Expropriation Claim of Belfinance Haussmann, L.L.C.
Georgia – Contract of Insurance No. E307

I. The Claim

By cover letter dated October 16, 2002, with attachments at Tabs 1-34, (1) Belfinance Haussmann, L.L.C., (2) Financial Management Associates, L.L.C., (3) Econo Capital Investments, L.L.C., and (4) Beffen Brothers, L.L.C. (collectively, the "U.S. Investors" or the "Insured") filed with OPIC a claim (the "Claim") for the total expropriation of its investment made in a joint venture company, The Stock Company Absolute Bank (Absolute Bank) (the "Foreign Enterprise").[1] Louis B. Lloyd has represented to OPIC that he is authorized to act on behalf of Belfinance and the other U.S. investors as President of Belfinance and otherwise through one or more powers of attorney.

OPIC finds that the Insured has failed to establish the validity of its claim that Georgian governmental authorities committed violations of international law that deprived the Insured of fundamental rights in its investment insured under the above-referenced contract (the "Contract").

II. Statement of Facts

In January 1994, the Foreign Enterprise was registered with, and issued a general license by, the National Bank of Georgia (the "NBG") to conduct an array of banking services in the Republic of Georgia. Nodar Dzhavakishvili, Chairman of the NBG, was the NBG official responsible for registering the Foreign Enterprise.[2] The then President of the Republic of Georgia, Eduard Shevardnadze, also granted the Foreign Enterprise the right to act as the official financial agent of the Republic of Georgia.

A group of U.S. investors organized by Mr. Georgi Shanidze was assigned a majority interest (57%) in the Foreign Enterprise in December 1994. In addition, the Foreign Enterprise was authorized by the shareholders to place an additional 10,000 shares representing 25% of its authorized capital with a strategic investor such as the European Bank for Reconstruction and Development (the "EBRD").

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[1] The Claim does not purport to set forth a statement of facts and OPIC does not accept the Insured's Claim as a statement of facts. At the same time, OPIC has no reason to believe that the attachments to the Insured's Claim are unreliable, and, to the extent they are quoted from and relied upon herein, OPIC accepts them. However, OPIC does not believe that the Claim and the attachments thereto present a complete and undistorted basis upon which to make its determinations. Consequently, OPIC has developed additional sources of information from its files on this matter as well as its contacts with and information from the U.S. State Department in Washington, DC, as well as the U.S. Embassy, the U.S. Agency for International Development, and the National Bank of Georgia, each in Tbilisi, Georgia. With the encouragement and permission of the Insured, OPIC developed additional information from its contacts with and/or review of files of PriceWaterhouseCoopers and the European Bank for Reconstruction and Development in London, United Kingdom.

[2] Mr. Dzhavakishvili later served as a consultant to the Georgian Consulting Company (GCC), a privately held company and owner of a minority interest in the Foreign Enterprise since December 1994. Mr. Dzhavakishvili was not affiliated with the NBG at the time of the GCC Report described below.

In early 1995, the Foreign Enterprise commenced operations. Since then and at least through 1998, the Foreign Enterprise succeeded in attracting high quality customers, including many top-ranked companies, donor agencies, embassies and high-worth individuals, due in no small part to its significant Western ownership and management. In the process, the Foreign Enterprise developed a portfolio of real estate and small-and medium-size enterprise loans while retaining earnings for further investment in the business without paying a dividend.

However, allegations of mismanagement within the Foreign Enterprise began to surface as early as November 1998. A report prepared by Mr. Dzhavakishvili of the Georgian Consulting Company (the "GCC"), a Georgian shareholder in the Foreign Enterprise, alleged that payments made to consulting companies and legal firms purportedly affiliated with the principals of certain U.S. shareholders served to make an end-run around the Foreign Enterprise's policy to retain earnings and essentially conceal that dividends were being paid to such shareholders only (the "GCC Report"). The GCC also alleged that Leigh Durland, the then President of the Foreign Enterprise, had instituted a change in credit policy without the requisite approval of the Supervisory Board. In addition, the GCC raised concerns that no General Meeting of Shareholders had been convened in 1995 and 1996, and no financial statements for these years had been submitted for the approval of the General Meeting of Shareholders within the required timeframes. Whether these allegations are true or not, they reflect Georgian shareholder concern about the propriety of the Foreign Enterprise's business dealings with affiliates of its controlling U.S. shareholders and dissatisfaction about financial management and corporate governance at the Foreign Enterprise.

As a result of the GCC Report, both the NBG and the Ministry of Internal Affairs (the "Internal Affairs Ministry") commenced an investigation on the Foreign Enterprise. This is the first instance known to OPIC when the Internal Affairs Ministry began to target the Foreign Enterprise for investigation.

Over seven months before its liquidation in 2001, the Foreign Enterprise was determined to have an estimated negative equity of approximately $5 million, at least partly resulting from fraudulent activity conducted by senior management of the Foreign Enterprise. From 1995 through at least 2000, NBG inspectors had allegedly awarded the Foreign Enterprise undeserved, extremely favorable ratings under the Capital, Assets, Management, Earnings and Liquidity (CAMEL) inspection system in exchange for bribe monies paid out of the Foreign Enterprise's funds by certain of its personnel. That is, although the NBG had discovered certain deficits, deficiencies and financial adversities caused by certain personnel of the Foreign Enterprise, it did not honor its legal obligation to honestly report and account for its findings. The funds so paid to the [NBG] personnel in exchange for their complicity were then recorded on the [Foreign Enterprise]'s books as loans made to fictitious entities (see Second Statement of Derek Farmer, Tab 34).

The Internal Affairs Ministry's audit focused on the Foreign Enterprise's lending activities with respect to a series of loans made in connection with a Georgian business named Sevelich. The Internal Affairs Ministry appeared to believe that certain officials of the Foreign Enterprise had knowingly engaged in fraud, forgery and other activities to support an effort to smuggle spirits from Georgia to Russia. The Board of Supervisors of the Foreign Enterprise was informed of these findings at their meeting in the second quarter of 1999.

In response, the Foreign Enterprise conducted a series of audits to investigate the Sevelich transactions and other loans. The audits and investigations found the Internal Affairs Ministry's allegations were not without grounds. For example, one report found that two officials of the Foreign Enterprise, Georgi Antadze and Michael Gvatua, had not only shown absolute disregard for important elements of the Foreign Enterprise's credit policies and practices with respect to this portfolio, but also probably conspired with one another to defraud the Foreign Enterprise. In addition, the brother-in-law of Mr. Shanidze took title to collateral transferred from Sevelich in connection with at least four of the seven loans approved by Messrs. Antadze and Gvatua. In all, one audit found fourteen instances of interested party loans given by the Foreign Enterprise. Also, the Foreign Enterprise's lending officers had routinely asked for bribes when approached for loans, and the motor pool (whose manager was a friend of the Shanidze family) and other staff of the Foreign Enterprise had submitted inflated expense reports for reimbursement. Thirty loans were given by the Credit Department of the Foreign Enterprise that violated the Foreign Enterprise's credit policy, and only 20 of the 66 total loans (corporate and individual) were reported as properly secured as of March 30, 2000. Moreover, $1,054,663 of the loan portfolio was disbursed without proper approval. At least one of the investigations found that Mr. Shanidze was the instigator of the illegal activities undertaken at the Foreign Enterprise. Accordingly, sometime in the course of 1999, the Foreign Enterprise removed Mr. Shanidze as its Chairman of the Board.

Subsequently, in June 2000, the EBRD's nominee resigned his seat on the Board of Supervisors of the Foreign Enterprise. In the course of the following month the Board of Supervisors formally appointed Mr. Derek Farmer as the new President of the Management Board of the Foreign Enterprise. The Foreign Enterprise's new management made substantial efforts to recover the loans. At the time, Mr. Farmer expressed his intent to follow-up the suggestion of the NBG and refer the case to the Economic Crimes Division of the Internal Affairs Ministry to ensure that a criminal investigation occurred. To this end, Mr. Farmer briefed the U.S. Ambassador for Georgia concerning the Foreign Enterprise's difficulties (Exhibit 20). The Ambassador purportedly agreed to write to the President of the NBG as well as the heads of the relevant ministries in order to express his concerns about the allegations of misconduct at the Foreign Enterprise and to request the full support of the Georgian authorities. These efforts appeared to cause Nikolai Mourgulia, the Foreign Enterprise's Deputy Finance Director, with the assistance of his supporters, to return $630,618 of the more than $1 million he had embezzled with the assistance of nine employees in various departments of the Foreign Enterprise.[3]

Prior to the internal investigations conducted by Mr. Farmer, on August 9, 2000, the NBG sent a proposed Memorandum of Understanding to Farmer requiring the Foreign Enterprise to acknowledge that the latter was experiencing serious problems with its capital, asset quality, revenues, and liquidity and that such problems could lead to the Foreign Enterprise's insolvency. It furthermore asserted the NBG's right to regulate a failing Foreign Enterprise, and threatened further action if certain stabilization and recapitalization measures were not pursued. Pursuant to the

[3] Translation of Decision of the Interior Affairs Ministry "On Cancelling the Criminal Case [against] and the Criminal Prosecution [of Nikolai Mourgulia," dated May 25, 2001 (signed by D. Katsarava, Major Investigator of the Investigation Department and approved by Z. Kuloshvili, Chief of the Investigation Department, and R. Megrelidze, Deputy Chief of the Investigation Department), with the endorsement of the Chief of the Department for Procedural Oversight over the Investigation of the General Prosecutor's Office of Georgia (R. Zhgenti), dated May 25, 2001 (the "Interior Affairs Ministry Decision"). OPIC obtained a copy of the translated Interior Affairs Ministry Decision from the U.S. Embassy in Tbilisi, Georgia by facsimile dated October 6, 2004.

Memorandum, the NBG closely monitored the Foreign Enterprise. At the same time, the NBG permitted the Foreign Enterprise to use deposit reserves to preserve its liquidity, opened a standby line of credit of $1 million and permitted deferral of the creation of loan reserves for a period of one year. Memorandum regarding Assessment of Absolute Bank's Position from Derek Farmer, President, Absolute Bank, to Charles Wrangham, EBRD, dated November 9, 2000 (the "Bank Assessment Memorandum", Tab 18).

In looking back over the early to mid-2000 period, the NBG had determined that the Foreign Enterprise's earnings were falling as a result of its problems with the underlying portfolio, based on the Foreign Enterprise's own internal analysis dated September 2000 showing net losses in 1999 for seven out of 12 months and a substantial drop in net profits of $516,952 in January 1999 to net losses of $368,045 in December 1999, and in 2000, a further substantial drop to net losses of $1,144,285 by September 8, 2000). The NGB also observed a substantial decline in the Foreign Enterprise's reported figures for total assets and loans outstanding, with interest income, for example, decreasing from $10 million in January 1999 to $6.5 million by September 8, 2000).

In response to the Memorandum of Understanding, Mr. Farmer sought the advice of the EBRD. In a facsimile dated August 14, 2000, Mr. Farmer wrote to the EBRD to express his concern that there was no clear direction by the U.S. shareholders concerning the position to be taken with the NBG regarding the future of the Foreign Enterprise. Moreover, Farmer explained that his main concern continued to be the Foreign Enterprise's negative equity, followed closely by the poor capital to assets ratio of the Foreign Enterprise. Mr. Farmer thus expressed the belief that the Foreign Enterprise had to either recapitalize or liquidate.

In response to Mr. Farmer's facsimile, and by letter dated August 22, 2000, the EBRD stated that the Foreign Enterprise actually had three options: (1) to do nothing; (2) to increase the capital; or (3) to liquidate the Foreign Enterprise in an orderly fashion. According to the EBRD, an increase of capital was the best option under the circumstances. To do nothing would put both the Foreign Enterprise at risk of temporary administration by the NBG, and would have negative consequences for the Georgian financial sector. Through liquidation the shareholders could avoid making an additional contribution of capital, but at the cost of recognizing that the original investment was lost. Liquidation would allow the Georgian government to avoid panic among the Foreign Enterprise's depositors, and consequently would allow Georgia to avoid a negative impact on the national financial sector as a whole.

In the EBRD's view, the Foreign Enterprise's portfolio was of very low quality, resulting from incompetence and malpractice in the lending functions of the Foreign Enterprise and dating back to at least 1996. The Foreign Enterprise had a negative net asset value; it was illiquid and was in a fragile position that could rapidly deteriorate at any time. If the shareholders did not recapitalize, the EBRD believed that the NBG would strip the Foreign Enterprise of its banking license and would be justified in such an action.

On September 7, 2000, Mr. Farmer and EBRD representatives met with the NBG to discuss the Foreign Enterprise's financial problems. (This meeting appears to have been rescheduled on at least two occasions in order to allow for the shareholders to reach agreement on a strategy.) The management of the Foreign Enterprise and the EBRD had proposed to the NBG that it appoint a

temporary administrator. However, an alternative proposal by the EBRD was adopted: the EBRD would arrange for an emergency forensic audit to be conducted by KPMG - and the NBG would allow the Foreign Enterprise to access its statutory deposits, to draw on a standby liquidity line of $1 million, and to grant temporary relief from its mandatory reserve requirements - so that the Foreign Enterprise could continue to operate while the investigation into wrongdoing at the bank went forward.

On September 27, 2000, the Interior Affairs Ministry opened a criminal investigation on the misappropriation of $1,017,862 from the Foreign Enterprise by Mr. Mourgulia (see Interior Affairs Ministry Decision, at 1).

On October 16, 2000, the U.S. Investors, represented by Messrs. Lloyd and DiBenedetto, met with the EBRD, Mr. Farmer and KPMG in London to discuss the findings of the KPMG audit. At the meeting, KPMG related that liquidity in the Foreign Enterprise was lacking and that therefore its financial position was tenuous. In fact, KPMG's forensic audit revealed a capital deficit of approximately $5 million (see Bank Assessment Memorandum, Tab 18). The EBRD said it might be willing to help recapitalize if the U.S. Investors took decisive action, but at this point it believed that the best action was to merge with a strong Georgian bank.

The parties present at the meeting also discussed the ongoing theft and fraud investigation. They recognized that any recoveries would depend on clear and vigorous support by the Georgian authorities. Mr. Lloyd followed with a letter to the NBG dated October 25, 2000 indicating that he and the other U.S. Investors were not impressed with the actions of the Georgian government to such date in bringing those responsible for fraud to justice, especially since, in their view, recovery would have increased the capital of the Foreign Enterprise and improved its capital ratios.

The U.S. Investors failed to develop a timely recovery plan pursuant to the KPMG recommendations. In his October 25 letter, Mr. Lloyd expressed gratitude for the extension and offer of cooperation by the NBG to the Foreign Enterprise but informed the NBG of the inability of the U.S. Investors to put additional capital in the Foreign Enterprise. Mr. Farmer expressed the view at the time that many Western regulators would have already taken action against an institution in similar financial straits. However, he remained hopeful that a turnaround would be possible, pending recapitalization and notwithstanding certain elements of the KPMG report.

On or about November 13, 2000, the EBRD took the position that the NBG should place the Foreign Enterprise under a regime of temporary administration in the interest of ensuring fairness and transparency in Georgia's banking system. The EBRD expressed its concern to the NBG that any future plan regarding the Foreign Enterprise would have to recognize that its equity no longer had any value. In its view, even if the bank remained open to maximize recoveries, the probability was high that the Foreign Enterprise would still fail, with those depositors who withdrew earlier unfairly gaining preference over those who withdrew later. By late November 2000, the EBRD had concluded that Foreign Enterprise had been the victim of mismanagement and internal fraud and that its own loan and equity investments were unrecoverable.

However, the NBG appeared to take a different view, expressing confidence in the ability of the new management team of the Foreign Enterprise and the belief that remaining open under this

new leadership was the best way to recover loans and protect depositors. In the NBG's view, the Foreign Enterprise was an important player in the country's banking system because of its reputation as one of the better banks in Georgia, owing to its Western shareholding and management.

On November 16, 2000, Mr. Lloyd wrote a letter to OPIC for the purpose of notifying it that the U.S. shareholders were intending to pursue some action against the EBRD and the government of Georgia because the Foreign Enterprise had been "subjected to massive fraud, political intervention (summarily revoking provisions in the original banking license), failure to pursue the fraud and corruption that has taken place by the [Internal Affairs Ministry] and the local police, failure to monitor properly the fraudulent activities of other parties who were representing certain government officials, fraud on the part of the EBRD in administering and supervising a loan program, and failure of the local U.S. authorities in keeping the U.S. shareholders apprised of the massive amount of corruption which exists at every level of business and government." He did not allege that any of these difficulties amounted to an expropriatory event, nor did he claim that the Insured's investment had been expropriated.[4] Instead, Mr. Lloyd indicated that the Insured would need time to compile all of the necessary information to support an unspecified claim. He specifically mentioned his coverage for loss of business income and the fact that the U.S. Investors were experiencing such losses (see letter from Belfinance Haussmann to OPIC, dated November 16, 2000).

On December 4, 2000, the NBG decided to issue a cease and desist order, creating a regime whereby the Foreign Enterprise came under the authority of the NBG. On February 9, 2001, Mr. Lloyd met with the President of the NBG in London, where it was made clear that a recapitalization plan had to be presented by the end of the month or the NBG would appoint a temporary administrator to control the Foreign Enterprise. The deadline subsequently passed without the presentation of any plan from the U.S. Investors and the other shareholders. In looking back over this period, the NBG observed that it had worked with the Foreign Enterprise and its principal officers and sponsors (i.e., Messrs. Lloyd and Farmer as well as a Mr. David Mapley) as it attempted to identify additional sources of investment, but noted that the current shareholders could or would not step forward to recapitalize the Foreign Enterprise and that no other proposed investors were willing to make any investment commitments.

On March 16, 2001, Mr. Lloyd communicated by letter with President Eduard Shevardnadze, informing the President that no progress had been seen after six months of investigation and no charges had been brought against the culpable individuals. He expressed the belief that the alleged perpetrators of the crimes against the Foreign Enterprise were manipulating Georgian governmental and judicial authorities in order to avoid the consequences of past actions and to cover up at all costs the problems caused by theft and false accounting. Mr. Lloyd made these allegations apparently unaware of the Interior Ministry's ongoing criminal investigation of Mr. Mougulia.

On March 20, 2001, the NBG notified the U.S. Investors of its intent to transfer the Foreign Enterprise into temporary administration immediately in order "to minimize the Foreign Enterprise's impact on the remaining commercial banks operating in Georgia," unless the Foreign Enterprise could produce a signed and unconditional letter of intent by an investor or group of investors to invest $5 million in cash in the Foreign Enterprise by March 21, 2001 (see Letter No. 522/06 from

[4] It also appears that Mr. Lloyd was unaware of the ongoing criminal investigation of Mr. Mourgulia.

Irakli Managadze, President, NBG, to Louis Lloyd, Belfinance, dated March 20, 2001). The U.S. Investors failed to comply with this demand (apparently making an additional investment of $262,000 only), and on March 23, 2001, pursuant to Decree No. 77, the NBG appointed Levan Nozadze temporary administrator of the Foreign Enterprise. On March 26, 2001, the President of NBG notified Mr. Lloyd and the U.S. shareholders about the takeover. The following day the NBG announced publicly that the Foreign Enterprise was under temporary administration because certain shareholders and managers had failed to repay or recover $4 million in bad loans and that approximately $1.2 million was embezzled from the Foreign Enterprise.[5] It stressed that neither the U.S. Investors nor the current administration took part in any wrongdoing.

On the day he was notified of the takeover, Mr. Lloyd again wrote OPIC and forwarded a copy of the NBG's notification and Decree No. 77. In his letter of March 26, 2001, Mr. Lloyd stated that the U.S. Investors had made an additional investment of $262,000 a few months earlier with the promise by the Georgian government that the individuals who were guilty of fraud would be brought to justice and the $1.5 million they had stolen would be returned. However, the Internal Affairs Ministry allegedly engaged in delaying tactics in order to extract bribes, according to Mr. Lloyd, and the U.S. Investors likewise received no cooperation from any government official in this matter.

By letter dated March 29, 2001, OPIC acknowledged receipt of Mr. Lloyd's March 26, 2001 letter and referred to its initial response to Mr. Lloyd of November 21, 2000. OPIC confirmed its understanding that the Insured intended to file a claim, explaining, however, that a claim for business income loss under a related contract of insurance (No. E336) could only be made in conjunction with a claim for political violence and concluding that it was unclear how the events described in Mr. Lloyd's letters of November 16, 2000 and March 26, 2001 would amount to an act of political violence. In the March 29th letter, OPIC reminded the Insured that on November 7, 2000 it had been faxed information on how to present a claim to OPIC, including under the Contract. In their correspondence with one another, a claim for expropriation was neither alleged by the Insured, nor understood by OPIC.

On April 17, 2001, the NBG's temporary administrator assigned the Foreign Enterprise's assets and liabilities to Cartu Bank, pursuant to Article 59.1(a) of the National Bank Law. On this same day, Mr. Farmer expressed concern to the NBG and its U.S. Agency for International Development (U.S. AID) advisors that a neutral party did not attest to the financial condition of the Foreign Enterprise as a basis for the sale of its assets to a third party. Mr. Farmer explained that these developments were contrary to the agreement that had been reached three weeks earlier that an audit was necessary at least before the transfer of ownership, in order to properly attest to balance sheet values and thereby provide some defense against future claims by the existing shareholders. The NBG agreed to comply.

According to the NBG, upon the appointment of the temporary administrator, Mr. Nozadze proceeded to conduct an inventory of the Foreign Enterprise's assets and liabilities and to seek out an acceptable investor to acquire substantially all of such assets and liabilities (i.e., except an unidentified loan). The NBG has represented to OPIC that such actions were not only authorized under Article 34 of the Law of Georgia on the Activities of Commercial Banks, but also consistent

[5] "NBG Temporary Administration Proceeded to Work in Absolute Bank," Black Sea Press, dated March 27, 2001.

with international practice. Moreover, the NBG has asserted that this approach was preferred to the option of last resort, i.e., outright liquidation through public auction.

On May 25, 2001, the Internal Affairs Ministry issued its decision to cancel the criminal case against and prosecution of Mr. Mourgulia, finding that Mr. Mourgulia had committed the crime of misappropriation of $1,017,862 under Article 220 of the Criminal Code of Georgia and caused significant damage to the Foreign Enterprise in the amount of $567,862. However, because Mr. Mourgulia's crime was not deemed a grave offense, he had no prior convictions, confessed to and expressed regret for his crime, and at the same time he voluntarily compensated the damage and was not viewed as a danger to society, the Interior Affairs Ministry closed the criminal case against and prosecution of him (see Interior Affairs Ministry Decision, at 4-5).

On May 31, 2001, the NBG announced that it had revoked the Foreign Enterprise's banking license and had adopted a decision to liquidate the Foreign Enterprise. The NBG grounded its decision on Article 59 of the National Bank Law and Articles 30, 25, and 36 of the Commercial Banking Law. By letter dated June 27, 2001, OPIC followed up its March 29, 2001 letter, requesting an update from the Insured on the status of its investigation regarding a potential claim and its intentions to file a claim and noting that OPIC had not received any response from the Insured to its March 29, 2001 letter. In response, Mr. Lloyd informed OPIC by letter dated June 28, 2001 that "it is taking us a great deal of time to gather the appropriate information that we believe is necessary, however, we intend to move forward with a claim as soon as we feel that we have all the documentation in place." Mr. Lloyd's letter did not indicate whether the Insured had challenged or was planning to challenge any of the decisions of the NBG, nor did it claim any expropriation of its investment, nor did it request any assistance from OPIC to advocate in its behalf. Simultaneous with this letter, however, the Insured certified to, *inter alia,* that "the Investor has taken all reasonable measures to preserve property, to pursue available administrative and judicial remedies, and to negotiate in good faith with governing authority of [the project country] in its sovereign capacity and otherwise, and with all other potential sources of compensation." If, indeed, the actions of the government of Georgia up to that point in time were expropriatory, Mr. Lloyd should have requested OPIC's assistance to forestall, if not avoid altogether, the revocation of the Foreign Enterprise's license and the Foreign Enterprise's liquidation. Moreover, when these actions were taken, he did not seek to challenge them, as he and the other U.S. Investors had standing under Georgian law to do.

By August of 2001, the NBG had revoked the licenses of six commercial banks, including the Foreign Enterprise.[6] The NBG also announced that any interested party could appeal its decision to the Tbilisi Circuit Court within six months of notification thereof; three of the six commercial banks affected sought such recourse.[7]

By letter dated January 17, 2002, OPIC followed-up its letter of June 28, 2001 to request a status report on the Insured's investigations regarding its potential claim and its intentions to file such a claim, reminding the Insured there were specific time limits for the filing of any claim. In response, Mr. Lloyd identified three possible claims, including expropriation, by letter dated January 21, 2002, noting that the Insured had begun collating the necessary supporting information and the

[6] "Review of Georgia's Banking System," Black Sea Press, dated October 5, 2001.
[7] May 31, 2001

difficulties it was facing in completing this effort. Mr. Lloyd also alleged that the NBG had improperly and illegally seized approximately $300,000 from the Foreign Enterprise during a legal dispute between the Foreign Enterprise and the Ministry of Finance (the "Finance Ministry"). Furthermore, Mr. Lloyd expressed the belief that the Foreign Enterprise could have avoided a default if the governmental authorities had simply pursued the culpable individuals.

By letter, dated April 1, 2002, OPIC replied that - notwithstanding the contents of his letter - Mr. Lloyd did not explain why such events substantiated a claim for expropriation nor did he provide any supporting evidence. In addition, OPIC informed Mr. Lloyd that he had failed to explain why or how all of Article VIII of the Contract was satisfied, that the information furnished thus far was insufficient to support an expropriation claim, and that OPIC was unable to determine whether an extension to file an expropriation claim was appropriate or necessary. In his reply dated April 2, 2002, Mr. Lloyd reaffirmed the intent of the Insured to file a claim according to our format and to file a claim for expropriation, political violence, or both. He also challenged the application of our six-month deadline rules for filing a valid claim given the difficulties of assembling the necessary information to support such claim.

As noted above, the Insured filed the Claim on or about October 16, 2002. By letter dated April 18, 2003, OPIC informed the Insured that on the basis of the information supplied to date, it was unable to establish the validity of the Claim and that it would have to deny the Claim within sixty days thereof unless the Insured was able to supply additional information. By letter dated June 14, 2003, counsel for the Insured claimed to take issue with every premise and conclusion of our preliminary determination and accepted our invitation to meet personally for an in-depth discussion of the issues. OPIC representatives met with Mr. Lloyd and the Insured's counsel to discuss the Claim, and agreed, *inter alia*, to work together to develop additional information necessary to establish and process the Claim.

To this end, OPIC obtained letters of authorization in October 2003 from the Insured to obtain information and other documents bearing on the Claim from the EBRD and KPMG, and through December 2003, established the terms by which such organizations would be willing and able to share such information. Also, in late October 2003, OPIC further investigated the Insured's Claim by meeting with various officials and individuals with knowledge of the Foreign Enterprise's business and demise described at the outset of this Memorandum, and by reviewing files made available to us. As a result, OPIC understands that, since the events described in the Insured's Claim, the Foreign Enterprise has been liquidated.

III. Determinations Under the Contract

A. **The actions taken by Georgian governing authorities in relation to the U.S. Investors' insured investment in Absolute Bank do not constitute total expropriation within the meaning of the Contract.**

Article IV of the Contract determines the scope of expropriation coverage. It provides, in Section 4.01 and as modified by Section 10.02, that compensation is payable for total expropriation, subject to certain exclusions and limitations, if an act or series of acts satisfies four requirements,

unless such act or acts are reasonable regulatory actions taken by Georgian governing authorities pursuant to their regulatory oversight of the financial sector.

1. <u>The acts constituting total expropriation are attributable to a foreign governing authority which is in *de facto* control of the part of the country in which the project is located.</u>

The placement by the NBG of the Foreign Enterprise under temporary administration *prima facie* fixed the date of the taking of effective control over the U.S. Investors' insured investment in Absolute Bank. See March 26, 2001 Letter from Mr. Lloyd (forwarding to OPIC a copy of the NBG's notice to the Investors of its decision to place the Foreign Enterprise under temporary administration and to put the U.S. Foreign Enterprise effectively out of business). This act led to a series of subsequent actions by the NBG and its temporary administrator, Mr. Nozadze, namely, to conduct an audit of the Foreign Enterprise's books, to determine that the Foreign Enterprise was insolvent, to transfer the assets and liabilities of the Foreign Enterprise to Cartu, and ultimately to liquidate the Foreign Enterprise. All of these actions demonstrate that the National Bank of Georgia was in effective control of the U.S. Investors' insured investment in the Foreign Enterprise. Furthermore, because it has exclusive authority for regulating the banking sector in Georgia, the actions demonstrate that the NBG was in *de facto* control of the area where the Foreign Enterprise was located. Therefore, the actions alleged to constitute the total expropriation of the Foreign Enterprise are attributable to a foreign governing authority that is in *de facto* control of the part of the country in which the project is located.

The Insured suggests that the NBG was party to a criminal conspiracy with various other Georgian governing authorities and former officials of the Foreign Enterprise from the very beginning of the Foreign Enterprise's formation. That is, the Insured alleges that the aforementioned individuals conspired to expropriate the U.S. Investors' insured investment in the Foreign Enterprise, and provides in support a statement of its former president, Mr. Farmer, that (1) prior to his administration, Foreign Enterprise personnel had bribed NBG personnel in the form of fictitious loans made to entities related to or associated with such NBG personnel in exchange for high, unearned, undeserved and falsified CAMEL ratings, and (2) the NBG had debited approximately $300,000 from the Foreign Enterprise's account and transferred such sum to the Finance Ministry in response to a purportedly fraudulent court order showing judgment against the Foreign Enterprise in favor of the Finance Ministry. II at 1-2. Even if the Insured had submitted incontrovertible proof of the NBG's actions or complicity therein, none of these actions was sufficient on its own, or together, to cause the Foreign Enterprise to fail and lead inevitably to its insolvency and the decision of the NBG to take over its administration and eventually liquidate the investment. As the record before us amply demonstrates, the Foreign Enterprise was grossly mismanaged and its resources plundered by former officials of the Foreign Enterprise well before the NBG was forced to take the decision to place the Foreign Enterprise under temporary administration.

The Insured further claims that the failure of Georgian governing authorities to pursue and prosecute the culpable former officials of the Foreign Enterprise inevitably led to the Foreign Enterprise's insolvency and the NBG's decision to take over administration of the Foreign Enterprise. However, even if the Interior Affairs Ministry took these actions and secured the return of the approximately $1.6 million in stolen funds, the Foreign Enterprise would have still been

insolvent with a capital deficit of nearly $5 million as determined by KPMG. In such circumstances, it would have been irresponsible for the NBG to continue to resist the imperative of placing the Foreign Enterprise under temporary administration. In fact, in a memorandum to the EBRD dated November 9, 2000, Mr. Farmer himself admitted that Western regulatory counterparts of the NBG likely would have already taken action against the Foreign Enterprise.[8] However, the NBG appeared willing to defer temporary administration to allow the Foreign Enterprise ample time to recover until it became clear that the U.S. Investors were unwilling or unable to provide the Foreign Enterprise with additional capital. Moreover, most of the allegations of a widespread government conspiracy to defraud the Investors largely rely on undocumented statements by the Insured, and to date cannot otherwise be substantiated. For example, there is nothing in the record to suggest that the NBG discouraged the Internal Affairs Ministry from pursuing and prosecuting culpable government officials or that the NBG or any of its officials benefited by the Internal Affairs Ministry's decision not to prosecute.

2. <u>The acts are violations of international law (without regard to the availability of local remedies) or material breaches of local law unless the acts are reasonable regulatory actions taken by Georgian governing authorities pursuant to their regulatory oversight of the financial sector.</u>

"A state is responsible under international law for injury resulting from (1) a taking by the state of the property of a national of another state that (a) is not for a public purpose, or (b) is discriminatory, or (c) is not accompanied by provision for just compensation."[9] In each of these circumstances, international law provides that the compensation must be paid. However, "a state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police powers of the state, if it is not discriminatory."[10] Thus, "[i]t is often necessary to determine, in the light of all of the circumstances, whether an action by a state constitutes a taking and requires compensation under international law, or is a police power regulation . . . that does not give rise to an obligation to compensate even though a foreign national suffers loss as a consequence."[11]

When a state takeover of an insolvent depository institution is directed towards preserving such institution's value for the benefit of its depositors, it is presumptively an action within the state's police powers and it is not compensable because it is exercised for a public purpose.

> [B]ankruptcy trustees acting under the supervision of the bankruptcy courts routinely take control of enterprises formerly controlled by the enterprises' owners; such action is not a taking for which the owners must be compensated. The trustees, under the supervision of the courts, engage in wholesale modification and cancellation of the rights of owners and creditors; these modifications and cancellations are also not

[8] *See, e.g.*, Curtis, *id.*, at 377 ("Indeed, the continued private operation of a capital-deficient institution, with its risks of failure and drain on society's resources, can be likened to a "noxious use" of property, which can be suppressed without activating the takings clause").
[9] The Restatement of the Law, Third, The Foreign Relations Law of the United States, section 712, at 196-97.
[10] *Id.*, comment g, at 201.
[11] *Id.*, Reporters' Note 6, at 211.

takings (for the most part). The circumstances of insolvency necessitate a readjustment of private rights in order to distribute loss of economic value fairly, as well as other socially desirable purposes. The government may undertake such readjustment without violating the takings clause . . . Regulatory disposition of financially troubled banks . . . is an exercise of the bankruptcy power . . . [T]hey are subject to regulatory regimes administered by specialized agencies, which among other responsibilities, supervise the reorganization or liquidation of banks . . . that became insolvent. . . [T]he regulatory structure applicable to depository institutions recognizes priority claims in cases of insolvency . . . Depositors take priority over owners. A substantial part of the general regulatory effort with respect to depository institutions is directed towards preserving an institution's value for the benefit of its depositors.[12]

The NBG's decisions to take control of the Foreign Enterprise - to transfer its assets and liabilities to a third party in the interests of protecting depositors, and to avoid instability in the banking sector of Georgia – were necessitated by a public purpose. The NBG is the sole institution responsible for protecting the interests of local depositors and ensuring stability in the banking sector of Georgia. When notifying the U.S. Investors of its intent to place the Foreign Enterprise under temporary administration, the NBG explained that it was planning to take this action in order to minimize the Foreign Enterprise's impact on the remaining commercial banks operating in Georgia. Section II at 5. Indeed, the NBG had resisted taking such action eight months earlier when it became clear that protection of the interests of local depositors might have required it. Instead, the NBG made a credit line available to the Foreign Enterprise and permitted it to access its capital reserve account at the NBG Bank. This was essentially a drawn-out effort by the NBG to help stabilize the Foreign Enterprise and avoid any negative impacts on the Georgian banking sector and on the interests of local depositors of the Foreign Enterprise. It cannot fairly be alleged that the NBG took measures against the Foreign Enterprise in a capricious or precipitous fashion. In fact, their initial actions were quite lenient and carried out in an apparent effort to facilitate the Foreign Enterprise's attempts to stabilize its operations. The regulatory actions of the NBG thus served a public purpose.

"One test suggested for determining whether regulation programs are intended to achieve expropriation is whether they are applied only to alien enterprises."[13] Even before the NBG's actions with respect to the Foreign Enterprise and certainly thereafter, many banks in Georgia had been taken over and liquidated for failure to observe the NBG's minimum capital reserve requirements, without regard to whether they were foreign-owned. Section II at 6. "A challenged regulation might be compared with the practice of major legal systems; the fact that a given regulation is supported . . . by an international agency to guide . . . behavior . . . may be seen as evidence of its legitimacy."[14] Indeed, the NBG was encouraged not only by the EBRD, but also by the International Monetary Fund and other multilateral institutions to strengthen the banking sector by shutting down insolvent banks, as well as increasing minimum capital reserve requirements going forward. Section II.A at 3, 4. "A State is not responsible for loss of property or for other economic disadvantage resulting from . . . any other action that is commonly accepted as within the police

[12] C. Curtis, The Takings Clause and Regulatory Takeovers of Banks and Thrifts, 27 Harv. J. on Legis. 367, at 371-72 (1990).
[13] The Restatement of the Law, Third, The Foreign Relations Law of the United States, section 712, Reporters' Note 6, at 211.
[14] *Id.*, at 212.

powers of States, provided it is not discriminatory and is not designed to cause the alien to abandon the property to the State or to sell it at a distress[ed] price."[15] The NBG's actions were a result of the Insured's failure to provide additional capital to the Foreign Enterprise, despite the multiple concessions and extensions granted by the NBG for recapitalization purposes. Nowhere does the Insured suggest that the NBG's regulatory actions were taken against the Foreign Enterprise to cause the U.S. Investors to abandon the Foreign Enterprise or to sell its interest in the Foreign Enterprise at a distressed price.

The actions taken by the NBG to place the Foreign Enterprise (a) initially under its supervision and (b) later under the temporary administration and (c) still later to transfer its assets and liabilities to a successor bank, and (d) finally to file for liquidation of the Foreign Enterprise are not material breaches of local law because they were taken only after (w) the Foreign Enterprise had failed to meet its minimum capital reserves, notwithstanding the NBG's reduction in the Foreign Enterprise's minimum capital reserve requirements and the opening of a line of credit to the Foreign Enterprise, (x) the Investor had failed to recapitalize the Foreign Enterprise, (y) the Foreign Enterprise's accounts had failed to show any remaining shareholders' equity, and (z) the temporary administrator had concluded that the Foreign Enterprise was insolvent, respectively. Whether the decision by the NBG to transfer the assets and liabilities of the Foreign Enterprise was a breach of local law because local law required the holding of a public auction and no such public auction was held may be open to question. However, this breach of law was not material, because KPMG had found a deficit of shareholders' equity in the amount of more than $5 million more than seven months before the NBG had reached essentially the same conclusion.

3. <u>The acts directly deprive the U.S. Investors of fundamental rights in the insured investment unless the acts are reasonable regulatory actions taken by Georgian governing authorities pursuant to their regulatory oversight of the financial sector.</u>

None of the aforementioned acts of the NBG, singly or together, had the effect of directly depriving the U.S. Investors' of fundamental rights in the insured investment in the Foreign Enterprise, because the U.S. Investors' equity in the Foreign Enterprise had already been dissipated (not only fully, but by a factor of three) and the shares of stock representing the U.S. Investors' rights to such equity had no monetary value.[16]

> Compensation to be just must be equivalent to the property taken and must be paid at the time of the taking or with interest from that date . . . There must be payment for the full value of the property . . . Such property should take into account 'going concern value,' if any, and other generally recognized principles of valuation.[17]

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[15] Too v. Greater Modesto Insurance Associates, AWD 460-880-2 (Dec. 29, 1989), reprinted in 23 Iran-U.S. Cl. Trib. Rep. 378.

[16] *See, e.g.*, Charles N. Brower & Jason D. Brueschke, The Iran-United States Claims Tribunal 372-73 (1998) (citing Amoco Int'l Fin. Corp., 15 Iran-U.S. Cl. Trib. Rep. at 164) ("Expropriation, which can be defined as a compulsory transfer of property rights, may extend to any right which can be the object of a commercial transaction, i.e., freely sold and bought, and thus has a monetary value.").

[17] The Restatement of the Law, Third, The Foreign Relations Law of the United States, section 712, comment d, at 198. *See also* Curtis, *id.*, at 380 ("[I]t is not owners' equity as reflected on the books of the business but rather what the owners could realize on the market. In each case the inquiry must be whether there is value present").

In the circumstances of this case, KPMG determined in its forensic audit of the Foreign Enterprise seven months earlier that such equity required a negative adjustment of $6.5 million, not only to adjust the Foreign Enterprise's balance sheet at September 30, 2000 for the $1.6 million in funds stolen from the Foreign Enterprise, but also for bad loans in the amount of $3.1 million, inadequately secured collateral in the amount of $1.4 million and other overvalued capital assets of the Foreign Enterprise in the amount of $400,000. These amounts when viewed in light of the allegations put forward by the GCC Report confirm the independent assessment of the EBRD that not only fraud and misappropriation dissipated the Foreign Enterprise, but also poor management and inadequate financial controls. In our view, their relative magnitudes suggest the latter more than the former. In any case, such findings call into question the reliability of all of the balance sheets of the Foreign Enterprise previously prepared by its management, confirmed by its auditors, and submitted by the Insured for our review. As the Insured has observed, even from the inception of the business, the mismanagement and fraud began to occur. Moreover, audits conducted by the Insured's legal counsel as well as the findings of the GCC Report indicate that the Investors knew or should have known of the proliferation of mismanagement and fraudulent activity as early as November 1998. Section II at 1. The Insured suggests that it was unaware of such activity until August 2000, which only further calls into question the quality of management prevalent in the Foreign Enterprise.

In addition, the aforementioned actions were reasonable regulatory actions taken by the NBG pursuant to its authority to regulate the banking sector of Georgia.

> When the government takes over an institution . . . , it does not appropriate for itself such value as may be in the institution; rather, it seeks to preserve that value by forestalling dissipation of it by improvident (or fraudulent) management. It is true that the government seeks to preserve the value of the institution and its assets for the benefit of the depositors in the first instance and not for the benefit of the owners except as [to] lower-priority claimants. But that does not mean that anything has been taken away from the owners. They know that the depositors' claim on the value of the institution is prior to theirs, and that value in the institution must be applied first to make the depositors whole.[18]

The Georgian government's failure to prosecute the culpable personnel did not directly deprive the U.S. Investors of their fundamental rights to the insured investment; it was the culpable personnel who caused the U.S. Investors to lose the insured investment. The Foreign Enterprise remained a going concern even after the full scope of the fraud was discovered and assessed, and was positioned to survive such losses with the financial support and encouragement of the NBG, had the U.S. Investors been able and willing to participate in a recapitalization of the Foreign Enterprise in order for it to meet the minimum capital requirements of the NBG. Even if the culpable individuals had been prosecuted, it does not follow that a successful prosecution would have led to recovery of the Foreign Enterprise's losses. For such recovery to occur, the Foreign Enterprise and/or the U.S. Investors would have had to file a suit for civil damages, prevail in the suit and collect, and there is nothing in the Claim to suggest that they took such action.

[18] Curtis, *id.*, at 381.

4. The violations of law are not remedied and expropriatory effect continues for six months.

There were no violations of law to remedy in connection with the U.S. Investors' Claim.

The above conclusion is reinforced by the U.S. Investors' failure to pursue any action to challenge any of the aforementioned decisions of the NBG, including the NBG's placement of the Foreign Enterprise under temporary administration, the transfer of its assets and liabilities to a third party in apparent violation of the public auction requirement, and its decision to liquidate the Foreign Enterprise; nor is there any assertion in the Claim or any indication in the supporting information that the Investors had hired local counsel to investigate the possibility of challenging such actions. Indeed, upon announcing its decision to revoke the license of the Foreign Enterprise, the NBG also made it publicly known that any interested party could appeal this decision to the Tbilisi Circuit Court within six months of notification thereof. Section II at 6. Although three of the six institutions thus regulated by the NBG made an appeal, published reports do not indicate that the Foreign Enterprise was among them.

B. **Applicable Exclusions**

Even in the unlikely event that one or more of the regulatory actions undertaken by the NBG and the governing authority of Georgia were deemed to fulfill the requirements of Section 4.01 of the Contract, it would be excluded from the scope of expropriation coverage by one or both of the following exclusions and no compensation should be payable to the Insured.

1. Provocation.

Section 4.03(a) of the Contract, as amended by Section 10.03 of the same, provides that no compensation for expropriation shall be payable if "the preponderant cause is unreasonable action (i) attributable to the Investor or (ii) attributable to another stockholder, or a controlling officer of or controlling investor in another stockholder, of the foreign enterprise that is reasonably related to or in furtherance of the business or activities of the foreign enterprise."

a. The unreasonable actions are attributable to another stockholder or controlling officer or Investor of another stockholder.

As was previously discussed, Messrs. Shanidze and Mourgulia engaged in a number of illegal and malfeasant activities ranging from fraud to defalcation. Messrs. Shanidze and Mourgulia were in a position of both ownership and managerial control over the Bank and its business dealings when the Foreign Enterprise was mismanaged and defrauded. In addition to being a controlling officer of the Foreign Enterprise from its inception, Mr. Shanidze was also a stockholder of the Foreign Enterprise, both directly and indirectly through his ownership of Armlender. Mr. Mourgulia was also a shareholder of the Foreign Enterprise from the date of his purchase of shares on or about March 23, 2000 until September 22, 2000.

Because illegal actions are unreasonable *per se*, any illegal act performed by the controlling officers or stockholders of the Foreign Enterprise (and there are many such instances) can qualify as an unreasonable action of the Foreign Enterprise pursuant to section 4.03(a) of the amended Contract. There are numerous examples of such actions, the most egregious of which is Mr. Mourgulia's embezzlement of more than $1 million of the Foreign Enterprise's funds. Mismanagement, however, is not necessarily illegal, and therefore is less clearly unreasonable. Yet in this case, there is ample evidence that the management practices were also unreasonable. For example, the Foreign Enterprise failed to hold shareholder meetings as required by law, and top management officials such as Messrs. Shanidze and Mourgulia disregarded important elements of the Foreign Enterprise's credit policies in approving and/or issuing loans.

These few examples of malfeasance and illegal activity are part of a history of mismanagement and fraud that caused the Foreign Enterprise to fail. Many of the documents made available for OPIC's review support this position. Moreover, the Foreign Enterprise sought and obtained emergency lines of credit from the NBG to cover its deteriorating financial situation induced by the fraud and defalcation of some of its stockholders, including Armlender and Messrs. Shanidze and Mourgulia. Therefore, actions attributable to the stockholders, and not the NBG, induced the Foreign Enterprise's insolvency and necessitated its liquidation.

Instead of recognizing these obvious and direct causes for the loss of its investment, the Insured claims that the corruption that allegedly pervaded the entire Georgian government is the preponderant cause of the Foreign Enterprise's failure. Specifically, it makes the following claim:

> the Georgian government and its agents, in concert, cooperation, and conspiracy with others, knowingly condoned, further, facilitated, suborned and supported unlawful schemes and devices through which the Bank's assets were plundered and the Bank was deliberately rendered "insolvent" and after knowingly and actively contributing to such "insolvency", the Georgian government and its agents then refused without any legitimate or plausible basis or explanation to enforce such *criminal* law as might have returned the Bank to solvency, and instead in bad faith, purportedly acting pursuant to Georgian *banking* law, relating to the consequences of an "insolvency" to which they themselves had actively contributed, seized and retained all of the Bank's assets, and transferred them to a co-conspirator.

To further buttress its generalized claim of pervasive corruption, the Insured describes two instances in which (1) the Georgian Finance Ministry and the Georgian judiciary allegedly conspired with the NBG to wrest $300,000 in funds from the Foreign Enterprise and (2) the NBG and the Georgian judiciary unlawfully seized collateral that one of the Foreign Enterprise's customers had pledged to secure a $150,000 loan on which the customer defaulted,[19] and concludes that "when, ultimately, it undertook to seize the Bank's assets, the Georgian government (acting through NBG, an official organ and instrumentality of the Republic) disregarded such practices and procedures as Georgian

[19] The first instance took place in the course of 2000 and the second instance took place during the second half of 1998, and neither appears to support the Insured's claim of a monolithic conspiracy of the Georgian government and its agents to expropriate the Insured's investment. They are, at best, peripheral to the Insured's Claim and have been deemed immaterial.

law itself would require even if the Bank had authentically suffered an 'insolvency' (which it did not) and the government had thus undertaken the seizure in good faith (which it did not)."[20]

There is no denying the fact that corruption has been deeply rooted not only in Georgian government but also business circles even before the dissolution of the Soviet Union. However, any emerging market that is "marked by civil war, ethnic secessionism, and economic deterioration", as Georgia was characterized to be in the Foreign Enterprise's Preliminary Business Plan, dated July 1, 1994, should be expected to pose potential investors to the risks of fraud, malfeasance and other corruption in its financial sector (see Tab 2, at 2-3 and 26). In fact, Mr. Lloyd was substantially aware of risks of this nature when he disclosed to OPIC during its underwriting of the Contract, *inter alia*, that (1) Soliko Khabeishvili, the Foreign Enterprise's first Chairman, and the head of the Eduard Shevardnadze Fund for Democracy and Revival, one of the Foreign Enterprise's key Georgian shareholders, was a "known crook", (2) officials of its other Georgian shareholders had allegedly been involved in financial crimes or abuse, and (3) President Shevardnadze seemed to be unable to crack down on organized crime.[21]

In short, even if there were any evidence to support the Insured's allegations of a corrupt governmental role in the Foreign Enterprise's failure, it has failed to show how such actions directly caused its losses and that such actions were the preponderante cause of its losses. In the first example, the Insured refers to a sworn statement of the Foreign Enterprise's first president and asserts that unnamed personnel of the Foreign Enterprise had used the Foreign Enterprise's funds annually to pay bribe monies in the form of fictitious loans to NBG inspectors in order to obtain favorable CAMEL ratings in an effort to hide and unsound and insufficiently collateralized loans (Claim, at 4-5). It fails to identify such personnel and loans; it also fails how the extension of such loans was a preponderant cause of the Foreign Enterprise's failure. It then proceeds to suggest that the Insured was disabled from uncovering the extent of the fraud and malfeasance for lack of reliable CAMEL ratings, as if it had no other means to ensure the observance of financial, managerial and legal control over the Foreign Enterprise and its activities.

In the second example, the Insured relies on the same sworn statement to assert that the Interior Affairs Ministry declined to pursue or prosecute any persons associated with the fraud and malfeasance unless the Foreign Enterprise's officers agreed to pay bribe monies and relates the Insured's information and belief that the Interior Affairs Ministry did not pursue or prosecute such persons because at least some part of the embezzled funds were used to re-elect President Shevardnadze (Claim, at 6). In the course of our investigation of the matter, however, we have determined that the Interior Affairs Ministry did, in fact, open a criminal investigation of at least Mr. Mourgulia and his role in this matter, but exercised its discretion not to prosecute him because he and his associates had secured the return of $567,863 of the over $1 million embezzled from the Foreign Enterprise.

In any case, the Insured assumed the above risks at the time it made its investment.[22]

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[20] See Section III.A.2.
[21] Notes from telephone conversation with Louis Lloyd on March 29, 1995, taken by OPIC.
[22] "There can be no assurance that political, economic, social or other developments in Georgia . . . will not have a material adverse effect on the Bank." Business Plan, at 2 and 26.

Because the former argument is well documented and supported by the record, and the alternative argument lacks any compelling evidentiary basis, it is most likely that unreasonable actions of stockholders and officials such as Messrs. Shanidze and Mourgulia were the preponderant cause of the failure of the Foreign Enterprise. Thus the provocation exclusion pursuant to Section 4.03(a) of the amended Contract applies and the Insured's claim would not be payable even if the requirements of Section 4.01 of the Contract were deemed fulfilled.

b. The unreasonable actions are attributable to the Investor and would be the preponderant cause of the purported expropriation.

The Investor acted unreasonably through the negligent administration of its duties as the controlling shareholders of the Foreign Enterprise and thereby created the circumstances for the subsequent chain of illegal actions and mismanagement that ultimately led to the insolvency and liquidation of the Foreign Enterprise. For example, the GCC Report alleged that consulting payments purportedly made to law firms and other entities affiliated with certain U.S. shareholders[23] were veiled dividends, and that it was the policy of the Foreign Enterprise not to pay out dividends to any of the shareholders at that time. Furthermore, the GCC Report found that Mr. Leigh Durland instituted a change in the credit extension policy that was never approved by the Supervisory Board of the Foreign Enterprise. No General Meeting of Shareholders was convened from 1995 to 1996, and no financial statements were submitted for its approval from 1996 to 1998. Finally, the Insured knew or should have known that the Internal Affairs Ministry placed the Foreign Enterprise under investigation in November 1998. However, the Insured took no immediate action in response to the investigation.

The negligent mismanagement directly led to the permissive environment in which certain senior managers of the Foreign Enterprise and other shareholders defrauded and mismanaged the institution to the point of insolvency. Therefore, it may be concluded that negligent actions attributable to the Investor provoked the failure and liquidation of the Foreign Enterprise. The Insured's claim thus would not be payable under the Contract in even if the requirements of Section 4.01 of the Contract were deemed fulfilled.

2. Organizational Defects.

Section 4.03(c) of the amended Contract, as amended by section 10.04 of the same, also provides that no compensation for expropriation shall be payable if . . . "(c) the action is taken as a consequence of the failure of the foreign enterprise to comply with the organizational requirements of the foreign governing authority." The minimum capital requirement is a fundamental organizational requirement, because it promotes the safety and soundness of the financial sector.[24] Indeed, upon the Foreign Enterprise's formation and as a condition precedent to its registration by the NBG, it was necessary for the shareholders to capitalize the Foreign Enterprise in an amount sufficient to qualify as a bank or other financial institution subject to the NBG's regulation. It was

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[23] Although the GCC Report does not clearly associate a specific U.S. shareholder to any of these purported affiliates, it identifies them as Armlender & Associates, Baker & Botts, Befinance Security, Casey Inc., Hahn & Hessen, and Junction Investors.

[24] Malloy, Michael, "Colloquium: Can 10b-5 for the Banks? The Effect of An Antifraud Rule on the Regulation of Banks," *Fordham Law Review*, May 1993: 61 Fordham L. Rev. 23.

therefore necessary to comply with this requirement at the creation of this financial institution. In addition to the initial minimum capital requirement, financial sector regulators require that adequate amounts of capital be maintained after the inception of the institution; the amount required changes with the needs of the financial sector. Such flexibility underlies the fact that "regulatory emphasis on continuing capital adequacy requirements appears to provide a more effective method of monitoring the safety and soundness of depository institutions [than minimum capital requirements upon formation],"[25] and by extension, the financial sector.

In the Republic of Georgia, the NBG is empowered to establish for commercial banks the minimum amounts of subscribed and paid in capital stock and establish rules for the creation of unimpaired capital and reserves.[26] The NBG can also revoke the banking license of a bank that fails to comply with the minimum amount of capital and reserves required by regulation of the NBG.[27] Here, the Foreign Enterprise met the minimum capital requirement established by the NBG at its inception, evidenced by the successful registration of the Foreign Enterprise on January 27, 1994. However, it failed – despite repeated opportunities – to comply with the requirement as it evolved. As a result, the Foreign Enterprise became insolvent, was placed under temporary administration, and eventually was liquidated by the NBG. Had the Insured or other shareholders been willing or able to recapitalize the Foreign Enterprise in compliance with the minimum continuing capital requirements, it is unlikely that the Foreign Enterprise would have been placed under temporary administration and ultimately liquidated. Therefore, liquidation of the Foreign Enterprise by the NBG is explained in large part by the failure of the Foreign Enterprise to comply with the organizational requirements of the foreign governing authority. Consequently, the Insured's Claim would not be payable as it would be excluded pursuant to the provisions of section 4.03 of the amended Contract even if the requirements of Section 4.01 of the Contract were deemed fulfilled.

C. <u>Amount of Compensation.</u>

We note that the Insured has (i) failed to claim any amount of compensation, as it was required to do under Section 8.01 of the Contract, as amended; (ii) failed to provide financial statements for the period when the date of the purported expropriatory event was likely to have occurred; (iii) none of the financial statements provided by the Insured was prepared in accordance with U.S. generally accepted accounting principles; and (iv) no adjustments were made to the most recent financial statement, as required under Section 5.03 of the Contract, notwithstanding the findings of the KPMG forensic audit.

Under Section 1.06 of the Contract, the aggregate amount of compensation available to the Insured in the event of a finding of full expropriation is limited to the active amount of coverage. This active amount was originally established by the parties to the Contract at $1,710,000, but was reduced at the Insured's election, to $1,244,000, effective June 19, 1999, and then to $500,000, effective June 19, 2000. However, because we find no validity to the Claim, the Insured is not entitled to such compensation, and the aforementioned deficiencies in its Claim are moot.

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[25] *Id.* at 42.
[26] Art. 9, Commercial Banking Law of the Republic of Georgia.
[27] Art. 6(1)(c), Commercial Banking Law.

D. **<u>No procedural issues.</u>**

There are no procedural issues that require discussion in connection with this claim determination.

E. **<u>The Investor has complied with its duties under the Contract.</u>**

By finding no validity to the Claim, we need not address whether the Investors have complied with their duties under the Contract, including, but not limited, to adequate notice to OPIC of a potential claim for expropriation coverage.

V. <u>Conclusion</u>

Based upon the foregoing determinations, OPIC finds that the Claim lacks validity and that the Insured is not entitled to compensation.

OVERSEAS PRIVATE INVESTMENT CORPORATION

By: ______________________________
Peter S. Watson

Its: President and Chief Executive Officer

Date: 12/22/04