White paper

A Brave New World? Political risk minimisation for wealth and business owners

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Understanding political risk and its implications

Political risk, in its many manifestations, is one of the most salient concerns of international investors today.

Not only are we living through unprecedented economic, social and political disruptions to everyday life as a result of the global coronavirus epidemic, but the ramifications for political risk interferences with international investments in particular are extensive. With nationalistic tendencies resurgent in many countries around the world, compounded by the coronavirus crisis with which governments are grappling in myriad ways, wealth and business owners are acutely aware of the risks of the new world to which they are awaking. Such risks are far from being confined to nationalisations or direct expropriations of international investments. More frequently, international investors in foreign countries can over time face materially different regulations and legal frameworks to those which originally informed – and perhaps even partially motivated – their investments. Looking to the medium and longer term, there are also serious risks relating to fundamentally altered legal and economic frameworks applicable to international investors, as well as issues of the possible transformation of taxation regimes as governments look for new revenue sources to pay for their outlays.

> Issues of favouritism and discrimination frequently pose obstacles for international investors

Perhaps more prosaically given these acute considerations, but no less important for international investors, changes in governments routinely throw up particular challenges. Such challenges can arise from host government political considerations that seem to bear little relation to the prospects or progress of the underlying investment projects. Issues of favouritism and discrimination frequently pose obstacles for international investors.

The economic prospects of international investments may furthermore be damaged or even destroyed by an array of state actors ranging from ministries and legislatures, to regulators and tax authorities.

Local courts may be unresponsive to legitimate legal claims, and due process issues in foreign courts in proceedings that will frequently be against host state or other local counterparties can further complicate matters.

Political risk is also a home country reality for many wealth and business owners and this not only in the developing world. Populist governments, confusion about how best to address income and wealth inequality and many other factors have made political risk something that wealth and business owners internationally need to consider. Often, however, wealth and business owners fail to adequately address political risk in their development of asset ownership and succession structures. But they should and must.

Minimising political risk

In simple terms, political risk has to be considered at three levels. First, attention needs to be given to political risk in the jurisdiction of the citizenship and/or residence of the wealth owner. This may involve dealing with more than one jurisdiction given that there may be multiple citizenships and fiscal residences involved. Second, political risk needs to be considered in the location that investment structures are maintained. A wealth owner may live onshore in the UK, for example, but there may be trusts, companies, partnerships, investment funds or other holding vehicles located elsewhere. The jurisdiction in which these structures are maintained is also highly relevant to any political risk minimisation strategy. Third, of course, is the country in which an investment is made.

Compared with commercial risks, political risks can be amorphous and hence difficult to predict and manage. Moreover, the political risks in the country of investment are likely to be different to those of the home country. Political risks can manifest in varied and challenging ways. Examples range from circumstances of revolution, civil unrest and civil war to politically charged changes in regimes or governments, marked policy and regulatory changes or discrimination. Moreover, recent and wide-ranging international changes to tax and transparency frameworks are related to political risk. As mentioned above, risks can exist in the countries of intermediate structures, such as investment vehicles, partly due to ongoing challenges to traditional offshore centres.

The scope for international investors to minimise political risk has historically been limited. A possibility for an aggrieved investor is to sue the host state government, such as for expropriation of investments, in the host country domestic courts. However, the likelihood of successful host country litigation against host state and local counterparties is often low, frequently leaving investors with inadequate or no compensation, even in cases of expropriation. Local court litigation is, therefore, rarely the preferred option, not least because the judiciary is part of the host state apparatus. In some circumstances, the problem may indeed have arisen from actions in the host state courts, in which case those courts are particularly unlikely to be receptive to a complaint. A reality is that under international law, it is generally accepted that a country has the sovereign ability to act within its borders, such as would be the case in relation to expropriation.

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The (often only theoretical) possibility of securing diplomatic protection from a home country government can be subject to complex political considerations and may not necessarily be forthcoming or effective. It is within the home country government's discretion as to whether or not to bring a claim on the investor's behalf and the investor is forced to rely on an unpredictable political process. The home country government may have no wish to engage in a dispute with another government for any number of geopolitical or economic reasons unrelated to the investor's claim. Moreover, a state-state legal confrontation can precipitate international tensions beyond the circumstances of a specific investor and investment.

Although political risk insurance can be a potential means of managing certain political risks, such as expropriation risks, its ambit is often narrow and the costs can be high. As experience shows, these historic limitations in managing political risk are far from academic.

But wealth and business owners can learn from history, and pay more attention to what has worked and has not worked in the context of political crisis. Wealth and business owners can also reflect on steps others have taken in uncertain times.

In and around the second world war, for example, a number of European companies, including the Philips Electronics group, took steps to isolate their European assets from holdings elsewhere, such as in the U.S. In the case of Philips, the group's U.S. assets were held in a trust carefully designed to separate the ownership of U.S. assets in the event of an expropriation or other political risk event in Europe. In the 1980s and early 1990s, many businesses in Hong Kong were restructured in view of perceived political risk associated with the return of Hong Kong to the People's Republic of China in 1997. Most common was the undertaking of corporate inversions – the removal of a holding company in the location of risk and its replacement by a holding company elsewhere, isolating the assets in the location of risk. Companies ranging from the Hong Kong and Shanghai Banking Corporation (now HSBC), Jardine Matheson and many others replaced their Hong Kong holding companies with holding companies in other jurisdictions. In the case of HSBC, the choice was the UK; in the case of Jardine Matheson, the choice was Bermuda.

For a business and wealth owner, the corporate inversion is only part of the political risk minimisation strategy. If the individual involved lives in country A and developed his business in that country, it would be quite common to see the progress of the business having involved the establishment of a company in Country A. As the business expands cross-border, subsidiaries are established in other locations. A corporate inversion involves the group restructuring such as to establish a new holding company in a "safe" jurisdiction, and ideally one that can benefit from investment protection agreements and otherwise provide political risk minimisation. Now there is no holding company in Country A – only a subsidiary of a holding company elsewhere. While the assets in Country A remain at risk, how those assets are owned can help to ensure compensation payments in the event of expropriation, something elaborated on below. Leveraging the assets in Country A can shift political risk to lenders, depending on the terms of the loans involved.

But if the business or wealth owner remains a resident of Country A in the example, having a holding company in Country B may be an incomplete approach to political risk minimisation. Country A could take steps to force a repatriation of assets held abroad by the individual involved, and parallels to this can be seen from recent events in Saudi Arabia. To further minimise political risk, a business or wealth owner can separate himself from the ownership of the assets held abroad, or adopt approaches designed to create automatically such a separation in the event of a political risk event occurring. An example of the first approach could involve having assets overseas held in a single premium life insurance policy over which the wealth or business owner retains no power to have the assets returned to him or her – the assets pass to the next generation on the death of the wealth or business owner, and until then are simply owned by the insurance company located, of course, in a safe jurisdiction other than Country A. An example of the second approach could involve ownership by a trust, with provisions that exclude as possible beneficiaries any individual residing in a country that is subject to a political risk event, such as repatriation orders or otherwise. Initially a member of the class of potential beneficiaries, the wealth or business owner living in Country A is cut out of possible benefit if risk manifests itself in Country A.

It is interesting that political risk can also be presented by third countries. The U.S., for example, has a number of means through which such risk can arise. Freezing or vesting orders can and are used against perceived enemies of the U.S. A wealth or business owner in country A may find themselves unable to access assets held internationally by virtue of this. Separation of ownership, through one of the approaches described above or otherwise may be designed to minimise the risk of a freezing or vesting order applying to a particular set of assets.

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History serves as a reminder of the disruption that occurs when revolutions happen, borders may be redrawn and wars can develop. Some notable examples of geopolitical disruption are the general expropriations which occurred following the Mexican revolution, the Bolshevik Revolution, the Nazi German invasion of Europe and the Cuban Revolution.

In South West Asia in 1947, there was the partition of India and Pakistan (elements of which are still being litigated today) and the creation of a third country Bangladesh in 1971. The Soviet invasion of Afghanistan and the Iranian revolution both followed in 1979 adding to regional volatility.

In every instance, assets including key industrial and commercial assets and land were seized from private citizens by governments, in some cases by being declared abandoned property. This taking of private property for supposedly public use is something which wealth owners globally still fear. However there are more options today to diminish the impact of big geopolitical changes via thoughtful asset protection strategies. Precedents are being established though many wealth owners are not aware of the possibilities given that much of the body of law in this area has been developed in the arena of international dispute resolution between sovereign countries.

Emerging and frontier markets represent growth opportunities, at least in the mid to long term. They attract cross-border investors looking for returns, including through private or listed equity and corporate and government debt. It is noteworthy therefore that there are according to the International Committee of the Red Cross (ICRC) 35 conflict zones in the world today, across emerging economies. In emerging markets GDP held by family business owners is often in excess of 80%. For these business owners, geographical diversification from their home country was not historically a priority since, in many cases, they were operating in relatively new nation states whose independence had been hard won. Today however it is very much the case since diversification, and growing beyond ones borders, is generally recognised as a practical business strategy. We are seeing these disruptive events with increased frequency because of the lack of political and economic stability in host sovereigns. These events include direct governmental interference from military takeovers, expropriation, or mandated national ownership of all or part of particular businesses as well as indirect actions such as currency restrictions or burdensome income or estate taxes. There is very little to suggest that these tendencies will be ameliorated by the current coronavirus epidemic, and growing evidence to suggest that they are likely to be aggravated in various respects.

For international or cross-border investors, seeking additional levels of protection from geopolitical changes is pragmatic. However, wealth owning business families in emerging economies tend to be part of the fabric of the countries where their businesses are or were headquartered. For families like these, leaving is not a preferred option and neither is it straightforward for them to challenge their government in the local courts. Often these wealth owners have contributed to societal improvements through education and healthcare and are important local stakeholders by holding governments to account and by encouraging public private partnerships. They often represent the preferred partners international investors seek and take comfort from in these markets. These business families should also seek advice on asset protection strategies more proactively.

> Political risk is now a fact of life across the world, it isn't confined to a select few countries that can be avoided.

While political risks will shape some investment decisions and flows, such risks cannot easily be bypassed by international investors. For one thing, political risk is now a fact of life across the world; it isn't confined to a select few countries that can be avoided. Second, given greater growth prospects and investment opportunities in many emerging markets, investors will continue to make investments there.

Furthermore, many wealth and business owners, including family offices, are giving greater focus to direct investments.[1] Family office investments are often international and increasingly include direct investments (whether by way of a controlling interest, minority shareholding, joint venture structure or otherwise) into foreign companies and foreign assets. While this capital moves across borders in search of greater rewards, it also brings risks. It is axiomatic that direct investments into other countries carry direct risks to those investments, particularly in times of increasing instability and uncertainty. Emerging or frontier economies carry risks which are often political and can be difficult to predict (such as sudden changes in attitudes to foreign investment or radical changes following government transitions). There is little to suggest that the global coronavirus crisis will enhance predictability, or restrain scapegoating of international investors which often accompanies politically and economically turbulent times.

Protectionism and political volatility are also on the rise more generally with the rise of populism and potential antecedents of trade wars. These threats can affect economic fundamentals, but they can also affect the very integrity of international investments.

Into this challenging context comes a very significant international legal instrument which is all too often overlooked by wealth and business owners: the investment treaty. Investment treaties are international agreements between sovereign states that aim to promote and encourage investments between them. Investment treaties can be multilateral (such as the Energy Charter Treaty), but bilateral investment treaties between two states (often referred to as BITs) are the most common form. There are over 3,000 investment treaties worldwide.

Although these investment treaties are entered into by sovereign states and operate on the public international law plane (rather than being contracts governed by a designated national law, such as English law), they provide direct rights for international investors which qualify for protection under their terms. For example, the bilateral investment treaty between the UK and Nigeria gives UK investors in Nigeria the following rights:

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[1] See, for example, Axial Forum Article (Nora Zhou) "*Family offices are going big on direct investments*", 16 November 2017, on iCapital Network's report on single-family offices: https://www.axial.net/forum/family-offices-are-making-more-direct-investments/ See also Bloomberg article (Peggy Collins and Simone Foxman) "*Rich families go solo on deals, moving away from private equity*", 3 May 2017, https://www.bloomberg.com/news/articles/2017-05-03/rich-families-go-solo-on-deals-moving-away-from-private-equity

1. a right to be treated fairly and equitably;
2. a right to full protection and security of investments;
3. a right not to be discriminated against by Nigeria, as compared with Nigerian investors;
4. a right not to be discriminated against by Nigeria, as compared with investors from third countries (i.e., countries other than the UK or Nigeria); and
5. a right to be compensated (with 'prompt, adequate and effective' compensation) for direct or indirect expropriation of investments (including measures having equivalent effect to expropriation).

These substantive rights are wide-ranging and protect UK investors vis-à-vis the State of Nigeria, which includes the Nigerian government, legislature, courts and regulatory authorities. However, perhaps the most important aspect of investment treaties is one of procedure: the right for investors (in the example given, UK investors) to bring direct international arbitration claims against the host country government (in this case, the Nigerian government) for breaching the substantive investment treaty obligations set out above.

The majority (but not all) investment treaties provide for the resolution of disputes directly between foreign investors and host states through international arbitration. If an investment treaty contains arbitration rights for investor-state disputes, an investor does not need to have a contract with the state providing for arbitration to be able to refer its dispute to international arbitration. The investor needs to follow the procedures set out under the dispute resolution clause of the relevant investment treaty.

Arbitration under investment treaties is often conducted under the auspices of ICSID, a branch of the World Bank. This framework and the World Bank's involvement is generally perceived to enhance state compliance with ICSID arbitration proceedings and Arbitral Awards. ICSID has specific rules and procedures for international investment dispute settlement, including by way of investor-state arbitration and a powerful enforcement mechanism.

Given the value of investment treaties to manage political risk, they are routinely considered and used by the world's largest multinationals and private equity companies in making and protecting international investments. Sophisticated international investors also increasingly structure their investments through holding companies and special purpose vehicles established in specific jurisdictions to take advantage of particular investment treaties, alongside other considerations.

To determine whether an investor has the protection of one or more investment treaties, the first stage is to identify whether there is an applicable treaty between the investor's home state and the host state of the investment. However, the question of whether an investor can rely on a specific treaty, and the arbitration provisions contained in it, depends on the scope and application of the treaty in question. In order to benefit from the standards of protection under a treaty, both the investor and the investment need to qualify under the terms of the investment treaty (which will be defined in the treaty itself). This is where specialist investment treaty protection advice must be sought since every treaty is unique (notwithstanding certain seeming similarities).

The importance of dovetailing investment protection with other considerations in investment structures, including taxation, corporate efficacy and disclosure, can be considerable. An investment structure that takes a holistic approach to all factors that are relevant to the specific circumstances is likely to be optimal.

Diversification of ownership structures is also an important element of political risk minimisation planning. In the investment world, diversification is almost always recommended to reduce investment risk. But business and wealth owners sometimes fail to consider diversification at the ownership level. Having everything held in a single trust or holding company means that a political risk event can affect the totality of the wealth or business owner's assets. Safer might be to use multiple structures, and in different locations and of different kinds. Some assets could be held in trusts, and perhaps some in trusts that are designed to limit distributions that can give rise to information exchange or governed by laws that may limit the scope of creditor claims. Other assets could be held in insurance arrangements or in other structures. And diversification can also include having different family members owning assets rather than concentrating ownership in one family member.

Location of residence of family members (and their citizenship) also comes into the picture. A family that is diversified in terms of where they live can take advantage of considerable political risk reduction, and in a world of mobility, this is more and more realistic. The UK has, among others, attracted wealth and business owners seeking a safer place to live, albeit that they continue to own and manage businesses in their home countries.

While this requires careful consideration and calibration of different legal specialisms, the net effect can be meaningful: the difference between losing the entire value of an investment or securing market compensation if political risks manifest that would otherwise damage or destroy the value of investments. The urgency of such considerations has never been more acute. The benefit of proactively focusing on these considerations are likely to be significant.

About the authors

Hussein Haeri is a partner and co-head of international arbitration at Withers LLP. He is a leading specialist in the field of international investment law and investment treaty arbitration and has served as counsel in over 20 investment treaty arbitrations between international investors and sovereign states. He has drafted model investment treaties and investment legislation for governments. He is a Solicitor-Advocate of the Higher Courts of England and Wales, and previously practiced law in New York and Paris.

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Hussein is ranked in Who's Who Legal (Arbitration: Future Leaders) which notes that he "impresses market commentators with his 'combination of strong litigation skills with expert knowledge in public international law'." Legal 500 states that Hussein is "a standout operator", "very strong" and is "acknowledged for his leadership qualities". Legal Business Disputes Yearbook says that Hussein is "A name that is destined to join the pantheon of stars in the international arbitration arena" Global Arbitration Review quotes leading market commentators as saying that Hussein is "A first rate lawyer who blends strategic thinking with excellent client management skills" and that he is "very knowledgeable about investor-state jurisprudence" and "an exceptional lawyer".

Hussein is a Visiting Lecturer at SOAS, University of London and has taught international arbitration and public international law at University College London and King's College London in the UK and at the Institut d'Études Politiques de Paris (Sciences Po) and the Université de Versailles in France. He is a Member of the Faculty of the Certificate Course in International Commercial and Investment Arbitration at Università Roma Tre in Italy.

Hussein has published extensively on investment treaty arbitration, including in an Oxford University Press published book ('Practicing Virtue: Inside International Arbitration') and in leading journals such as Arbitration International and the BCDR International Arbitration Review (on which Hussein is a Member of the Advisory Board).

Iraj Ispahani is the CEO of Ispahani Advisory Ltd. and is based in London. Iraj serves as a Group Director and Board Member of Ispahani Group, a family business headquartered in Bangladesh which celebrates 200 years in 2020.

Iraj is a 10th generation member of the Ispahani family. The Ispahanis have been involved in business in South Asia since 1820. With corporate offices in Chittagong, Dhaka and Khulna and, through its tea, textile, jute, property and shipping divisions, the Group employs approximately 10,000 people.

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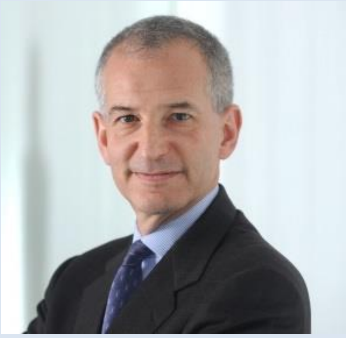
Corporate and Social Responsibility form a large part of the Ispahani philosophy. Throughout its history the family has endeavoured to support and advance worthwhile causes and has established schools and colleges in Bangladesh as well as the renowned Ispahani Islamia Eye Hospital in 1960.

Iraj has held global and regional leadership roles in banking at JP Morgan and talent management at Korn/ Ferry where he focused on advising the buy side including asset and wealth managers, hedge funds and private equity firms. He also co-founded Cantos an online corporate communications business in 2001.

During his sixteen year career at JP Morgan, where he was Global COO of the Financial Institutions Group, Iraj worked in fixed-income markets, investment banking and asset and wealth management. At the JP Morgan Private Bank in London and Geneva Iraj advised wealth owners on investment strategy and generational planning. At Korn/Ferry he led financial services in EMEA and advised clients on governance, leadership and talent. He was also global head of client strategy and a member of the office of the CEO.

In January 2020 Iraj was appointed Chair of The Shakespeare's Globe Council. Prior to this Iraj served as Deputy Chairman and Trustee of Shakespeare's Globe. He also served as Chairman of the Remuneration Committee and Chairman of the Nominations Committee. He is a Member of the Advisory Board of 'Seeing is Believing', Standard Chartered Bank's global initiative to tackle avoidable blindness in collaboration with The International Agency for the Prevention of Blindness (IAPB). In October 2019 Iraj was appointed as an Independent Trustee of the newly established Standard Chartered Foundation. Iraj is an Advisor to UNICEF in the UK and in Bangladesh. Iraj is a Founding Advisor of the Responsible Family Business and Wealth Ownership program created by Cambridge Judge Business School Executive Education and is one of the lecturers and facilitators.

Iraj was educated at Winchester College and holds a Master's of Philosophy degree in international relations from Cambridge University and a Bachelor's Degree (with honours) from London University in politics and history.



Philip Marcovici is retired from the practice of law and consults with governments, financial institutions and global families in relation to tax, wealth management and other matters. Philip is on the boards of several entities within the wealth management industry, as well as of entities within family succession and philanthropic structures.

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Philip was a partner of Baker & McKenzie, a firm he joined in 1982, and practiced in the area of international taxation throughout his legal career. Philip was based in the Hong Kong office of Baker & McKenzie for twelve years, relocating to the Zurich office of Baker & McKenzie in 1996. Philip has also practiced law in each of New York and Vancouver, British Columbia. Philip retired from Baker & McKenzie at the end of 2009.

In 2013, Philip received a Lifetime Achievement Award from the Society of Estate and Trust Practitioners.

In 2016, Philip had his latest book, The Destructive Power of Family Wealth, published by John Wiley & Sons.

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