Clifford Chance

Thought leadership

Managing political risk in a volatile world

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Key takeaways

1. Whether a company is relying on national laws, direct agreements or investment treaties for protection, enforceable dispute resolution mechanisms are key, with recourse to international arbitration preferred.
2. Political risk insurance (PRI) can guard against an array of real and present risks, but insureds should review their insurance programmes holistically and may also need to look to other forms of insurance for certain risks.
3. PRI and other forms of protection can work hand-in-hand, but it's important that all obligations are understood at the structuring stage rather than when it comes to making a claim.

A backdrop of conflicts, continued resource nationalism, as well as significant and sudden policy changes in countries previously considered safe and stable, means businesses face an array of risks when conducting business across borders, from expropriation of assets to trade disruption and war. In this briefing we look at how companies can protect themselves when they invest overseas.

The four main methods for managing political risks are:

1. **National investment laws:** laws in the host country that regulate foreign investment but may also create rights for certain investors.
2. **Direct agreements with foreign states:** bespoke and generally transaction-specific agreements protecting the investor against adverse developments in the host country.
3. **Investment treaties:** agreements between two or more countries designed to promote and protect foreign investment.
4. **Political risk insurance (PRI):** policies insuring against the risk of certain adverse events in a host country, often tailored to the risks faced in relation to a specific transaction.

Amid the range of additional risks companies face today, the latter needs to be considered alongside other types of insurance that may also respond to political and related risks, for example:

- political violence insurance, covering damage caused by violent acts but generally excluding war between major powers;
- industry-specific war and terrorism policies (for example, for the aviation sector);
- more general policies, such as property, cyber, construction and credit insurance.

1 National investment laws

To promote foreign investment, some countries enact laws that make guarantees to prospective investors which meet certain requirements – for example, promises not to nationalise or expropriate without compensation, or not to discriminate and accord foreign investors the same protections as a domestic company. "For example, if there's a war or a riot, foreign investors should, under those national investment laws, have the right to be protected by the security forces of the state in the same way as a domestic company," explains Peter Harris, a Clifford Chance Partner based in Tokyo.

A major limiting factor for the protection these laws provide is their enforceability. "In many cases you'll find it doesn't have any kind of dispute resolution mechanism, in which case it is essentially worthless," says Harris. Often, the only recourse under the laws is through national courts. However, these may not be independent, especially where there has been a change in government, a coup or another event occasioning a change in policy direction against foreign investors.

The key thing to look for is an international arbitration clause, so that investors can pursue claims under an international enforcement framework, such as those provided by the Convention on the Settlement of Investment Disputes between States and National of Other States (known as the "ICSID Convention") or the New York Convention. However, even where the state is a party to such conventions, wording can be unclear or make the state's consent to arbitration conditional. It is therefore crucial to review the arbitration clause to assess whether the legal rights granted by the national investment law are enforceable. "I've unfortunately been involved in some cases where the tribunal has found that, despite there being a national investment law and an arbitration clause, there wasn't consent to arbitration without the state taking another step," says Harris.

That is not to say national investment laws should be dismissed – it just depends on the particular law in question. "We represented a European company in an ICC commercial arbitration against a state-owned entity in Central America," says José García Cueto, a Clifford Chance Partner based in Washington, DC. "The state lost and took measures to annul the award and disincentivise our client from enforcing the award, including securing a US$2 billion domestic court injunction against our client. While analysing our options, we discovered there was an old investment law with recourse to ICSID arbitration. The state reacted by repealing the law, but we were quicker. We filed our arbitration before ICSID the day before the law was repealed and secured a cash settlement in the hundreds of millions for our clients."

2 Direct agreements with states

Often the best way for an investor to protect itself is by negotiating a bespoke agreement with the government of the host country, although its ability to strike such a deal will depend on the size and specifics of the investment.

Along with protection against expropriation, these agreements may include further guarantees, such as a stabilisation clause precluding changes to parts of the host country's legal or regulatory regime relevant to the investment, or providing for compensation if there are changes. "For example, if you're an investor in the renewables sector and your investment is only going to be profitable if a certain feed-in tariff is maintained, you could include that in your agreement. If the state wants the investment, ultimately it may be motivated to sign up to that," says Harris.

Again, provisions that allow investors to hold governments to their word are crucial. As well as an international arbitration clause and waivers of sovereign immunity, a clause stipulating either international law or a foreign jurisdiction's law as the governing law of the agreement is key. Otherwise, a government could simply legislate to make performance of its obligations unlawful or cancel the investor's rights. "What we most commonly see is a governing law clause which provides that where the laws of the state and international law are not consistent, international law will prevail," adds Harris.

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Peter Harris
Partner

3 Investment treaties

Protection from political risks may also be found under international agreements between states that establish standards for how investments made by one country's nationals or companies are to be treated in another. These guard against risks such as expropriation and discrimination, as well as providing mechanisms for dispute resolution in a neutral forum outside the host country, yielding a decision that cannot be appealed on the merits and that can be enforced globally.

To qualify for protection under these treaties, an investor must meet certain requirements (some states exclude protection in relation to holding companies that do not conduct substantial business in the host country, for instance). To be enforceable, the treaty must also contain standing consent to arbitration, at the election of the investor.

There are more than 2,200 bilateral investment treaties currently in force; of these, the UK is party to more than 80. By far the most used forum is the International Centre for the Settlement of Investment Disputes, ICSID – a member organisation of the World Bank. These treaties can be a powerful tool, and Clifford Chance has acted for clients that have been able to obtain compensation using them. ICSID arbitration (at least the fact of it, if not the filings and details of the award) is public, and so triggering the notice period for arbitration under a treaty can be an effective means of bringing a government to the table. "Governments know they're going to attract attention if they receive these claims," says Harris.

4 Political risk insurance

The risks covered by PRI overlap with the adverse developments that national investment laws, investment treaties and direct agreements with states seek to guard against. Among the risks from which a PRI policy can offer protection are:

- **Confiscation, nationalisation, expropriation or deprivation:** the host government taking actions to acquire an asset or investment;
- **Contract frustration:** the non-performance of contractual obligations by a counterparty due to government actions;
- **Currency inconvertibility:** the host government restricting the conversion or transfer of local currency into foreign currency;
- **Forced abandonment and divestiture:** the host government forcing a company to abandon or divest itself of the investment, typically a physical asset;
- **Licence cancellation:** the host government cancelling necessary licences, permits or contracts;
- **Non-honouring of arbitral award:** a more limited form of cover for when an arbitral award obtained by an insured is not paid; and
- **Political violence:** loss resulting from war, civil unrest or terrorism (can sit under PRI or as a stand-alone cover).

"These risks remain very relevant," says Chris Ingham, a Clifford Chance Partner based in London. "Confiscation or nationalisation remains a serious risk – for example, there has been widespread confiscation in West Africa after a number of military coups."

However, the current risk landscape could test how insurance operates, and requires companies to look to other forms of insurance to ensure they are satisfactorily protected. For instance, war and political violence policies may respond to instances where there has been physical damage to assets. But PRI is unlikely to be the first port of call to seek protection from the broader economic impact of events such as the closing of the Strait of Hormuz. Instead, companies may need to look to specialised trade disruption, business interruption or credit insurance policies. They also need to bear exclusions in mind, in particular war exclusions.

"It's not just a case of saying I've got a policy that covers war and a policy that excludes war, therefore the two fit together. War exclusions can be very broadly drafted, excluding losses indirectly caused by war which may not be covered under war or political violence policies. You need to consider carefully the types of risks you are exposed to, and ensure you have cover which will respond to those particular risks and that there isn't a relevant exclusion," says Ingham.

Failure to review insurance arrangements holistically can lead to nasty surprises, as recent events demonstrate. "With the COVID pandemic, we saw an issue arising where companies had business interruption policies they expected would respond in the event that their business suffered serious interruption," says Ingham. "What we actually found was that many of those policies provided only limited cover for pandemics, which meant many businesses were left to bear a significant portion (and in some cases all) of the losses themselves."

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Chris Ingham
Partner

Advantages of PRI

That said, PRI remains a valuable tool and one that comes with significant upside. There is a big difference between contracting with an insurer that has agreed to pay for losses resulting from defined political risks and contracting with a state under, for instance, a national investment law or bilateral investment treaty, which focuses on state responsibility. "Making a claim against an insurer ought to be so much more straightforward than making a claim against the state," says Baljit Rai, Director of Insurance Litigation, based in London. Added to this, the claims process for PRI is governed by clear contractual provisions, meaning pursuing recoveries from an insurer ought to be faster, more predictable and less expensive than from a state.

The wording of a PRI policy can also be specifically negotiated to suit the particular needs of a project. Policy period, the risks insured, how loss will be calculated and who the insured entity is are all things that can be tailored on a case-by-case basis.

An additional benefit that arises when PRI is provided by a state-backed insurer or a multilateral organisation such as the Multilateral Investment Guarantee Agency (MIGA) is that an investor's concerns can be elevated to the interstate level. Governments tend to be more cautious about negatively affecting projects insured by state-backed entities. "Organisations like MIGA and public insurers can almost solve issues before they arise and, if they do arise, they can mediate and seek resolution between a private investor and a state," says Rai.

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Baljit Rai
Director of Insurance Litigation

Disadvantages of PRI

However, PRI is not a fail-safe solution: it can sometimes be prohibitively expensive and the coverage it provides will be capped and subject to exclusions.

Another limitation is that, despite a steady stream of new entrants, the insurance market's capacity and appetite fluctuates depending on geography, shifting geopolitics and industry. "For instance, it will be more difficult to obtain PRI for extractive projects like mining or oil and gas because of the increased risk of expropriation and nationalisation," says Rai. Insurers will also underwrite risks in line with their underwriting criteria, which for state-backed insurers may mean they only provide PRI where it aligns with the state's foreign and security policy objectives.

Even where cover can be secured, coverage disputes are not uncommon. A recent example is litigation over aircraft left stranded in Russia following the 2022 invasion of Ukraine. These claims were under aviation policies which included cover for political perils. "While the court's decision was in favour of the insureds, finding that losses resulted from a war risks peril, the insurers have obtained permission to appeal on certain grounds and therefore an appeal hearing is pending," Rai explains.

How does PRI compare with other forms of protection?

Investment treaties typically work hand-in-hand with PRI and confer a number of further benefits, namely an international and neutral forum for dispute resolution (typically through arbitration), the ability to negotiate directly with the state, and greater leverage. "You're dealing with top officials and issues that may impact the reputation of the state and the capacity of the state to finance itself. That gives you an edge," says Cueto. "For instance, the World Bank tracks investment treaties and measures adopted by states, and that has an impact on World Bank loans. Investment treaty arbitrations also have an impact on a state's credit rating and reputation as a safe foreign investment destination."

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José García Cueto
Partner

Another upside is lower cost of capital. A 2019 study that analysed 45,000 syndicated loans concluded that debt contracts covered by investment treaties had commercially significant price and non-price advantages over similarly positioned loan contracts without investment treaty protection. These included increased loan capacity, lower interest rates, reduced need for collateral and fewer covenants.

Investment treaties are also not perfect, however. Unlike direct agreements or PRI, they are not bespoke to the investor's needs, and dealing with state actors may be a curse as well as a blessing. "Your interest may not be aligned with the political interest of the country at that point," Cueto adds.

In addition to being bespoke, direct agreements come with more confidentiality, which can be a both a positive and a negative. National investment laws, meanwhile, suffer from the dispute resolution difficulties outlined above, but can be a useful negotiating tool. "You're suing the government under its own law. Reading their own rules back to them can be quite powerful," says Harris.

How does PRI work alongside other forms of protection?

When it comes to guarding against political risks, it's not an either/or, and PRI can be included in the structure alongside other forms of protection. However, there are important considerations that need to be thought about when structuring and not when a claim arises. Some forms of insurance cover are very clearly secondary protections, the most obvious being non-honouring arbitral awards. "That only responds once you have sought to exercise your contractual or treaty rights, you've obtained an arbitration award and that award has not been paid," says Ingham. "Then the insurer will step in and pay that on your behalf." There can also be disputes as to whether the insured peril has genuinely arisen. For instance, in respect of a claim for contract frustration, it may be necessary to pursue the counterparty and test their justifications for the non-performance of the contract to ascertain whether a political risk has occurred.

Even when there is no express requirement to do so, insureds need to keep in mind the subrogation of their rights to the insurer once the claim has been paid, and the risk of these rights lapsing if the insured does not take action, as this might be treated by the insurer as a breach of duties owed to it or a failure to mitigate. "An insured should be really clear on what subrogation rights an insurer will actually have, and what level of assistance it is required to provide. Under English law, the starting point is that an insurer who pays out is subrogated to all the rights of the insured unless a contrary agreement is in place," says Alex Gabriel, a Senior Associate based in London.

Ingham concludes: "If the reason you're taking the insurance out is because you want to rely solely on bringing your claim against an insurer as an independent third party, you need to consider very carefully what obligations you owe under the insurance and what steps you would need to take to demonstrate you have a valid claim."

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Alex Gabriel
Senior Associate

What challenges can arise when bringing a claim?

The provisions set out by the policy for bringing a claim should be reviewed carefully by the insured. A key challenge is proving the peril, with onus for this resting on the insured, while the insurers have the burden of proving an exclusion applies. "Disputes frequently arise because government actions tend to be informal, indirect and ambiguous," says Rai. "Even where there are clear government acts, disagreements can still arise." Because of this, it is important to collate strong evidence – both factual and expert – and put together a paper trail of mitigation steps prior to presenting to a claim to an insurer. "It should not be underestimated how difficult it can be to prove state intent, especially in opaque regimes where it will be vital to adduce strong expert evidence," says Rai. In that context, there may be security concerns for witnesses who are reluctant to speak out against the offending regime. Most policies will contain confidential arbitration provisions, but where a dispute is being heard by the courts, protection may be on offer provided certain criteria are met.

Another challenge is ensuring the PRI policy is not invalidated because of breaches by the insured, either at the point it is taken out or during the life of the policy. Complying with the duty of fair presentation, as well as terms framed as warranties and condition precedents is particularly vital.

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