COVID-19 and record oil price volatility are likely to increase political risk for investments in emerging markets. This will be the result of recessions and strains on government finances worldwide, made worse in oil producing countries by plunging revenues and the possibility in some states of resulting political instability. Therefore, there is no better time for investors to consider how they can manage political risk. Among the various tools available, there is one that is often overlooked but which can be highly effective. It is also free.

Investors can obtain political risk protection for international investments if they structure to take advantage of investment treaties. If a host state expropriates, discriminates, or acts contrary to investors’ legitimate expectations, then treaties may give investors the right to compensation. This has real value in reducing the risk of problems emerging in the first place and in providing a platform for agreed resolution. If compensation cannot be agreed, then investors may have the right to bring claims in international arbitration proceedings; to date, there have been almost 1,000 investor-state arbitrations, most of these involving investments in emerging markets. Where claims succeed, there are limited grounds for states to challenge arbitral awards or resist enforcement, and it is often possible to enforce against the debtor state’s commercial assets located in other jurisdictions.

However, to obtain these benefits, investments must be structured at the outset to take advantage of investment treaties.

What are investment treaties?

There are over 2,600 bilateral and multilateral investment treaties currently in force. These are treaties between two or more states, which provide private-sector investors from one state that invest into another participating state with the benefit of legally enforceable protections. The great majority of emerging market countries are party to several such treaties.

What protections are available?

Protections typically include: (i) a prohibition against expropriation of an investment by a host state without paying adequate compensation; (ii) a prohibition against discrimination against an investor or investment; (iii) a requirement that the host state accord “fair and equitable treatment” to covered investments, which includes the obligation not to act contrary to investors’ legitimate expectations and not to deny justice to investors. If the host state breaches these obligations, then the investor may be
able to bring an international arbitration claim before a neutral tribunal to recover the losses it has suffered as a result. Often, merely the threat of such a claim may enable the investor to seek a negotiated resolution.

Investors in all sectors are able to benefit from the protections of these treaties. Although the many investor-state arbitrations have related to natural resources or other tangible assets, recent tribunal decisions have made clear that investors in financial services, intellectual property, and other intangible assets are also protected.

Protection against changes in government policy

Recent decisions have extended the “fair and equitable treatment” standard to provide a degree of protection against changes in government policy.

Many of the sectors in which private equity investors may consider investing or have already invested are subject to changes in the political and regulatory environment, which can increase the riskiness of the investment. Although countries are naturally permitted to change their laws and policies, in recent cases tribunals have been increasingly willing to find that investors had legitimate expectations that certain regulatory environments would persist, particularly if policies and laws were designed to incentivize investments, and then were changed.

In recent years, investors have seen this play out in the renewables sector, where regulatory changes in several jurisdictions have given rise to numerous claims. The obvious example is Spain, in relation to the policies it introduced in 2007 in order to stimulate investment in the renewables sector. These policies provided that energy produced by registered generators commissioned by 1 January 2012 could be sold to the network for a regulated feed-in tariff (FIT) for the lifetime of the installation. However, a series of new measures enacted between 2012 and 2014 changed the earlier regime, setting a lower FIT for all generators, including those covered by the 2007 legislation. Some investors alleged that the new regime reduced their FIT by around 70%.

Over 50 investor-state claims against Spain have been initiated in relation to these reforms. Of these, fifteen have so far resulted in awards in favor of the investor, while only three have been decided in favor of the state. The awards against Spain have been significant, totaling at least EUR900m. In addition, the pending claims against Spain total approximately USD7.3b.

Several private equity investors are among the claimants in the Spanish solar cases – for example, UK private equity firm Eisner Infrastructure Limited obtained an award in 2017 for EUR128m, and a subsidiary of UK-based Infrared Capital claimed approximately EUR75.7m in damages and obtained an award against Spain in August 2019. US private equity firm First Reserve obtained an award in May 2019 against Spain of EUR41.8m.

The numerous claims and awards against Spain appear to have incentivized the country to change the law – in November 2019, the Spanish Council of Ministers approved a Royal Decree which would restore the FIT to the rate that investors had previously expected until 2031. Those investors who had initiated claims against Spain would only be able to benefit from this if they withdrew their claims by September 30, 2020. It remains to be seen how effective this legislation has been and how many investors decided to drop their claims, but
several new claims have been initiated against Spain since the Royal Decree.

How can investors obtain treaty protection?

In order to benefit from the protection of an investment treaty, an investor needs to show that it has a qualifying investment. Some treaties define investment more broadly than others, but typically an investment needs to involve (i) a contribution of money or assets; (ii) be of a certain duration; and (iii) involve an element of risk. Most treaties allow investments to be held directly or indirectly, and so the structure of private equity holdings may allow for a choice of multiple investment treaties. Otherwise, obtaining the benefits of a treaty may be as simple as structuring the investment through a holding company in a jurisdiction which has a treaty with the host state. Clearly, private equity investors have numerous considerations when structuring an investment – not least tax efficiency - but it is worth adding investment treaties to the list. Some jurisdictions which are commonly used for holding investments are also signatories to numerous investment treaties, such as the Netherlands (party to over 80 treaties) and Luxembourg (over 70 treaties). On the other hand, certain offshore jurisdictions may not be the best choices for treaty protections. For example, the Cayman Islands is not a party to any investment treaties and has the benefits of only three of the United Kingdom’s BITs extended to it.

However, it is important to seek legal advice at the structuring stage because the terms of potential treaties must be examined carefully and some treaties contain more stringent requirements for investments. Additionally, some treaties include defenses for host countries such as a “denial of benefits” provision, which permits host states to deny the benefits of a treaty to claimants which have no substantial business activities in the jurisdiction and are owned or controlled by a party in a third country, thus ruling out protections for shell companies.

Arbitration

Many states are, to a greater or lesser extent, concerned to avoid investor-state arbitrations and the damage these may cause to investor sentiment. Therefore, it is common for the implicit threat of arbitration to be used as leverage to try to resolve investment disputes. If that fails, then most treaties require that once a notice of dispute is filed then the investor and state must engage in discussions to seek a resolution. The ultimate option is the commencement of arbitration proceedings.

Arbitration has the benefit of being a neutral process that is independent of national courts. Typically, each side appoints their own choice of arbitrator, and the two party-appointed arbitrators select a third.

Investor-state arbitration can be a lengthy and expensive process, typically taking three to four years to complete. However, in recent years, there has been a growing availability of third-party funding that can enable investors to pursue arbitration without incurring cost. Typically, third-party funders pay the claimant’s costs in return for receiving a multiple of those costs back if the case succeeds and proceeds are recovered from the state respondent. Alternatively, sometimes the funder may receive a percentage of any proceeds up to a cap. Anecdotal evidence suggests that the majority of new investor-state arbitrations now have third-party funding.

Case Studies
There are numerous instances of investors successfully bringing investor-state arbitrations.

Perhaps the highest profile example to date is the claim brought against Russia by Dutch former shareholders of the oil company Yukos. The claim was brought under the Energy Charter Treaty (a multilateral investment treaty) and alleged that Russia had wrongfully expropriated the company without paying compensation. The arbitral tribunal at the Permanent Court of Arbitration in The Hague awarded the investors USD50b in damages, a decision that in February 2020 was upheld by the Hague Court of Appeal.

However, treaty arbitration claims are often brought for much smaller amounts. For example, a Hong Kong investor brought a claim against Peru under the China-Peru Bilateral Investment Treaty in relation to a tax audit and subsequent seizing of the investor’s assets in that jurisdiction. The arbitral tribunal found that the tax enforcement measures were so arbitrary and onerous that they amounted to a de facto expropriation of the claimant’s investments, and awarded USD786,000 damages. In another recent case, an investor successfully brought a claim against Egypt for expropriation of real estate, with the tribunal awarding USD127m in damages.

Enforcement of awards

Succeeding in arbitration is of course pyrrhic unless the award can be enforced. Investors are often skeptical that host states will voluntarily pay awards or that their home courts will enable enforcement. However, arbitration awards can in principle be recognized and enforced in third party states under one of three international treaties for the recognition and enforcement of arbitral awards, usually subject only to limited grounds for challenge.

The real difficulty is often more practical. Under most systems of law, a state’s assets are available for execution only if they are commercial assets. Therefore, sometimes an award creditor is obliged to undertake an international search for commercial assets belonging to the state debtor against which it can enforce. For example, in May 2020 the successful claimants in the Yukos arbitration discussed above seized the well-known Stolichnaya and Moskovskaya vodka trademarks owned by Russia in the Netherlands.

Structure investments to obtain protection

In the current environment, now is the time for investors to consider structuring new investments to take advantage of investment treaties. Additionally, it may not be too late to re-structure existing investments to benefit from treaty protection.

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