

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 aftermath of the global coronavirus pandemic and ongoing international conflict, but the ramifications for political risk interferences with international investments in particular are extensive. With nationalistic tendencies and regional conflict or competition resurgent in many countries around the world, compounded by the exposure of vulnerabilities in many economies, 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 that 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, regulatory 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 down debt incurred during the recent pandemic and resulting global financial and supply chain disruption.

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, particularly in the face of policies intended to bolster hard-hit local or domestic industries and actors. However, political risk factors may occur even as a result of non-discriminatory emergency measures, such as lockdowns or movement restrictions imposed during the pandemic.

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. Uncertainty for investors may also arise from competing positions taken by different branches within a government, such as when the Mexican judiciary suspended parts of a 2021 law on the hydrocarbon industry days after its enactment.

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. The proliferation of sanctions in response to recent geopolitical events represents another key political risk factor, particularly for individuals and families connected to jurisdictions that are the subject of national or international sanctions regimes. Sanctions may make it difficult to access assets or funds or may involve the revocation of certain investment protections. 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, including related to digital services or crypto-assets, 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.

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, quick 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 and related diplomatic sensitivities. 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. Further, the recent multi-billion dollar losses faced by insurance companies after the coronavirus pandemic may make some companies reluctant to extend coverage or delay payment under existing policies. 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 US.

In the case of Philips, the group's US assets were held in a trust carefully designed to separate the ownership of US 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. 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.

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. More recently, the Russian invasion of Ukraine set off complex political and economic responses, raising political risk factors. Ongoing conflict or the resurgence of violence in parts of Africa and the Middle East are reminders of the continuity of disruption that can have regional and global impacts. Such events indicate that political risk is not necessarily bound by region, industry or economy.

In such developments, it is common for assets including key industrial and commercial assets and land to be 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 that wealth owners globally still fear. Other flow-on risks related to geopolitical conflicts or strategic competition are the imposition by governments of export controls, or increased vetting for companies involved in sensitive sectors such as defence, space, technology or infrastructure. 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.

The recent pandemic displayed that political risk factors are not confined to those resulting from conflict or populist policies of regimes. Rather, emergency measures put in place to protect public health also affected a range of business and investment interests, such as lockdowns, trading restrictions and supply chain disruptions.

There has also been a marked increase in ESG-related risk. Changing social and political attitudes to carbon-based investments are likely to increase the risk of such investments in the future. Governments are under increasing pressure to tackle climate change through ambitious emission targets, and implement environmental, social, and labour standards across a range of sectors. There is an increase in litigation before national courts over environmental or labour violations that may have occurred overseas. While such measures may not present immediate risks such as expropriation, the impacts of protests, civil unrest, or resource and environmental nationalism should be considered for their longer-term impacts on certain investments and assets.

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) over a 100 armed conflict zones in the world today, including 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 one's 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 and the spread of instability in regions where conflict or competition is proliferating. These events include direct governmental interference from military takeovers, expropriation, changes in regulatory landscapes, 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.

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.

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. 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). The events of the pandemic, and recent political and economic upheaval indicate that there is little to suggest that regional or global dynamics over the next few years will see any increase in 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, 'tit-for-tat' trade measures between states, and a growing number of trade disputes. These threats can affect economic fundamentals, but they can also affect the very integrity of international investments and the stability of host state regulatory environments.

Into this challenging context comes a very significant international legal instrument that 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, 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 and almost 400 treaties with investment provisions. These include some of the latest cross-regional free trade agreements, such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the EU-Canada Comprehensive Economic and Trade Agreement (CETA), and the Protocol on Investment to the African Continental Free Trade Area Agreement (AfCFTA).

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 that 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:

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).
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 of (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). Further, if successful in obtaining an arbitral award against the State in question, an investor should be mindful of factors affecting the ability to enforce an award in different jurisdictions. Being located in a heavily sanctioned jurisdiction may also make it difficult to receive payment in satisfaction for arbitral awards. 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. 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. Relatedly, the relationship between family members and the economic investment at issue, particularly where trust arrangements are involved, may affect whether family members can be seen as 'investors' and thereby receive the benefit of protection under an investment treaty.

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 is likely to be significant.