

Protecting foreign investment from political risk

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International law permits countries to exercise complete control over persons and property within jurisdictional reach. Given this rule many investors are surprised to learn that tools for managing governmental risk can be inexpensively incorporated into acquisition plans for potentially exposed assets.

This note reviews the use of investment protection agreements to reduce risks to assets posed by rogue governments. These treaties are the key asset protection strategy for international investment in emerging markets.

Investment protection agreements

The world has approximately 2,500 investment protection agreements designed to safeguard the rights of cross-border investors against capricious government interference. Emerging market countries in Latin America, Eastern Europe, Asia and Africa – the main risk areas – generally participate actively in the treaty networks.

Bilateral investment protection agreements restrain, in reciprocal undertakings, government actions which prejudice the rights of protected investors through the exercise of governmental powers in an arbitrary fashion.

The treaties establish conduct and process standards for treatment of foreign investors with explicitly enumerated protections for covered nationals. Where the protections for invested assets are not observed foreign investors can arbitrate against the host contracting state and secure enforceable compensation.

Investment protection agreements are mechanically similar to tax treaties. They are negotiated and concluded on a government-to-government basis, conferring direct benefit on private sector parties. Investors established in a country lacking an investment protection treaty with the target investment state can also benefit by structuring indirectly through a country which enjoys treaty protection.

Investment protection treaties follow a general pattern though they vary in subtle but significant respects. Selection of the most favourable treaty will depend on a number of factors, including:

- > treaty definitions and restrictions, including those in any ancillary agreements or protocols between the governmental parties;
- > availability of most favoured nation protections and the implications under related agreements;
- > tax planning considerations in the contemplated investment structure;
- > availability of treaty protections where the protected investor holds the target assets indirectly; and
- > prescribed formalities in the arbitral and compensation process, including compliance with pre-conditions in asserting claims.

This newsletter was prepared by members of the Investment Funds Group and Corporate Finance and Securities Group at Stikeman Elliott.

Available protections

Compensation rights under investment agreements arise in the event of:

- > discriminatory expropriation;
- > forced sale of property to the government at an undervalue;
- > government imposition of foreign exchange controls inhibiting extraction of profits or proceeds;
- > licence cancellations or alterations to government concessions without due process; and
- > interference covered by expanded protections under "most favoured nation" provisions.

Dispute resolution

Arbitrations are organised under the auspices of an international tribunal, generally under UN rules or those of the International Centre for Settlement of Investment Disputes (ICSID) supported by the World Bank. Investors are able to pursue claims directly against the host jurisdiction in the event of breach without the requirement for intervention or support by their home country government. Conduct of the arbitration and enforcement process takes place entirely outside the host jurisdiction for the investment.

Arbitration under an investment treaty is expensive and time consuming and accordingly is most appealing when the investment is substantial. However, a claim to such treaty protection is always a valuable bargaining chip in any negotiation and often leads to favourable settlement without the need to litigate.

Enforcement

Compensation awarded by the arbitral tribunal is generally enforceable against the commercial assets of the defaulting government in more than 160 countries worldwide pursuant to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Arbitration and enforcement rights are typically unaffected by cancellation of a treaty after rights have accrued. Specific performance rights are unusual but are occasionally available.

Commercial applications for investment protection treaties

A number of claims have been brought recently in the Latin American context, in particular, in Venezuela, Argentina and Bolivia.

This planning is particularly attractive for assets prone to government interference such as natural resources, infrastructure and real estate. In today's risk averse environment investment protection agreements are also increasingly attractive to protect pension and mutual fund investments. Protection under investment treaties is generally inexpensive to implement and does not involve the ongoing costs required to maintain insurance cover.

Using these treaties, political risk can often be effectively reduced in a discreet fashion, leaving investors free to concentrate on the commercial attractions of proposed foreign investment.

For further information please contact your Stikeman Elliott representative, the authors listed above or any member of our Investment Funds Group and Corporate Finance and Securities Group listed at www.stikeman.com

CANADIAN TREATIES

Canada has more than twenty treaties, referred to as "foreign investment protection agreements (FIPAs)" in Canadian parlance. Canada is actively pursuing FIPA negotiations to expand its treaty network and in particular, has concluded negotiations with India. In a further sign of commitment Canada has also signed (ratification pending) the ICSID Convention.

Canadian Investment Protection Treaties

Argentina
Armenia
Barbados
Costa Rica
Croatia
Czech Republic
Ecuador
Egypt
Hungary
Latvia
Lebanon
Panama
Peru
Philippines
Poland
Romania
Russian Federation
Slovak Republic
Thailand
Trinidad and Tobago
Ukraine
Uruguay
Venezuela