INVESTMENT PROTECTION: PROTECTING INVESTMENTS IN A VOLATILE WORLD

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Legal Briefings – By **Christian Leathley, Partner**

Christian Leathley discusses the ways in which investors can pre-empt and plan for changes in the political landscape and minimise the impact on their investments and risk to their reputation. He draws on current trends in terms of contractual protections and key issues for investors in a new era of transparency. He also considers how host states can manage their investment relationships and their obligations to govern effectively against the backdrop of their international law commitments.

The last couple of decades have seen unprecedented growth in foreign direct investment. Economies which have historically been closed to foreign investors have opened their doors, adopting more liberal investment policies. Countries seek exploitation of their natural resources to fund the development of their broader economy, and across the world, development continues apace to provide and improve essential services such as power and telecommunications.

As reported by UNCTAD in their Global Investment Trends Monitor in January of last year, in 2014 developing economies saw their FDI reaching a new high of more than US$700 billion, 4% higher than 2013, with a global share of 56%. A considerable volume of FDI is into countries in which good governance is in its infancy, the rule of law is not always enforced, and/or an effective regulatory framework is developing. The investment may be into a disputed territory or an area that is in the process of geo-political change. Even where an investment is made in a relatively stable political democracy, the Arab Spring and the EU sovereign debt crisis are just two examples from the past few years that show situations can change rapidly. Further, and impacted by changes in the political and financial landscape, in parts of the world resource nationalism has been on the rise.

“ THE POLITICAL AND REPUTATIONAL RISKS IN INVESTING IN DISPUTED TERRITORY ARE SIGNIFICANT. THESE MAY IMPACT ACROSS AN INVESTOR’S GLOBAL OPERATIONS…”

No investor can completely insulate investment from these kinds of changes, and pricing of country risk will remain an integral component in deciding whether to make an investment. Our experience has shown that the way in which an investor can best position themselves is to factor in investment protection across the life-cycle of an investment, from its very early stages until a project is completed or an investment divested.

DISPUTED TERRITORIES AND POLITICAL FLUX

Some of the world’s most resource-rich areas are subject to boundary disputes and savvy investors seek advice on the implications of such disputes from the beginning of their decision to invest. Disputes as to sovereignty over a particular region or territory have legal ramifications. For example, there may be uncertainty as to whether the government that claims to grant rights is legally able to do so and making the investment may put an investor at risk of actions against it, for example, for aiding and abetting a breach of international law or for being complicit in alleged human rights violations committed by organs of the host state associated with the investment.

The political and reputational risks in investing in disputed territory are significant. These may impact across an investor’s global operations – for example, it may affect relationships with other governments who take an official or unofficial stance on the disputed territory, corporate partnerships in other projects, and access to finance. There may also be global pressure from protest groups or shareholder criticism for making the investment.

The complex considerations for companies wishing to do business in disputed territory are beyond the scope of this article but will be discussed in more detail in the next issue of Inside Arbitration.

PLAYING THE LONG GAME: DOMESTIC LAW, CONTRACTUAL PROTECTIONS, AND FORWARD-THINKING INVESTMENT STRUCTURING

An investor can take steps to create as consistent, predictable and transparent a legal backdrop for itself as possible before making its investment. This can be done on a number of levels – by understanding the domestic legal framework, negotiating appropriate contractual protections, and by structuring the investment so that the investor may benefit from international law protections. However, what is equally important is for the investor to lay the groundwork from the outset for taking advantage of these protections should there be a dispute later. This strategy is explained further below.

Turning to the layers of protection, first there may be domestic laws that can help an investor's position. Many countries, particularly those that are seeking to attract FDI, have an investment code or investment law which contains a number of protections or guarantees about the legal treatment of investments made in the territory. Fundamental to weighing the benefits of the protections offered by an investment code is the way in which those protections can or must be enforced. An investment code may provide for a choice of dispute resolution fora, including arbitration under the ICSID Rules. This puts investors in a stronger position as they can look to a neutral forum outside the territory of the host state to resolve disputes. However, the protections offered are less attractive if the code can only be enforced in the domestic courts in the territory of the investment. The courts may not be independent of the host state government, may be slow or inexperienced, and arbitrary application of the code could be a risk.

Investors will also look to contractual protections. In particular, stabilisation clauses can be very important for an investor. Stabilisation clauses may take a number of different forms and investors must consider carefully the type, likely effect and enforceability of a stabilisation clause, and the potential remedies for breach by the host state.

The current trend on the investor-side is towards so-called “economic equilibrium” clauses, which focus on stabilising the economic return on the investment, as opposed to traditional stabilisation clauses, which freeze the legal or regulatory framework.

With the former, the host state is not fettered in its ability to change the regulatory landscape of the investment but any such change will trigger a recalibration of the economic balance of the contract and/or a right to compensation. As such clauses interfere the least with the state’s right to legislate, there is less perceived risk of the clause been struck down as unenforceable under domestic or international law.

It is also important that contracts with the host state – including joint venture agreements with state-owned joint venture partners – provide, where possible, for dispute resolution outside the host state. While the investor might prefer for disputes to be resolved in the courts of a country in which the courts are well-developed and uphold the rule of law, in practice, a host state is unlikely to agree to resolution of disputes in the investor’s home courts or even in the courts of a neutral third country. As a consequence, arbitration clauses are increasingly favoured by both investors and states, as they offer a neutral and independent forum for the resolution of disputes. An investor in particular will often favour arbitration due to the relative ease of enforcement of an arbitral award under the New York Convention regime. Investors may push for resolution of disputes under their contracts with the host state at the International Centre for the Settlement of Investment Disputes, but may also accept institutional or ad hoc arbitration.

“INVESTMENT TREATIES THEREFORE PROVIDE AN IMPORTANT ‘LONG STOP’ FOR INVESTORS WHO CAN RELY ON THEM SHOULD THERE BE CHANGES IN POLITICAL POLICIES, REGULATORY FRAMEWORK OR ADDITIONAL RESTRICTIONS IMPOSED ...”

Many investors are aware of bilateral and multilateral investment treaties and other international agreements (either regional or sectoral) between states in which those states offer investors of the other state international law protections such as compensation for expropriation of an investment and a guarantee of fair and equitable treatment. An investor can sue the host state directly for breach of these standards. Investment treaties therefore provide an important “long stop” for investors who can rely on them should there be, for example, changes in political policies, the regulatory framework for the investment, or additional restrictions imposed on the investment which affect its economic viability. When making an investment, many investors focus solely on ensuring the best investment structure for tax reasons, but it is often possible to marry tax advice with investment protection structuring to take advantage of treaty protection for the future.

Structuring of investments to take advantage of these treaty-based investment protections is a key part of protection planning. However, it is also important that an investor think through the likely basis of any future treaty-based claims and how it would establish those claims. In many cases brought against host states under investment treaties, an investor seeks to establish that the state has failed to meet expectations held by the investor as to the future treatment of its investment (known as “legitimate expectations”) and has therefore failed to treat it fairly and equitably. The foundation for those legitimate expectations will be the words or conduct of the host state. The host state’s commitments to the investor may be communicated through assurances of a minister or other official and the way in which the investor can evidence those communications, what it understood by them, and how it relied on them, will be important. An investor should make sure that its expectations, and, importantly, what has led to them, are clearly and contemporaneously documented – this may be in correspondence or internal memoranda but, if possible, the investor may be able to achieve contractual recognition of the host state’s promises.

“ PROACTIVELY SEEKING LEGAL ADVICE IN FLUCTUATING POLITICAL CIRCUMSTANCES WILL PUT AN INVESTOR IN THE BEST POSITION TO MITIGATE EMERGING RISK”

DEALING WITH CHANGES IN THE POLITICAL LANDSCAPE

Political change that affects an investment rarely occurs out of the blue and an investor often feels the wind of change before any significant host state action is taken which directly impacts the investment. An investor needs to maintain a dialogue with the host state as to its intended actions and the potential consequences, as well as seeking to protect its investment.

Proactively seeking legal advice in fluctuating political circumstances will put an investor in the best position to mitigate emerging risk.

For example, where there are potential state succession issues, strategic advice on an ongoing basis can help an investor identify, understand and plan for implications to their business associated with changes in government and clashing constitutional or regulatory regimes. For investors who have not considered investment treaty protection when making their investment, these very early rumblings of changes to regulatory policy or political change may offer an opportunity for the investor to restructure its investment through other entities to improve its treaty protection. There is a careful balance to be struck here – investment arbitration tribunals have not accepted jurisdiction in cases in which “abusive” re-structuring has taken place after a dispute with a host state has arisen with the purpose of obtaining the protection of an investment treaty. However, investors who have acted quickly in restructuring investments when very early signs of political change have arisen have been able to take advantage of the protections of an investment treaty. Whether this is achievable in practical terms will depend on the size and nature of the investor’s organisation. An investor is in a stronger position if there are strong lines of communication between the operational staff in country, who are most likely to be the first aware of the stirrings of change, and those who are in a position to recognise the potential for restructuring the investment to take advantage of treaty protections.

Similarly, a host state can reap the benefits of engaging investment treaty arbitration specialists at an early stage in both its dealings with potential investors, and, once an investment has been made, in its regulatory decision-making. Bilateral and multilateral investment treaties do not, in themselves, preclude a state from regulating. However, a host state can mitigate the risk of claims thereunder, both in terms of the way in which it deals with prospective investors (for example, by way of express limits placed on the expectations which investors should derive from tender invitations), and in making sure that it regulates and manages relationships with investors in an appropriate way, conscious of the international law obligations it owes.

“THE CURRENT TREND ON THE INVESTOR-SIDE IS TOWARDS SO-CALLED ‘ECONOMIC EQUILIBRIUM’ CLAUSES ...”

DISPUTE RESOLUTION AND REPUTATIONAL RISK

In the event that a host government takes action which negatively affects the investment, the investor's reactions can be crucial to both their legal case and their reputation. On a practical level, an investor who is removed from its operations needs to consider how to secure evidence that may have been left behind, as well as protecting its assets and its staff. Quick and responsive legal advice is essential to take necessary steps to get interim relief where possible. Reputational risk, both in the host state and beyond, may be significant and an investor's counsel must work closely with its communications advisers to ensure that legal and reputational positioning is consistent. In an era of increasing transparency in resolution of investor-state disputes, it will be important to understand the extent to which information relevant to the dispute will be publicly accessible. Further, legal counsel must be sensitive to the reputational risks of investor-state dispute settlement for the investor, including by "testing" their arguments against the investor's CSR and business and human rights policies to identify and minimise any potential perceived inconsistencies.

COUNSEL CHOICES FOR INVESTMENT PROTECTION ISSUES

Investment protection issues largely concern domestic host state law and international law rights and obligations. Given the focus on international law, experience in this legal field is highly transferable between regions, although in some cases, language skills and in-depth political and cultural knowledge can be an advantage. In all cases, it is undoubtedly advisable to engage a versatile and experienced specialist investment treaty counsel, who can see the position from both an investor and state perspective, no matter for which party they are acting. As explained above, early engagement can offer a legal and strategic advantage, assisting both investors and states to keep on top of their rights and obligations.

WHY HERBERT SMITH FREEHILLS

Our investment protection and treaty arbitration team can stand shoulder to shoulder with you throughout your investment, providing strategic advice to protect and assist you throughout the life cycle of your investment, not only after a dispute arises. Unlike many other firms, we advise not only private investors, but also governments. This gives us an advantage in our practice as we understand the demands and needs of both type of clients; as a practice, we are versatile and tailor our support to our client's needs. Further, the exposure that we have gained acting for both investors and states provides us with the ability to see every angle of an issue.

> " A broad PIL practice encompassing boundary disputes, treaty interpretation, investment treaty arbitration and sovereign immunity expertise. Benefits from an extensive network of offices, with dedicated PIL experts active across Europe and Asia, in New York, and more recently Australia and South Korea"
> **BAND 1, CHAMBERS GLOBAL 2015**

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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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