HERBERT SMITH FREEHILLS

HOW INVESTMENT TREATIES CAN PROTECT FOREIGN INVESTMENTS AGAINST STATE ACTION

Insight
Legal Briefings

In an increasingly fractious global trading environment, foreign investors can use all the help they can get. Enter investment treaties

PODCAST

Herbert Smith Freehills Podcasts · Navigating The Low Oil Price Environment EP2

Crude oil exporting countries are facing challenging times, with the energy markets on which they rely for their export revenues in turmoil. For many of these countries, an enduring low oil price will lead to difficulty balancing the national budget, and deplete foreign currency reserves. Moreover, the hardest hit may well be those countries already beset by other issues, such as political instability, security concerns and corruption.

Collapsing oil prices can precipitate significant political change. Algeria offers a classic example – plunging oil prices in the 1980s preceded an economic crisis, drastic austerity measures in order to keep servicing foreign debt, political unrest, and ultimately, a civil war. Algeria faces this latest fall in the price of crude after over a year of protests pushing for political reform and it is certainly not the only oil exporting nation in which the stability of the political environment is already fragile.

There is an obvious link between oil exporting countries and inward FDI. Not only are international oil companies (**IOCs**) engaged in long term exploration and production ventures, oil revenues regularly fund other capital-intensive State projects (such as infrastructure or telecoms), which projects are often supported by foreign investment. As States react to the low oil price, including by addressing the ensuing economic and/or political fall-out, it is almost inevitable that foreign investors will be impacted.

As discussed in our podcast here, IOCs will look to contractual protections to the extent that the State is a party to those contracts. However, foreign investors faced with State action undermining their investment may also consider recourse under international law, through the protections contained in investment treaties.

Investment treaties are agreements between two or more States containing reciprocal undertakings for the promotion and protection of private investments made by nationals of the State signatories in each other's territories. Such agreements have historically been entered into to provide confidence to foreign investors that their investment will not be negatively affected by certain types of irregular action by the State hosting the investment (the "host" State) and that if it is, to enable the investor to claim damages. Most commonly, these are bilateral arrangements (called bilateral investment treaties, or BITs), multilateral treaties or free trade agreements containing investment protections. The protections offered by investment treaties can be enforced against the host State by investors of the other State, usually by international arbitration.

Each treaty must be considered on its terms but they commonly include the following investment protections:

- a protection against the unlawful expropriation of an investment without adequate compensation, whether directly or indirectly through a series of governmental acts which encroach on an investment and result in it being deprived of value;

- the guarantee of fair and equitable treatment (or FET), which is recognised to protect investors from the arbitrary or discriminatory exercise by the host State of its regulatory power, procedural unfairness or lack of due process, bad faith, or a failure to protect an investor's legitimate expectations as to how they will be treated. Stabilisation clauses - often found in oil-related contracts with the State and discussed in our previous podcast here – can be highly relevant in respect of this latter aspect of the FET guarantee;

- a guarantee of full protection and security for the investment and for the investor, which is generally understood to concern physical protection of the investment by the State but has been found to encompass legal protection;

- guarantees of treatment no less favourable than that given either to nationals of the host State of the investment or to nationals of third States, which prevent the host State discriminating against the foreign investor;

- a so-called "umbrella clause", which can have the effect of bringing other obligations of the State entered into in connection with an investment under the scope of the protections of the BIT; and

- the right to repatriate profit and capital.

So, how may States react to the drop in oil price, and how may an investment treaty be relevant to foreign investors in both oil and other sectors?

States under pressure to maintain a certain level of revenue from oil may seek to increase State take. This may be by way of an express review or forced renegotiation of petroleum contracts to increase government share, or by increasing taxes or using other fiscal instruments (such as levies, corporate income taxes, profit taxes, resource rent taxes, or value-added taxes). More general tax rises to compensate from loss of oil export revenue may of course impact foreign investment outside of the oil industry. Whilst investment treaties regularly contain provisions which preserve the State's right to impose taxation, in certain circumstances such actions have nonetheless previously been found to constitute an indirect expropriation of an investment, and to violate an investor's legitimate expectations, breaching the guarantee of fair and equitable treatment. Where the State fails to comply with contractual obligations in connection with the investment, an umbrella clause may also be relevant in bringing those actions within the scope of protection of the investment treaty.

Depending on the State's exposure to low oil prices in the context of its contracts with IOCs, pressure may be brought to bear on the IOC to renegotiate those contracts, compelling the IOC to shoulder more of the risk. Investors in a joint venture or other collaborative relationship with a national oil company (**NOC**), may face increasing interference from the State in the management of the NOC, which impacts on contractual performance of the NOC and ultimately on the investment. Again, depending on the circumstances, such State interference may constitute a breach of the IOC's treaty rights. Moreover, it is possible that actions of the NOC itself could be attributed to the State and therefore, depending on the circumstances, constitute a breach of a treaty.

States may also take extreme measures to try to address an impending or worsening financial crisis. When faced with similar circumstances, States have voluntarily depreciated currency, imposed *de facto* capital controls by way of the freezing of certain banking activity, and forced currency conversions. Such measures could constitute, for example, an expropriation and/or a breach of free transfer/repatriation of profits protections. Leaving aside such immediate measures, the destabilising effect of another oil price crash could give rise to widespread economic and political reform in a number of oil-exporting countries, changing the investment environment, impacting foreign investment in a number of ways, and raising many questions around the consistency of such actions with the State's treaty obligations.

Further, as has been previously witnessed, a low oil price environment could lead or contribute to deteriorating security conditions, increased insurgency, civil unrest or disruption. If this impacts on foreign investment (whether or not directly connected to the oil industry), the full protection and security standard may be relevant.

Investment treaty claims are highly fact- and treaty-specific, but for foreign investors impacted by State action in the context of oil price turmoil, it is certainly worth considering whether treaty-based remedies can offer some recourse.

Navigating the low price oil environment

SHARE

Share to Facebook Share to Twitter Share to LinkedIn Email Print

Show Share Links

RELATED TOPICS

Public Policy & International Trade

FEATURED INSIGHTS

FEATURED INSIGHTS

HELPING YOU STAY AHEAD OF THE BIG ISSUES

BROWSE BY:

- TECH, DIGITAL & DATA

- GEOPOLITICS AND BUSINESS

- NEW BUSINESS LANDSCAPE

RELATED ARTICLES

UPDATED: UK NATIONAL SECURITY ACT 2021 - WHAT INVESTORS NEED TO KNOW

Foreign investment: Rising tides of politics in regulation

Comply or Explain to climate-related reporting – A cross-industry roadmap

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

ANDREW CANNON
PARTNER, LONDON

+44 20 7466 2852
Andrew.Cannon@hsf.com

LAURENCE FRANC-MENGET
PARTNER, PARIS

+33 1 53 57 73 70
laurence.franc-menget@hsf.com

HANNAH AMBROSE
SENIOR ASSOCIATE, LONDON
+44 20 7466 7585
Hannah.Ambrose@hsf.com

© HERBERT SMITH FREEHILLS LLP 2022