are particularly vulnerable. The potential for borrowers to default on loans abroad, given the commercial uncertainties of starting a business overseas, is far greater than the potential for borrowers to default on domestic loans.

d. Multilateral Investment Guaranty Agency Insurance

The success of OPIC laid the groundwork for the Multilateral Investment Guaranty Agency (MIGA). The World Bank established MIGA on April 12, 1988. Like other World Bank organizations, the Bank's governing board created MIGA to "facilitate and encourage the flow of resources for productive purposes to member countries, particularly developing member countries." In keeping with this objective, MIGA's purpose is twofold: (1) to provide consulta-
tion on the improvement of investment conditions for member countries, and (2) to insure foreign investments against noncommercial risks.\textsuperscript{176} The types of risk insurable by MIGA resemble the types of risk insurable by OPIC.

MIGA insures investors against political risk.\textsuperscript{177} Like OPIC, MIGA policies protect investors against expropriation, currency inconvertibility, political violence, and breach of contract risks.\textsuperscript{178} To be eligible for coverage against these risks, applicants must meet several criteria.

First, applicants must be engaged in the export or export financing of U.S. goods.\textsuperscript{179} Second, applicants must be nationals of a MIGA member country other than the host country.\textsuperscript{180} Third, applicants must request insurance for an investment.\textsuperscript{181} Fourth, investments must represent new development.\textsuperscript{182} Fifth, prospective investments must be approved by the host country.\textsuperscript{183} Finally, investments must involve the transfer of resources from abroad into the host country.\textsuperscript{184}

As compared to OPIC, MIGA’s coverage is limited.\textsuperscript{185} The Bank restricts MIGA’s coverage to fifteen years in duration and $50 million for each project.\textsuperscript{186} The Bank designed MIGA to operate on a self-sustaining basis, paying claims and meeting operating expenses out of operating income.\textsuperscript{187} As a new agency MIGA has not yet established a record of reliability.\textsuperscript{188} For this reason, investors sometimes use MIGA as a backup to OPIC insurance.\textsuperscript{189} Since MIGA is a World Bank organization, it commands the respect of the international community and, as a multilateral institution, avoids the constraints of domestic concerns.\textsuperscript{190}

\textsuperscript{176} Id. para. 4.

\textsuperscript{177} Id.

\textsuperscript{178} Shanks, supra note 101, § III(D)(2)(a). In contrast to OPIC expropriation coverage, MIGA’s expropriation coverage protects investors against partial expropriation. Id. For example, MIGA would cover a foreign investor squeezed out of a foreign business that was majority owned by a foreign government. See id. In this instance MIGA would compensate the investor for the loss in value of the investor’s interest, whereas OPIC would only compensate the investor for a totally diluted interest. See id. Aside from this difference, MIGA’s coverage against political risk is the same as OPIC’s. Id.

\textsuperscript{179} Id. § III(D)(2)(a).

\textsuperscript{180} Id.

\textsuperscript{181} Id. The MIGA Convention purposefully avoids defining “investment” in order to make MIGA insurance available to emerging forms of industrial cooperation. See MIGA Convention, supra note 174, at 1600.

\textsuperscript{182} Shanks, supra note 101, § III(D)(2)(a).

\textsuperscript{183} Id.

\textsuperscript{184} Id.

\textsuperscript{185} Shanks, supra note 96, Managing Political Risks § B(2).

\textsuperscript{186} Id.

\textsuperscript{187} MIGA Convention, supra note 174, at 1601.

\textsuperscript{188} See Shanks, supra note 96, Managing Political Risks § B(2).

\textsuperscript{189} Id.

\textsuperscript{190} Id.
e. Title Insurance

The best, but probably least realistic, way to insure foreign collateral against loss is through a title insurance policy.\textsuperscript{191} If political acts cloud title, the mortgagee, who is the beneficiary of the policy, could recover and, in turn, subrogate any claims against the government to the insurer.

The domestic title insurance industry arose out of the need of mortgage lenders to protect themselves against the risks of doing business with borrowers in other states.\textsuperscript{192} This same need for protection applies in the international forum.\textsuperscript{193} Unfortunately, investors will find international title insurance difficult to obtain, especially in Eastern Europe where uncertainty regarding property ownership makes title virtually uninsurable.\textsuperscript{194}

3. Conclusion

Investors can currently obtain international insurance throughout Eastern Europe. Investors in the former Communist bloc now have two insurance organizations to protect them against political risk—OPIC and MIGA. The availability of international arbitration and title insurance adds a second degree of protection. Investors may now undertake projects that otherwise would not be feasible because of political risks.

For lenders these protective mechanisms make foreign collateral more attractive. First, political risk insurance functions much the way that casualty insurance functions for domestic collateral—a lender could require a borrower to obtain political risk insurance before the lender will accept foreign realty as collateral. Second, a lender could require a borrower and the state to agree that any dispute arising from the purchase of land be resolved through international arbitration. The availability of a neutral form of dispute resolution will strengthen the lender's confidence in the quality of the purchaser's ownership interest. Finally, a lender could reduce its exposure to risk by requiring a borrower to obtain international title insurance where available.

C. Indirect Political Risks

Direct political risks aside, landowners still face political risks that indirectly affect the security of foreign collateral. To reduce these risks international investment treaties typically provide remedies for indirect political contingencies. Two issues usually addressed are profit repatriation and income taxes.

\textsuperscript{192} Id.
\textsuperscript{193} Id.
\textsuperscript{194} See supra note 60; see also Michael L. Neff, Comment, \textit{Eastern Europe's Policy on Restitution of Property in the 1990s}, 10 \textit{Dick. J. Int'l L.} 357, 358 (1992). The Czech Republic, Slovakia, Hungary, and Poland all have considered returning real property to owners whose land was expropriated during Communist rule. \textit{Id.}

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1. Repatriation of Profits

a. Problem

Transferring surplus profits from a host country is one of the challenges of doing business overseas. Foreign laws often restrict the percentage of business profits that can be transferred out of a country. For example, Polish law limits the amount of profits a foreign-owned business may repatriate in any given year to its trade surplus for that year.

Restrictions on profit repatriation pose problems for foreign investors. Even though investors realize profits overseas, they may not be able to convert the profits into domestic currency. This fact concerns lenders. Usually, borrowers intend to pay off their mortgages with profits generated by the realty or a business located on the realty. If income earned from the property cannot be fully repatriated, borrowers may be unable to meet their mortgage obligations, even though their overseas investments are thriving.

b. Solution

i. Treaties. Developing countries recognize that limiting profit repatriation discourages foreign investment. As a result, investment treaties frequently relax restrictions on profit repatriation. The U.S.-Poland BIT, for example, requires progressively favorable repatriation treatment for U.S. investors as compared with existing law. The U.S.-Poland BIT calls for a gradual increase in the percentage of profits eligible for repatriation through 1994. After 1995 all profits will be eligible for repatriation.

The U.S.-Poland BIT provision concerning profit repatriation mitigates a sub-

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195. Leich, supra note 119, at 899.
196. Id. In Poland a foreign company may only repatriate 15% of profits earned in excess of its export surplus. Id. Repatriation of profits is not a problem for foreign investors doing business in the Czech Republic and Slovakia. Cole, supra note 16, at 673. The Czechoslovak Foreign Exchange Act provides for the free repatriation of all profits. Id.
198. Leich, supra note 119, at 899.
199. Id. The profits repatriation scale, as established by the treaty, is as follows:
   - as of January 1, 1992—20% of profits gained in 1990-91;
   - as of January 1, 1993—35% of profits gained in 1990-92;
   - as of January 1, 1994—50% of profits gained in 1990-93;
   - as of January 1, 1995—80% of profits gained in 1990-94;
   - as of January 1, 1996—100% of profits gained in 1990-95.

“If the Republic of Poland introduces full convertibility of its currency before 1st January, 1996, transfers of profits shall be made without restrictions from the date of introduction to full convertibility.” U.S.-Poland BIT, supra note 104, Protocol para. 4. The treaty provides further that: “The Republic of Poland shall ensure that the opportunity exists to invest profits which cannot be transferred in accordance with paragraph 4 of this Protocol in a bank account that yields a positive real rate of interest.” Id. Protocol para. 5.
stantial risk of doing business in a foreign nation.\textsuperscript{201} Lenders can structure mortgage repayment schedules according to the treaty's profit repatriation provisions. If the Polish Government refuses to honor the repatriation provisions of the treaty, the borrower will have a cause of action against the government.\textsuperscript{202} International arbitration could resolve this dispute.\textsuperscript{203}

\textbf{ii. Insurance.} As secondary protection against currency inconvertibility, investors could obtain insurance. OPIC and MIGA both cover currency inconvertibility.\textsuperscript{204} OPIC defines currency inconvertibility as the inability of an investor "to convert earnings from or returns of the foreign investment into U.S. dollars for a period of 90 days."\textsuperscript{205} OPIC insurance, however, does not cover currency devaluation, which is an uninsurable commercial risk.\textsuperscript{206}

2. \textit{Income Tax}

a. Problem

Each country, as a sovereign, has the freedom to impose taxes on those who do business or own property within its jurisdictional boundaries.\textsuperscript{207} In Eastern Europe each country has its own system of tax assessment and collection.\textsuperscript{208} While the tax systems of the Czech Republic, Slovakia, Hungary, and Poland have many similarities, they also have marked differences.

Shortly before its demise, the former Czechoslovakia unveiled a wide-ranging tax reform package modeled after European Community practice.\textsuperscript{209} When the Czech Republic and Slovakia declared their independence from former Czechoslovakia, each adopted its own system of taxation.\textsuperscript{210} Aside from subtle differences, the tax codes of these two countries closely resemble each other and reflect former Czechoslovakia's move toward a western system of taxation.\textsuperscript{211}

\begin{itemize}
  \item \textsuperscript{201} Although the parties did not negotiate the U.S.-Poland BIT for the exclusive purpose of protecting foreign investments in Poland, it certainly accomplishes this objective. See Ewing, supra note 104, at 360. Indeed, the Letter of Submittal to the U.S.-Poland BIT states: In addition, the treaty will encourage, facilitate and protect U.S. investment and business activity in Poland, which can act as an important stimulus to economic reform. Potential U.S. investors who otherwise might perceive uncertainties in the current business climate in Poland will find considerable assurance in the protections provided by this treaty.
  \item \textsuperscript{202} See supra note 27 and accompanying text.
  \item \textsuperscript{203} See Gaillard, supra note 117, comments. Failure to honor a treaty provision is the kind of dispute international arbitration was designed to resolve. See id. This situation demonstrates the effectiveness of strengthening political certainty through bilateral investment treaties. See id.
  \item \textsuperscript{204} Shanks, supra note 96, Managing Political Risks §§ B(1), B(2).
  \item \textsuperscript{205} Id. Types of Risk para. 3.
  \item \textsuperscript{206} Id. Managing Political Risks § B(1).
  \item \textsuperscript{207} See, e.g., U.S. CONST. art. I, § 8 (Congress vested with the power to lay and collect taxes).
  \item \textsuperscript{209} \textit{Doing Business in the Czech Republic and Slovakia}, supra note 11, § 7.1.1.
  \item \textsuperscript{210} Id.
  \item \textsuperscript{211} Id. §§ 7.1.2-7.10. Both tax systems include corporate tax, value-added tax, personal income tax, consumption tax, real estate taxes, road tax, estate and gift tax, and local taxes. Id.
\end{itemize}

\textit{SPRING 1994}
In 1988 and 1991 the Hungarian Parliament changed the country’s tax system to more closely resemble Western tax structures. Currently, Hungary assesses four types of taxes: corporation taxes, value-added tax, personal income tax, and withholding tax. All Hungarian business entities, whether corporate, partnership, or state, are taxed on the same basis.

The Hungarian Government assesses corporate tax against all business profits, despite foreign participation. Like most western systems of taxation, profits may not be reduced by the payment of dividends or interest, but losses may be carried forward. To encourage foreign investment, profits earned by Hungarian joint ventures enjoy favorable tax treatment.

The Polish tax system resembles the tax systems of the Czech Republic, Slovakia, and Hungary. The principal taxes in Poland are corporation tax, withholding tax, real estate tax, and income tax. Poland is currently considering changing its tax system to align it more closely with the tax systems of other European countries.

Under the current Polish tax structure the government taxes corporate profits at a 40 percent rate. The government also taxes joint ventures with foreign participation at a 40 percent rate after a three-year tax holiday. Like its Eastern European neighbors, Poland has negotiated tax treaties with other countries.

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212. Coopers & Lybrand, Hungary, supra note 20, § 5.1.
213. Hammer, supra note 208, Hungary § I(i). Excluded from the list are real property taxes. Id. With the introduction of private land ownership, real property taxes are sure to follow. The government needs these taxes in order to further align the Hungarian taxation system with western systems of taxation. See generally Gluck, supra note 18, at 163-64.
215. Doing Business in Hungary, supra note 17, § 7.2.2. The corporate tax system is progressive: 35% on the first three million forints and 40% on the profits thereafter. Hammer, supra note 208, Hungary § II(i).
216. Id.
217. Id. Hungary § VII(ii). Joint ventures with at least 25% foreign participation receive a 20% tax rate reduction. Id. This reduction only applies to joint ventures operating before January 1, 1991. Id.
218. Hammer, supra note 208, Poland § I(i). Poland’s tax system provides for the taxation of privately owned real estate. Id. Treating real estate as a taxable entity is consistent with Polish laws on property ownership, which have always recognized the private ownership of land. See generally Slupinski, supra note 60, § I.
219. Coopers & Lybrand, Poland, supra note 25, § 5.1.
220. Hammer, supra note 208, Poland § II(i). The 40% tax rate is a flat rate applied equally to all corporations conducting business in Poland. Coopers & Lybrand, Poland, supra note 25, § 5.2. However, certain corporate investments receive significant tax incentives. Investment expenditures in connection with environmental protection are 100% deductible in the year of purchase. Hammer, supra note 208, Poland § II(ii)(c)(i). Investment expenditures in connection with agriculture are 50% deductible in the year of purchase. Id.
221. Hammer, supra note 208, Poland § IV(iii). Under certain circumstances, the three-year tax holiday may be extended, or the joint venture may be exempted from taxes altogether. Id. Poland § IV(iii).
222. Id. Poland § VI.
These treaties modify the applicability of the general tax code to foreign corporations doing business in Poland.223

Eastern European tax systems are problematic because they are continually changing. The Czech Republic, Slovakia, Hungary, and Poland recently have all modified their tax structures. Continually changing tax systems create an uncertain environment for foreign investment. The profitability of many investments turns on their tax implications.224 Unfavorable tax structures may cause investors to abandon foreign projects instead of continuing to fortify them.225 De facto expropriation from discriminatory tax systems also concerns foreign investors.226

b. Solution

Investment treaties often include provisions to mitigate the risks to foreign investors caused by changing tax rates and de facto expropriation. For example, the U.S.-Poland BIT generally addresses the issue of taxation227 by requiring both parties to apply tax policies fairly and equitably.228 A bilateral tax treaty between the United States and Poland addresses more specific tax concerns.229

Undoubtedly, questions will arise regarding the interpretation of tax treaty provisions. For this reason, international tax agreements, like BITs, should include provisions for international arbitration.230 A neutral forum for dispute resolution will protect investors against losses from changing tax structures and de facto expropriation.

D. ENVIRONMENTAL RISKS

Often, lenders require borrowers to insure property pledged as collateral against damage caused by natural disasters.231 If a natural disaster destroys a substantial portion of the pledged property, insurance policies protect the

223. Id.
224. Cf. Sills, supra note 2, at 50, 54.
225. See generally id. Many U.S. real estate projects became economically unfeasible after the 1986 tax reform. Id.
226. Shanks, supra note 96, Types of Risk para. 5. Taxation is within the sovereign police power of a nation. Id. Discriminatory changes in a host country's tax law could possibly result in a "substantial loss of control over an investment or its putative benefits." Id.
227. Leich, supra note 119, at 900. The U.S.-Poland BIT does not specifically address tax issues because the United States traditionally handles tax matters in separate tax treaties. Id.
228. Id. The U.S.-Poland BIT provides: "With respect to its tax policies, each party should strive to accord fairness and equity in the treatment of, investment of, and commercial activity conducted by, nationals and companies of the other party." U.S.-Poland BIT, supra note 104, art. VI(1).
230. See, e.g., U.S.-Poland BIT, supra note 104, art. IX(2).
231. See Wade v. Seeburg, 688 S.W.2d 638 (Tex. App.—Texarkana 1985, no writ) (a deed of trust expressly provided that the borrower would insure the mortgaged property against loss by fire). Natural disasters other than fire that could substantially destroy property and improvements include floods, tornados, hurricanes, and hail.

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lender by providing the borrower with the funds necessary to restore the collateral to its prior state.232

Internationally, lenders can demand the same type of protection. Fortunately, several sources throughout Eastern Europe provide casualty insurance. Shortly before the succession of the Czech Republic and Slovakia, the former Czechoslovak government introduced new insurance legislation.233 Czech, Slovak, and foreign companies now offer several types of policies.234 In Hungary six insurance carriers currently write policies.235 Finally, in Poland insiders speculate that the government will fully privatize the insurance industry and more types of insurance should become available.236

E. COMMERCIAL RISKS

1. Problem

The developing market economies of Eastern Europe pose more than political risks. Besides political risks, lenders must also account for commercial risks, which generally are greater in the markets of developing countries.237 These risks include cost overruns during construction, quality control, undercapitalization, and currency devaluation.238 Measuring these risks is difficult, but important. If commercial risks are uncontrollable, an investor will have difficulty financing a project.239

2. Solution

In general, commercial risks are uninsurable.240 Treaties do not provide protection against commercial risks.241 Investors usually allocate risks of this nature by contract.242 To protect themselves against commercial risks lenders can require borrowers to maintain defined levels of capitalization, file quarterly profit reports, and annually appraise the value of realty that serves as collateral. All these procedures would help mitigate a lender's exposure to commercial risks.

232. See generally id.
233. Doing Business in the Czech Republic and Slovakia, supra note 11, § 5.3.5.
234. Id.
235. Doing Business in Hungary, supra note 17, § 5.5.
236. Doing Business in Poland, supra note 24, § 5.5. Meanwhile, the state controls the insurance market. Id.
237. Shanks, supra note 101, § II(A).
238. Id. The Member States of the European Community could significantly reduce the risk of currency devaluation if they decide to adopt a common currency. See generally Maxwell J. Fry, Monetary Policy Implementation During Europe's Transition to a Single Economy, in EUROPEAN BANKING 43-64 (Andy Mullineux ed., 1992). A common currency would be supported by the economies of several nations and therefore mitigate the volatility of currency traded in newly formed market economies. See generally id.
239. McGown, supra note 7.
240. Shanks, supra note 101, § II(A). OPIC and MIGA will not insure against any commercial risk. Id.
241. See generally U.S.-Poland BIT, supra note 104.
242. Shanks, supra note 101, § II(A).
Nonetheless, investors cannot provide for every commercial contingency. If an uninsured commercial risk forces a lender to foreclose on a borrower’s property, new challenges await.

F. LEGAL CHALLENGES

1. Problem

As a general rule, the law of the state where real estate is situated resolves all questions concerning the real estate and the interpretation and effect of instruments relating to the land and interests in the land. This rule normally poses no problems because the lender and the property are usually domiciled in the same state.

Similarly, the laws of the state govern mortgages on land situated in that state since mortgages represent an interest in land. The local law of situs also governs foreclosures because foreclosures represent interests in land. On the other hand, the laws of the jurisdiction where the parties write the mortgage decide issues that do not affect an interest in the land, such as deficiency judgments.

These rules serve as a general background for foreign investors who want to purchase land in Eastern Europe. In many Eastern European countries long-term interest rates are high. The long-term interest rate in Poland, for example, is near 60 percent. As a result, foreign investors will likely look to domestic creditors to finance their purchases. If an investor can find a domestic lender who will offer credit, foreign law will govern the foreign property pledged as collateral, despite provisions in the loan agreement to the contrary. For this reason, lenders should familiarize themselves with the property laws of the jurisdiction where the pledged realty is located.


247. Id. § 229 cmt. e; see also State Farm Life Ins. Co. v. Pyare Square Corp., 331 N.W.2d 656 (Wis. 1983) (court applied Wisconsin law to determine whether mortgagor had right to reinstate mortgage of Minnesota property).

248. A deficiency judgment allows the lender to seek recovery from the borrower’s personal property if proceeds from the sale of the foreclosed mortgaged property do not satisfy the debt. DUKEMINIER & KRIER, supra note 80, at 590. Texas, for example, preserves a lender’s right to recovery by deficiency judgment in its civil statutes. TEX. PROP. CODE ANN. § 51.003 (West 1993).

249. Doing Business in Poland, supra note 24, § 5.3.2.

250. Id. § 5.3.3.

251. According to joint venture law, a foreign company may freely borrow abroad without a permit. Slupinski, supra note 60, § VII(B).

2. Example—Polish Property Law

If the investor pledges Polish property as collateral, the property laws of Poland will govern the land.\textsuperscript{253} Fortunately, Polish property law incorporates many Western common law principles of property ownership.\textsuperscript{254} Like its neighbors to the west, Poland bases its laws of property ownership on a system of record title.\textsuperscript{255}

Polish law divides the Polish real estate register into four categories: location and use, property rights, limited property rights and easements, and mortgages.\textsuperscript{256} The offices of the state notary keep these records on file.\textsuperscript{257} The public may examine the register to determine the status of a piece of real property.\textsuperscript{258}

Polish property law recognizes security interests in real estate.\textsuperscript{259} Although rarely used initially they now are beginning to play a larger role in Polish property law as the market economy expands.\textsuperscript{260}

Mortgages of Polish real estate attach to the real estate as real property rights.\textsuperscript{261} These rights follow the debt, even if the creditor assigns the debt, until the borrower fully satisfies the creditor.\textsuperscript{262} Upon mortgage default the mortgagee may seek satisfaction from the mortgagor through an execution procedure.\textsuperscript{263} To obtain relief through an execution procedure the mortgagee must petition the court for an "execution clause."\textsuperscript{264} When appropriate, the court clerk will foreclose on the mortgage and force the sale of the property through a public auction to satisfy the mortgagee.\textsuperscript{265}

Whether Polish property law recognizes deficiency judgments remains unclear.\textsuperscript{266} Since deficiency claims go toward the full satisfaction of the mortgagee, it seems unlikely that a Polish court would uphold an action in foreclosure to satisfy a mortgagee but refuse an action for the full satisfaction of the debt through a deficiency proceeding.\textsuperscript{267}

\begin{itemize}
\item \textsuperscript{253} See id.
\item \textsuperscript{254} See generally, Slupinski, supra note 60.
\item \textsuperscript{255} Id. § VII(A).
\item \textsuperscript{256} Id.
\item \textsuperscript{257} Id.
\item \textsuperscript{258} Id.
\item \textsuperscript{259} Id.
\item \textsuperscript{260} Id.
\item \textsuperscript{261} Id.
\item \textsuperscript{262} Id. § VII(B).
\item \textsuperscript{263} Id. An execution procedure directs an official to sell the property of a debtor in order to satisfy a judgment. Foust v. Foust, 302 P.2d 11, 13 (Cal. 1956).
\item \textsuperscript{264} Slupinski, supra note 60, § VII(B).
\item \textsuperscript{265} According to Polish law a permit from the Ministry of Internal Affairs is required for foreign persons (without Polish interests) to acquire real property in Poland—no matter by way of purchase or by execution upon a mortgage. Id. § VII(B). Without such permission a foreign creditor may not acquire ownership of foreclosed real estate. Id.
\item \textsuperscript{266} See generally id. § VII(A).
\item \textsuperscript{267} See generally id.
\end{itemize}
3. Solution

The situs rule challenges a lender's ability to accept foreign realty as collateral.\textsuperscript{268} Fortunately, investors can control risks associated with the situs rule. In countries like Poland where the Ministry of Internal Affairs must approve all foreign purchases of land, the lender, as a condition to extending the loan, could require the borrower to enter an agreement concerning foreclosure with the host government. The host government could then guarantee the lender's ability to realize its interest in case of default. This guarantee could include provisions to resolve disputes arising under the agreement through international arbitration.\textsuperscript{269} In this way, the borrower assures the lender that if the lender has to foreclose, it can do so peacefully, or else recover damages through international arbitration.\textsuperscript{270}

Requiring the borrower to maintain an unencumbered asset base equal to the outstanding debt on the mortgage also addresses problems associated with the situs rule. If a lender cannot realize its interest in foreign collateral through foreclosure proceedings, it could still make itself whole through a deficiency action against the asset base.\textsuperscript{271} Such a requirement shifts to the borrower the effects of a risk traditionally borne by the lender. In this way the borrower, not the lender, would bear the risk of unfavorable foreclosure laws.\textsuperscript{272}

Finally, requiring the borrower to sign a deed of trust would mitigate problems associated with the situs rule.\textsuperscript{273} A deed of trust would allow the lender to privately foreclose on the collateral upon default.\textsuperscript{274} However, since a deed of trust resembles a mortgage, it would entail many of the same problems.\textsuperscript{275}

\textsuperscript{268} This is especially true in Poland, where the lender might be unable to realize its interest in the realty because the Ministry of Internal Affairs refused to issue a permit. \textit{See generally supra} note 74 and accompanying text.

\textsuperscript{269} Arbitration through the ICSID would be the appropriate choice for arbitration proceedings because the ICSID was chartered to decide disputes between a state and a company. Gaillard, \textit{supra} note 117, comments. Such is the case here. A dispute over the enforcement of an agreement allowing foreign foreclosures is a dispute between the lender and the state.

\textsuperscript{270} The indirect nature of the relationship between a lender and the host country might call into question the applicability of a ruling by the ICSID as a means of enforcing a guarantee for foreclosure interests. Article 25(1) limits the jurisdiction of ICSID to disputes "arising directly out of an investment, between a Contracting State . . . and a National of another Contracting State." \textsc{ICSID} Convention, \textit{supra} note 117, art. 25(1). Perhaps the guarantee could be linked directly to the borrower with the lender having the right to enforce it.

\textsuperscript{271} \textit{See supra} note 248 and accompanying text. The laws governing the debt for which the mortgage was given determine issues that do not affect interests in land, such as deficiency judgments. \textit{Id.} As a result, if the lender requires the borrower to maintain a predetermined asset base, the lender can receive a deficiency judgment against this asset base if it cannot realize its interest through foreclosure proceedings. \textit{See id.}

\textsuperscript{272} The borrower should perhaps more appropriately bear this risk, since a borrower has more direct control over the destiny of foreign property registered in its name. Additionally, the exposure of a large asset base would increase the borrower's propensity to insure its property against direct and indirect political risks.

\textsuperscript{273} \textit{See supra} note 81.

\textsuperscript{274} \textit{Id.}

\textsuperscript{275} \textsc{Dukeminier \& Krier}, \textit{supra} note 80, at 591.
proceeds from the sale of the property may not cover the balance of the loan. The lender then would still have to seek a deficiency judgment against the borrower to cover the outstanding balance of the loan.\textsuperscript{276} A traditional mortgage provides this same remedy.\textsuperscript{277}

III. Conclusion

Political and economic changes in Eastern Europe have encouraged western investment. The expanding ability of foreign investors to purchase real estate in the Czech Republic, Slovakia, Poland, and Hungary provides new opportunities. In practice, however, investors have found it difficult to capitalize on these new opportunities.

Traditionally, western investors borrow money to purchase real estate and pledge the property as collateral for the loan. If the borrower cannot repay the mortgage, the lender forecloses on its equitable interest to use the land. The lender then credits the proceeds from the sale of the property against the outstanding balance on the loan. Unfortunately, the political and economic structures of Eastern Europe complicate this simple process.

When evaluating the sufficiency of real collateral in Eastern Europe, lenders must account for direct political risks such as expropriation and political violence, indirect political risks such as repatriation limitations and adverse income tax structures, environmental risks such as fire and natural disaster, commercial risks such as currency devaluation and cost overruns, and legal risks such as the situs rule. Accordingly, many lenders refuse to extend loans secured by foreign collateral. In their view the risks exceed the possible rewards.

Today, however, several mechanisms are in place that increase the attractiveness of foreign collateral and promote overseas lending. Developing countries eager to attract foreign capital have negotiated investment treaties with western nations. International investment organizations have developed insurance and arbitration programs. All these programs are designed to mitigate the direct and indirect political risks faced by foreign lenders.

With cooperation, lenders and borrowers can share the burden of environmental, commercial, and legal risks inherent in overseas investing. Although these risks are not all insurable, they are manageable. Lenders and borrowers working together can make Eastern European investments profitable for both parties.

\textsuperscript{276} \textit{Id.} the absence of antideficiency legislation that has been enacted by several jurisdictions. \\
\textit{Id.}

\textsuperscript{277} \textit{Id.}