

political risk insurance newsletter

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Treaty-Based Recourse for Investor-Host Government Disputes

By Robert T. Wray and Felton (Mac) Johnston

Key Provisions of BITs and Multilateral Investment Treaties

More than 2,000 Bilateral Investment Treaties (“BITs”) among 175 signatory states, and a growing number of multilateral treaties, such as NAFTA and the Energy Charter Treaty (“ECT”), enhance the international legal rights of cross-border investors and their ability to enforce them. These beefed-up recovery possibilities may improve the environment for political risk insurance underwriters and insureds.

The substantive provisions of BITs and multilateral treaties typically promise that eligible investments will be afforded national and most favored nation (MFN) treatment, fair and equitable treatment (which usually means the minimum standard of treatment under customary international law) and certain transparency commitments. Specific assurances are typically offered with respect to expropriation, transfer risk, and sometimes compensation for political violence damage, as well as relief from “performance requirements” and barriers to entry and employment of aliens. Important variations, however, can be found in BITs and multilateral treaties particularly in the way in which investment remedies are expressed in the text of the treaty. For example, both NAFTA and the ECT require that compensation for expropriation be paid at “fair market value” while BITs from countries such as France, Italy and the United Kingdom require compensation at “real,” “market” or “genuine” value. Even though several treaties may enunciate national and MFN rights in the same manner, the standard of treatment under a particular treaty will reflect the treatment the host government

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The BITs typically assure eligible nationals of the signatory states specific protection of certain investment rights and direct access to a forum for resolving investment disputes with the state in which their investment was made. Although industrial nations tend to have their own models for a BIT and multilateral treaties have core provisions, in the end the terms are negotiated country by country and special reservations, conditions, and interpretations apply in each case. Before taking comfort in and relying on the existence of such treaties, investors and their political risk insurers need to be alert to those terms and to circumstances in which the treaties might not prove effective.

Interview with Luis Dodero of MIGA



Luis Dodero, Vice President and General Counsel of the Multilateral Investment Guarantee Agency (MIGA), will retire this year after holding that position since the agency’s inception sixteen years ago. He has played a major role in MIGA’s development and its success as a leading provider of political risk insurance. We asked Mr. Dodero to respond to some questions about the agency and his experience there.

Q: MIGA has some interesting experience resolving investor-host government disputes. How would you describe the process – as mediation, suasion, or something else? What have you learned from your experience that might help underwriters and investors?

A: MIGA may be involved in two different type of disputes: those concerning an insured investor and the

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Are Banks and Political Risk Insurers Separated by a Common Language?

By David Neckar

We invited David Neckar, Practice Leader, Political Risks and Credit Insurance, Global Markets of Willis Ltd. to comment on issues that have arisen out of recent political risk insurance claims in Argentina.

Two countries “separated by a common language” was Churchill’s comment on the United States and the United Kingdom. Some have maintained that it applies equally to the domains of banking and insurance, when it comes to political risk policies. Is it language or is it something else? Looking at banks’ recent experience of the Argentina crisis, we can try to answer that question and draw some practical conclusions.

Background

Until the collapse of Argentina in 2002, banks had been buying significant amounts of political risk insurance (PRI) as risk mitigation for loans in countries that were at or close to country risk limits. The obligors were frequently private corporations involved in utilities (e.g. electricity) or in infrastructure projects (e.g. toll roads).

Policy forms

PRI was typically provided on the “Lender’s Form” which was based on Expropriation and Currency Inconvertibility as key insured perils. The structure of the policies required the insured perils to be identified as the direct cause of the non-payment of the sums due under the loan.

Events

Argentina’s political and economic fabric collapsed at the end of 2001, leading to Emergency Laws being passed in early 2002. The peso, previously pegged at parity to the US dollar, was un-pegged and promptly fell to around 30 cents. Local dollar obligations were “pesofied”, tolls were frozen.

Impact on banks’ loans

Obligors were faced with a threefold increase in their debts and with a government that did not provide alleviation (e.g. by allowing increases in tariffs). They defaulted and sought to reschedule. Many were technically insolvent – it was hard to know what a “going concern” basis was in such circumstances.

Banks’ views on PRI policies

Banks considered that defaults had occurred and were directly caused by the government action, or in some cases inaction (in not permitting renegotiation of agreements). Claims were due and should be met promptly. Time was of the essence. Regulators were looking closely at the provisioning for non-performing assets.

Insurers’ views

Insurers felt that close examination of the policy language was required to identify the proximate cause of the losses: were the obligors unable to pay because they were insolvent, prior to the government action? Information provided at the time of underwriting was re-examined. Supported by a clause that laid the onus of proof on the Insured to prove their loss (known as the “reverse onus of proof”), some insurers moved slowly, declining to make even preliminary judgements on liability.

Brokers’ views

Although brokers were keen to promote dialogue to resolve claims, they were placed in a difficult position when lawyers were appointed, for example over issues of legal privilege. Taking a proactive role required close coordination with the lawyers, which was not easy.

Consequences

Banks sought to make things move faster by commencing arbitration procedures – only to discover that this process had the opposite effect. Eventually, compromise settlements were made. In many cases banks actually made reasonable recoveries from insurers – although at a serious cost of time, stress and bad feeling.

Timely settlements

It is important to note that timely claims payments were made. Policies that covered obligor non-payment as the insured peril were simpler to manage. The first claim payment for an Argentine loss was on one such policy in London, settled promptly on the day the claims waiting period expired. On Lenders’ Forms, some insurers engaged in claims negotiations at an early stage and avoided lengthy legal process.

Was it a question of language?

At one level, the disputes arose over different interpretations of policy language. But, it was not so much language that marked the separation of views, as differences of procedures, expectations and corporate culture.

Banks wanted a simple speedy process, based on their practice of rapid settlements under counter-indemnities. They had not appreciated the procedural nature of the insurance contract, especially the need to establish the cause of the loss. They were intensely frustrated by the grinding process of insurers’ requests for information.

Insurers were generally defensive, but they pointed out that the policy terms supported their position. They appeared to be unhappy about banks appointing external legal counsel at an early stage and to believe that banks were not providing full information at all stages.

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Treaty-Based Recourse for Investor-Host Government Disputes

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affords to its national investors (in the case of national treatment) and to the most favored foreign investor (in the case of MFN treatment).

If an investor believes the sovereign has violated these treaty promises to the investor's disadvantage, it can, after some period for negotiations to resolve the issues, pursue recourse through dispute resolution mechanisms. The treaties commonly offer the investor a choice of fora – local courts, or arbitration under ICSID, UNCITRAL, or some other mutually agreed body and rules.

But neither the substantive rights nor the avenues of relief will have value unless the particular investor and investment are qualified under the terms of the treaty. Typically, an “investor” is defined as a national or an enterprise (private and often state-owned enterprises also) of a signatory state, but an enterprise might not be eligible for the treaty's benefits if it is headquartered elsewhere or controlled by non-nationals (especially of a country with which the country receiving the investment is on bad terms), or if it has no substantive business activities in its “home” signatory country.

The eligible “investment” will cover a gamut of resource transfers: debt and equity-like instruments, physical property, contractual commitments such as concessions, intellectual property, guaranties, etc. but not all treaties embrace the same things or describe them similarly. In the case of the ECT, the investment must be associated with an economic activity in the energy sector. Countries typically exclude certain economic activities or industrial sectors from promised national or MFN treatment, such as NAFTA's reservations on oil, gas, petroleum products and atomic energy or the ECT's inapplicability to charcoal and “fuel wood materials”.

The Benefits to Political Risk Insurers

A sovereign's treaty obligation to respect investor rights improves the climate for investment generally. The prospect that an aggrieved investor may pursue arbitration to enforce the sovereign's promises, and also enlist its government's support for that purpose, may well constrain the host sovereign's behavior. If not, political risk insurers may still benefit from BIT or multilateral treaty rights that pertain to a particular transaction. Arbitration has a value to investors and possibly their insurers as subrogees of the insured investor. It presents a forum to resolve whether a compensable loss under the treaty has really occurred and to establish the sovereign's liability for that loss. Arbitration therefore can establish a path to recovery, which is central to most political risk insurance underwriting.

Close examination of treaty provisions is therefore essential to determine if treaty benefits will be available to a particular investor and investment and for the insurers who may be subrogated. In cases of ambiguity about that availability it may be worth seeking formal clarification from the appropriate government agencies of the state in which the investment is to be made.

The utility of the treaty provisions to insurers may also depend on their own

policy terms regarding subrogation, assignment of interests, and the policyholder's obligations to act on the insurer's behalf. Public and private political risk insurers' standard policy forms give them general rights of subrogation or assignment relating to the interests and claims of the insured. Most policies for lenders and some for equity investors require policyholders to take reasonable actions to aid the insurer's recovery efforts. Several insurers' policies provide that instead of assigning title, rights, or currency, the insured may be required to transfer a beneficial interest. But what if such a transfer or even assignment of a beneficial interest would result in the investor or the insurer being ineligible to take advantage of the benefits of the relevant BIT or multilateral treaty?

“The utility of the treaty provisions to insurers may also depend on their own policy terms regarding subrogation, assignment of interests, and the policyholder's obligations to act on the insurer's behalf.”

If the treaty is silent with respect to the foregoing, it is likely that the question would be resolved through the application of customary international law rules which could require that an investor maintain its national identity from the date of the events giving rise to the claim through the date of resolution of the claim. An assignment or transfer to an insurer whose country is not a party to the relevant treaty could preclude the insurer and the investor from obtaining the treaty's investment and arbitration rights.

While many of the treaties contain specific provisions recognizing the subrogation rights which have been acquired by “designated agencies” of a signatory country, they will not necessarily confer similar rights on private insurers.

Even when the investor or its insurer concludes that treaty and insurance policy terms provide good comfort for the case at hand, there is still a danger that the treaty may not survive the period of investment or coverage, as a result of its abrogation, or that the enforcement of a treaty arbitral award would be resisted by host governments (as recent reports from Argentina seem to suggest with respect to ICSID awards). In an extreme case the insurer might provide for the termination of coverage in the event the treaty is not still in force on the date of loss.

Conclusion

BITs and multilateral investment treaties generally reflect and help to reinforce a signatory government's favorable disposition toward foreign investment. Knowing whether the terms of such agreements are binding with respect to a particular investment and investor – and whether they accrue through subrogation or assignment to its political risk insurer – may require transaction specific research. However, for investments of considerable scale or sensitivity, the results of that research may be well worth the efforts of investors and their insurers. ■

Interview with Luis Dodero of MIGA

host country and those arising out of investments not insured by the Agency. In the first case, MIGA gets involved, not only to avoid paying a claim, but also to minimize the adverse consequences that the dispute may have in the ability of the country to attract foreign investment. In the second case, when MIGA is convinced that the dispute is having this adverse effect, we can provide mediation services. We believe that our intervention constitute mediation, since our efforts are addressed primarily to encourage the parties to find a solution that is mutually satisfactory. I must say that I am very proud of what MIGA has achieved in this field during our short life, a little over 15 years. We have helped resolve disputes involving non-insured investors and Argentina, Brazil, Ghana, Guatemala and Ethiopia, and between insured investors and Bolivia, Guatemala, Argentina, Brazil, China, Moldova and Indonesia.

With certain exceptions, the common denominator of these disputes is a deep disagreement between the Government and the investor on regulations and tariffs by the latter for power, water or transportation. In most cases, the projects that trigger the disputes are privatized public services, where there is public discontent with an increase of the tariffs and the discontent could have an important impact on the results of the next presidential/ provincial elections. Even if the investor is abiding by the tariff increase formula agreed upon in the concession agreement with the Government, the latter alleges that (using legalistic terms) the so-called principle *rebus sic stantibus*, i.e., if the circumstances change, the contract should be amended to be adapted to the new situation, and that this principle prevails over that known as *pacta sunt servanda* or sanctity of the contract. In my opinion, most of these cases meet internationally recognized definitions of expropriation and, as such, they may become legal expropriations if the government can prove that they were in the public interest and pays appropriate compensation. However, it is not easy to obtain compensation from governments that are usually going through a financial crisis. MIGA's preferred solution is always to try to find a non-monetary way of compensation by the government and convince the claimant that it is always in its interest to accept a small and temporary reduction in the contractual increase of the tariffs, if they want to continue doing business in the country.

The inference of the above is that coverage of privatized public services constitutes some of the riskiest business a political risk insurer can cover, independently of the country where the investment is made (remember the power crisis in California!). Prices of these services have a very strong political impact, since the public tend to put the blame on the government when they cannot afford water or electricity, even if the reason for the increase is totally independent from the government or the investor, (such as increase in the price of oil). Investors must realize that if they want to stay in the country they have to be flexible in their negotiations and that governments don't like them using the arbitration provisions in their contracts. Countries, on the other hand, must take into account that the final

objective of a private investor is to make a profit, not to provide a concessionary public service.

Q: What are the principal changes of substance in MIGA's recently revised standard policy forms, and why were they made?

A: MIGA's policies ("contracts of guarantee"), were drafted 16 years ago. It was time to update them to better fit the changes in the investment environment and to make them more client friendly. We have modified both the form and the substance of the general conditions. We have tried to have very few provisions that apply to all risks, so that by reading the section concerning each risk the investor knows what is covered, most of its rights and obligations and doesn't need to go to another section to find out what is excluded from coverage or when and how a claim must be filed. We have also included in the contract the provisions concerning corruption and hiring of child or forced labor that before had been included as amendments to the contract.

The main modifications of the substance are the inclusion in the contract of the coverage of breach of contract risk and a better definition of the "stand-by" coverage, i.e., the commitment by MIGA to accept increases in the insured amount during the life of the contract under certain conditions.

Q: MIGA's guarantee contracts specify a unique set of rules for settling disputes between policyholders and MIGA. Why is this so, and how do MIGA's rules differ from the mechanisms used by other political risk insurers, such as AAA or the London Court of International Arbitration?

A: MIGA's Convention (its charter) sets forth that disputes between the guarantee holder and the Agency arising out of a contract of guarantee, must be subject to arbitration. The issue of the applicable law is a little more complex. While the Convention is silent in this respect, the Operational Regulations of the Agency set forth that the applicable law will be the Contract of Guarantee, the Convention and, if these rules cannot be applied to the dispute, general principles of law.

Concerning the specific ad hoc arbitration rules under MIGA contract of guarantee, they are drafted, as directed by the Operational Regulations, following very closely the rules of the International Center for the Settlement of Investment Disputes (ICSID), the dispute resolution center of the World Bank Group. However, in order to avoid perceived conflicts of interest, the appointing authority, in case there is no agreements between the parties on the appointment of the third arbitrator, is not the Secretary General of ICSID, but the Secretary General of the Permanent Court of Arbitration of The Hague (my first trip after joining MIGA was to The Hague, where I concluded an agreement in this respect with the Secretary General of the Permanent Court). In addition, the third arbitrator doesn't have to be selected from the ICSID list of arbitrators.

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Interview with Luis Doderó of MIGA

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Q: MIGA's guarantee contracts state that "all provisions of the Contract shall be presumed and construed to be consistent with the Convention and the Operational Regulations." What does this mean? Those are two hefty documents. What are the practical implications of this provision that Guarantee Holders should be aware of?

A: This provision was included in the Operational Regulations so that MIGA will follow the principle applicable to multilateral organizations that they cannot invoke their own rules to justify their failure to perform a treaty to which they are parties. An arbitration tribunal can rule that MIGA did not comply with its own Convention and Regulations, but MIGA cannot allege that its own contract does not meet the requirements of these rules. A contract between two private parties is subject normally to a national law. Any of the parties can always argue that the contract does not comply with the law, but, as mentioned above, MIGA's contract is subject to MIGA's rules and it wouldn't make any sense that MIGA could challenge this.

"...coverage of privatized public services constitutes some of the riskiest business a political risk insurer can cover, independently of the country where the investment is made..."

Q: How would you describe MIGA's preferred creditor status, in theory and in practice?

A: I would state that legally, MIGA has no preferred creditor status. In accordance with Article 18 of the Convention, when MIGA pays a claim, it becomes subrogated to the rights or claims that the guarantee holder may have against the host country, no more, no less. The fact is that a member of the World Bank Group has always more leverage with the government of a member country than a private or even most national insurers. This reality has been verified over the years in a number of countries, which have given better treatment to investors insured by MIGA than that given to other investors. In addition, MIGA has concluded bilateral treaties with the majority of its developing member countries by which it enjoys most favorable treatment.

Q: What do you think will be the new initiatives that MIGA should take over the next (a) five years? (b) ten years?

A: In mid-2004, MIGA experienced a significant turnover in its senior management ranks. A new team headed by Ms. Yukiko Omura, our Executive Vice President, is currently considering a wide range of new

initiatives. I would expect that these will be unveiled in early 2005. Among the possibilities are some amendments to our Convention, to allow, for example, the coverage of non-shareholder loans even when they are not related to an investment covered or to be covered by MIGA.

Q: What do you think should be the new initiatives that MIGA should take over the next (a) five years? (b) ten years?

A: Within 5 years, I would like MIGA to create a center for mediation of investment disputes, in cooperation with other members of the World Bank Group (we are working on it). We should also be providing and receiving more reinsurance to and from national investment insurers. Within ten years I would like MIGA to provide some kind of non-commercial coverage to encourage domestic investment in developing countries.

Q: In 2005 you will be retiring from MIGA, where you have been its one and only General Counsel for some sixteen years. What are you most proud of having achieved during your tenure?

A: I am retiring from MIGA in 2005, after nearly 16 years as its only General Counsel. Needless to say, I am proud to have grown with the Agency and helped it overcome hundreds of challenges. The Legal Department played a key role in convincing more than 100 countries to become members of MIGA (even those who applied the "Calvo Clause", which in principle were totally opposed to ratify an international treaty that subject them to international arbitration), and about a decade later, to effectively double its capitalization.

I am particularly proud of the team I have recruited, including lawyers and non-lawyers, and what we have collectively accomplished through the issuance of more than 700 guarantees to investors. These MIGA guarantees facilitated more than US\$50 billion of investment to our developing member countries. These investments, in turn, have generated thousands of stable jobs, brought new technologies to the host countries and brought poor countries closer to international marketplaces.

I am also proud to have worked not only to conceptualize programs like the Guarantee Trust Funds, but to bring them to reality in post-conflict countries such as Bosnia and Afghanistan. On a personal level, I am also proud of the creative role I played in preparing the guidelines that have allowed MIGA to cover sub-sovereign risk and to provide breach of contract coverage. I have taken risks, but it was worth it. I would like to think that I have left my successor a very firm foundation on which to grow the Agency in the next decade. ■

Are Banks and Political Risk Insurers Separated by a Common Language?

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What practical conclusions can we draw?

Starting with the underwriting information: we need to achieve as full a picture of the risk as possible - possibly based on an agreed set of underwriting documents as a reference point throughout the life of the transaction, not just in the event of a claim.

On the policy form: we need to deal with imprecise exclusions, conditions precedent and warranties, lack of detail in the claims process, to list the most pressing issues. It will be especially difficult to tackle standard "market" clauses, such as those relating to currency fluctuations and the reverse onus of proof.

On claims: it might be sensible to agree service level agreements to resolve differences in expectations over procedures: for example set out response times for both parties and possibly provide preliminary claims evaluation at an early stage.

To conclude – with a broker's perspective - these are areas where the broker can bring both parties together, help find contractual consensus, common language and so reconcile the cultures of banking and insurance. ■

about this newsletter

This is the first issue of the *robert wray PLLC* Political Risk Insurance Newsletter. Our intention is to provide a forum for the exchange of information and opinions relating to topics that will be of interest to political risk insurers, buyers, brokers, attorneys and others. We invite contributions and suggestions from professionals in the field.

As we intend in future issues to have more extensive coverage of transactions, personnel changes and other important developments in the political risk insurance sector, we invite readers to submit relevant information.

If you would like to receive this or future issues of the PRI Newsletter electronically or if you have friends or colleagues who would be interested to join our distribution list, please e-mail us at info@robertwraypllc.com.

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Personnel Changes

Peter S. Watson, President and Chief Executive Officer of the Overseas Private Investment Corporation, resigned effective February 28, 2005. Mr. Watson was President and CEO of OPIC since June, 2001. He is currently serving as Visiting Fellow, Economic Studies at the Brookings Institution. ■

Transactions of Interest

The American International Group Inc. (AIG) is reported to have led a syndicate to provide cancellation protection to the International Olympic Committee (IOC) for the 2004 Olympics. Claims would be payable up to US \$170 million for cancellation of the events resulting from war, terrorism and natural disasters. The deal marked the first time the IOC has taken out a risk management policy of this type and the committee has indicated its intention to procure similar coverage for future Olympic Games. ■

about robert wray PLLC

robert wray PLLC is a law firm focused on analyzing complex issues and providing innovative solutions in the areas of political risk insurance, project finance, transportation infrastructure, privatization and aircraft finance. The firm's political risk insurance practice, led by Robert T. Wray and Felton (Mac) Johnston, offers comprehensive advice related to the mitigation of risks and selection and acquisition of political risk insurance associated with international investments.

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