

“YOUR POWER PLANT OR YOUR LIFE”:
INVESTMENT INSURANCE AND THE HOLD-UP PROBLEM

A THESIS
SUBMITTED TO THE
STANFORD PROGRAM IN INTERNATIONAL LEGAL STUDIES
AT THE STANFORD LAW SCHOOL
STANFORD UNIVERSITY
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF
MASTER IN LEGAL STUDIES

BY

Brian Jose Miguel Quinn

May 2001

Abstract

Where there is law and a reliable legal system, parties can rely on the courts to enforce contractual obligations upon the parties when and if there is a dispute. In the absence of a reliable legal system, parties tend to find ways to adapt. In many types of transactions, reputation of the parties can be an important factor in determining whether and with whom one does business. Where parties cannot directly assess the reputation of counterparts, they often look to third parties, known to both parties, for a signal as to the credibility of the parties. Banks and financial institutions often play an important role as an intermediary for reputation. Having a good understanding of the reputation of players is critical to the ability of banks and financial institutions to ensuring repayment of their loans. While this is a natural role for these institutions, they are happy to be supplanted if they can be guaranteed repayment of their loans. Government sponsored export promotion programs provide insurance and guarantees to lenders, and thereby take up the responsibility to determine the reputations of parties to the transaction. Insurers and guarantors, however, are not particularly concerned with issues of reputation. Their motivations for providing insurance involve more than simply economic return; often their presence is dictated as much by political, social, diplomatic, and bureaucratic motivations as it is by the potential financial return of an investment. As a result, they tend not to convey valuable information about reputation and at the same time are unable to impose sanctions against defaulting countries. The result is an incentive for host governments to act opportunistically against privately financed infrastructure. Ultimately, transactions costs may dictate that the most durable approach to financing infrastructure in the developing economies where transactions costs are high remains the public financing through the international capital markets and not private investment. The experiences of power project in India, Indonesia and Pakistan are used to illustrate the risk structures and the influence of particular risk strategies on outcomes.

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