CAREFUL CONSIDERATION - MANUFACTURING TODAY

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Legal Briefings – By **Nicholas Peacock, Jerome Temme and Olga Dementyeva**

Dealing with political risk in the manufacturing business; or how to protect your cross-border investment.

Growth in emerging markets, fuelled by rising affluence and increased consumer spending, is creating on-going new demand in the manufacturing sector. However, with opportunity comes risk. Commitments to long-term projects and in-country manufacture mean putting your investment, facilities and personnel into new and challenging environments. In addition to standard commercial risks (such as a cargo making it from A to B), expanding into new markets can mean exposure to unwelcome 'political risk', ie changes to the legal or political environment, such as nationalisation or civil unrest. Such changes may threaten the smooth functioning, profitability, and sometimes the very existence of the investment.

There are various ways of dealing with political risk. Protective provisions can be agreed in contracts with the local government promising that the legal environment for the investor will remain stable. Alternatively, investors can obtain political risk insurance. This article focuses on how you can maximise protection from political risk by structuring or restructuring your foreign investment in the most beneficial way to make use of international treaty protection.

WHAT KIND OF POLITICAL RISK DO FOREIGN INVESTORS IN THE MANUFACTURING SECTOR FACE?

Risks connected with doing business in a particular country, which are usually linked to a change in the political climate, are generally referred to as 'political risk', and may include a change in the country's legal or regulatory environment, which render the investment unprofitable or impossible to carry out. Examples include the local government's interference in the investment realisation (eg, a failure to make payments under contracts), a change in the fiscal environment and, in more extreme circumstances, nationalisation.

Recent years have made all too clear that few countries are immune to seismic shifts in their legal and political environment. Venezuela is a stark example. Despite having been a prosperous country in the past, and despite holding vast oil and gas reserves, the country has experienced an investment exodus, with various international manufacturers fleeing Venezuela following economic and social deterioration, protracted court proceedings and continuing political uncertainty. Political risk can, however, also arise when governments take seemingly less dramatic measures; a few years ago, Slovakia changed its constitution allegedly in order to prevent a Polish investor from bottling Slovakia-drilled mineral water in Poland.

HOW CAN CROSS-BORDER MANUFACTURERS PROTECT THEIR INVESTMENT FROM POLITICAL RISK?

As an investor you can seek direct assurances from the government of the state where the investment is made. You can also rely on the state's investment law to protect your interests, or on political risk insurance to get compensation. In addition, investors in the manufacturing sector should consider whether their proposed or existing investment structure allows them to take full advantage of any international investment treaties.

There are investment treaties between groups of states, but most commonly investment treaties are between two states (aka, 'bilateral investment treaties'). In these treaties, the signatory states promise to encourage and protect investors coming from the other state(s). This is intended to promote investment between the two countries by offering foreign investors a degree of comfort as to how they and their investments will be treated, including the prospect of receiving compensation in case something goes wrong.

Some of the typical protections contained in such treaties include promises that (a) there will be no arbitrary expropriation of the manufacturing facilities and that an investor will receive compensation if an asset is nationalised or seized by the state, (b) the investor and its investment will be treated 'fairly', orc) the foreign investor will not be treated less favourably than the state's own nationals in the same position.

Where actions by local governments or other state organs harm an investment, investors can generally seek compensation from the government in local courts. However, it may not be possible to receive meaningful (and timely) compensation from public bodies in the local courts, which might not be perceived to be entirely independent from the government. Investment treaties allow investors to bring claims before international arbitration tribunals directly against the state in which the investment is made. Although this will usually be a last resort, the ability to seek an order from an international tribunal that a host state desist from a harmful act, or alternatively pay compensation if the value of the investment is damaged or lost, is a meaningful remedy that should be preserved wherever possible.

HOW TO STRUCTURE (OR RESTRUCTURE) YOUR FOREIGN INVESTMENT?

When you are considering the best structure to invest in cross-border manufacturing facilities (or re-structure the already existing foreign investment), economic, tax, regulatory and other strategic considerations regarding the investment environment might remain determinative. But in addition to that, your business should consider the investment treaty protections that may be available to you, depending on the jurisdiction from which the cross-border investment is planned to be made.

Investment treaties exist between many countries in the world, but not between all countries; in addition, some treaties are more favourable to investors than others. The nationality of the investing entity will be essential, as investors can rely on treaties which are concluded between the state in which their investing entity (or potentially its parent company) is incorporated and the state in which the investment is made.

Investments in the manufacturing sector are often capital-intensive and the decision to build manufacturing capacity in a foreign country will require a commitment for many years. When political risk turns into a threat for your investment, it is often impossible to restructure, withdraw your investment or exit the country. Managing the risk, for example through investment treaty protection, will therefore be crucial.

KEY TAKE-AWAY

Where available, treaty protection should be part of the early planning for any major cross-border project or investment. As global supply chains and cross-border manufacture increase, and in view of the volatile political landscape, the need to give sophisticated consideration to mitigating legal and political risk is essential.

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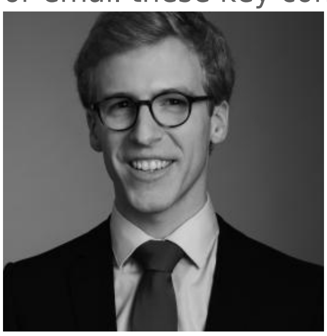
KEY CONTACTS

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



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