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Résumé de l'article

Le risque politique est une composante de l'investissement à l'étranger. Il découlera soit de l'instabilité du gouvernement ou du régime politique, soit de certaines politiques gouvernementales restrictives ou contraignantes. Pour faire face à ce risque, deux mécanismes complémentaires sont utilisés : l'évaluation du risque et les mesures préventives.

En prenant pour exemple les pays d'Amérique latine, l'auteur explique comment l'évaluation du risque politique se fait grâce à des indices de risques, publics ou corporatifs. Chacun a développé ses méthodes d'évaluation et celles utilisées par General Motors et Union Carbide sont ici analysées.

L'auteur traite ensuite des moyens ouverts à un investisseur pour prévoir et minimiser les effets négatifs de la réalisation d'un risque politique. Comme mesures préventives, il identifie la mise en place d'une stratégie globale de la part de l'investisseur ou l'utilisation de techniques légales de protection. Parmi celles-ci, l'auteur analyse les clauses de stabilisation et d'internationalisation; la protection qu'offrent certains traités bilatéraux et multilatéraux aux investissements à l'étranger; les garanties qui peuvent être obtenues auprès d'organismes tels l'Agence multilatérale de garantie des investissements ; et le transfert de domicile des entités légales.

DROIT COMPARÉ

Comment maîtriser les risques dans les contrats internationaux/ How to Manage Risks in International Business *

Assessment of the Political Risk in a Country : a Practitioner's View

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ABSTRACT

Political risk is inherent to foreign investment. It stems from either the government's or the political regime's instability, or restrictive and compelling governmental policies. To cope with this risk, two complementary instruments are used : risk assessment and deterrent measures.

Taking into consideration South America, the author explains how the political risk assessment is realized through risks indexes,

RÉSUMÉ

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En prenant pour exemple les pays d'Amérique latine, l'auteur

* N. de la r. : Nous remercions les professeurs Nicole Lacasse et Louis Perret de nous avoir permis de publier, en primeur, une sélection des communications présentées au Colloque « Comment maîtriser les risques dans les contrats internationaux/ *How to Manage Risks in International Business* » tenu à Ottawa le 18 octobre 1989 sous leur direction. Les actes du Colloque paraîtront dans la Collection Bleue.

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public or corporate: each carries its own criteria as shown here by the analysis of General Motors and Union Carbide methods of assessment.

The author then discusses the means available to the investor to forecast and minimize the negative effects of the actualization of a political risk. He identifies two main categories of deterrent measures: business oriented strategies carried out by the investor or legal techniques of protection. Among the latter, the author analyses the stabilization and internationalization clauses; the security offered by certain bilateral or multilateral treaties to foreign investment; the guarantees agreed upon by organizations such as the Multilateral Investment Guarantee Agency; the transfer of domicile of legal entities.

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> On New Year's Eve, before the tumultuous events of 1978-79, President Jimmy Carter, while toasting the Shah in Tehran, referred to Iran as an "island of stability" in the Persian Gulf. President Carter's remarks reflected the consensus opinion about Iran not only among United States government officials but among most business firms operating in Iran as well. [1]

INTRODUCTION

Business risk, that is, the future contingency of gain or loss, is a variable of every business decision. It is, without any doubt, one of the principal considerations that a businessman must face when assessing an investment project. The probability that adverse situations arise that may affect the feasibility or profitability of the venture, which are impossible to identify at the time of undertaking the new activities, is a factor that every investor must judge and take into account when making an objective study of the feasibility of the enterprise that he is going to develop.

The above is specially true in international business projects since the investor is not always familiar with the local aspects nor with the components of the business climate of another country, and hence, he must conduct a much more complex and extensive study than would be required for the investment in his country of origin. The country's idiosyncracy, its economic problems, its monetary system, its tax and exchange laws, its attitude towards and treatment of foreign investors, its legal system, its political regime and stability, are only some of the factors

1. C.R.Jr. KENNEDY, "Multinational Corporations and Political Risk in the Persian Gulf", (1984) 16 *International Journal of Middle East Studies* 391.

that the businessmen must take into account in arriving at a prudent investment decision.

Among the risks most commonly considered and assessed are the financial and commercial or marketing types because they are such as businessmen are normally prepared to face. However, there is a particular type of risk which becomes more important day by day whose effects on international business is more frequent : the political risk.

In this presentation we want to show the political risk as one of the variables that must be seriously considered by any company that wishes to carry out business in the international field, within the frame of this important seminar on how to secure international transactions. To develop the subject, we shall start with the notion of political risk, analyzing the different situations that it may cover and study some cases that show situations in which the occurrence of political risks has generated difficulties for foreign investors. We shall show some problems in forecasting and assessing the political risks of a country, and finally we will mention protection mechanisms against the adverse effects of the occurrence of such risks, emphasizing the importance of the lawyer in drawing up the legal mechanisms of protection.

I. POLITICAL RISK

> Political risk can be defined as the probability that a given political event will result in financial losses for any particular firm. Many different kinds of political risk events exist and can be broadly divided into extralegal and legal-governmental risk. Extralegal political risk includes any event that emanates from outside existing authority or from legitimacy structures of the state, such as terrorism, sabotage, military coups, or revolutions. Legal-governmental risk, however, is a direct product of the ongoing political process and includes such events as democratic elections leading to a new government or changes in the law concerning trade, labor, joint venture, subsidy, technology, monetary and developmental policies. [2]
>
> Political risk in international business exists (1) when discontinuities occur in the environment, (2) when they are difficult to anticipate and (3) when they result from political change. To constitute a "risk" these changes in the business environment must have the potential for significantly affecting the profit or other goals of a particular enterprise. Essential to this definition are, therefore, the concepts of discontinuity and of direct effects on the firm. [3]

2. *Id.*, pp. 391-392.
3. J.-C. COSSET and B. DOUTRIAUX DE LA RIANDERIE, "Political Risk and Foreign Exchange Rates : An Efficient-Markets Approach", (Fall 1985) 16 *Journal of International Business Studies*, p. 22.

Taking into account the above definitions, one may state that political risk is the contingency that future and uncertain events, originating in the political environment or in the adoption of certain policies by the State recipient of the investment, modify the conditions in which a business has been organized and consequently change its perspectives on its future activities and gains. The new conditions may be the result of either instability of the government or of the political regime, or of the adoption of certain policies by governments which directly affect business.

A. INSTABILITY OF THE GOVERNMENT OR OF THE POLITICAL REGIME

Such instability is caused by social-economic problems (poverty, unemployment and labor conflicts, low *per capita* income, industrial or economic recession, high level of inflation, etc.) or by political ones (confrontation between different factions or political parties, including the presence of armed subversion, generating significant violence or civil war, coup d'État attempts, etc.).

This was the situation generated by political changes in Iran, following the overthrow of the Shah and the establishment of a theocracy with the Islamic Revolution of 1979, which were mentioned at the beginning of this presentation.

As examples of the types of risks, we may point out those existing in various Latin-American countries, without intending with this listing to make an analysis of the political risk in each of them :

PANAMA. With the internal political circumstances generated by the *de facto* continuation in power of General M. A. Noriega, accused of drug traffic by the United States, after the annulment of democratic elections and of various military coup attempts, with the strong opposition which counts with wide international support, the business climate was modified, it ceased to be a safe heaven for international banking transactions, loosing liquidity and eventually its appeal to those who entrusted their funds to financial institutions.

NICARAGUA. With the success of the 1979 revolution, its political regime changed dramatically, which consequently modified the rules of the game for foreign investors. Due to the long fight between the leftist Sandinista government and the counter-revolution, the country is facing a very high level of social, economic and political crisis, which has without any doubt influenced the factors for investment decision taking.

EL SALVADOR. With the civil war that is going on and the unsuccessful peace dialogue attempts between the democratic government and a strong left-wing guerrilla, an unstable business climate is generated for foreign enterprises in the medium term, and its situation is unforecastable in the long term.

PERU. With its economic difficulties, high levels of informality in its productive system, indebtedness level and domestic public order position resulting from the impact of guerilla, it also presents a situation of instability which is taken into consideration by business analysts as an important variable.

ARGENTINA. It also suffers from problems in its economy — very high level of inflation and devaluation, high level of external indebtedness and difficult domestic circumstances, given the still tense relations between the civil and the military. Even though the recent democratic change into power has brought about a new stage in the recovery process, it is necessary to observe the evolution of the different political and economic factors that affect its environment for foreign investment.

COLOMBIA. Lastly, we will mention the Colombian case, which has been widely covered in the international press of the last few months. Colombia has a democratic tradition stemming from more than one century of constitutional succession in power. Even though this century has witnessed some periods of political violence and it has the problems of a developing nation, Colombia has gradually turned into a country attractive to foreign capital, specially in its important natural resources of mining and oil.

The consolidation of the guerrillas since the 1970's, though representing a very small portion of the population of the country and supported only by minority groups, produces an adverse effect on the business climate. The Colombian army has had to face the armed attacks of the Left, but it should be stressed that there are some attempts between the government and most of these groups for a dialogue tending to become a "peace treaty". As a reaction to the growth of the guerrilla movement, paramilitary groups have emerged, accused of receiving financing from drug traffickers.

The ELN guerrilla group has caused considerable losses to the oil industry operation in Colombia, which is basically carried out under contractual joint ventures with multinational companies. These losses result from blow ups during the last two years, of the pipeline which takes the crude oil from Caño Limón (one of the most important wells discovered in the past years within the framework of a joint venture between the Colombian government and Occidental Petroleum) to the port of Coveñas.

On this last point it is worth mentioning an aspect related to the ethics of multinational enterprises facing circumstances involving political risks in their international operations. An example that, by itself, shows a situation of this type was that of a multinational enterprise of recognized international standing, to whom the Occidental-Empresa Colombiana de Petróleos joint venture, awarded a substantial contract for the construction of the Caño Limón-Coveñas pipeline mentioned above. As stated by a former Minister of Mines, it is believed that facing extortion from a small guerrilla group at the time, the company agreed to deliver millions in exchange for the guarantee not to be obstructed during the laying of the pipeline. The contractor was able to complete the work without delay; however, the guerrilla group was tremendously strenghtened and it became a highly dangerous organization for the oil venture and it has caused terrorist acts of destruction of the pipeline, amounting to enormous losses for the country and for the foreign investor.

Lastly, Colombia's problems caused by the international drug traffic are known to all. Colombia has a strategic geographic position between the points of production and of consumption, which, tied to a very high and overgrowing demand for drugs, has generated criminal groups with a very high economic power. Against this scourge, the government, with the support of the people, has permanently fought a war that has recently become very intense. Today, this war against drug traffickers has reached world scale but its effects are felt specially in Colombia.

To sum up, Colombia has suffered the negative impact produced by guerrilla groups and narcotraffickers. Nevertheless it has been widely overcome by the benefits and the perspectives that the country offers and it reflects in the economic indexes; its strict compliance with foreign debt, and other such factors have placed her in an outstanding position in the Latin-American context.

Next to show the above, we will list how the debt of Latin-American countries is being quoted, which in some way shows how the international financial market perceives their economic perspective :

Country	Quotation (%) debt New York, June 11, 1989
Argentina	17.5 %
Brazil	32 %
Chili	64.5 %
Mexico	44 %
Venezuela	41 %
Ecuador	15 %
Colombia	50 %

(Source : Merrill Lynch, taken from America Economia, August, 1989).

B. ADOPTION OF CERTAIN POLICIES BY GOVERNMENTS WHICH DIRECTLY AFFECT BUSINESS

Such policies could consist of nationalization of sectors of the economy, expropriation of assets, elimination or substantial modification of the right to remit profits abroad or repatriate capitals or unilateral termination by the State of contracts executed with foreign enterprises, among others.

Some important decisions from international courts refer to these circumstances, which are very interesting to study, to observe how they have resolved conflicts arising from such changes in the policies of a country. We highlight below some of the most significant on the subject that we are now dealing with.

BP Exploration Company (Lybia) Limited
v. *Government of The Lybian Arab Republic*[4]

On December 18th 1957, the Petroleum Commission of the Government of Lybia granted a Concession to a citizen of the United States. In 1960, BP Exploration Company (Lybia) Limited acquired from the said citizen an undivided one half interest in the Concession. This Concession contained the grant of an exclusive right for fifty years, to search for and extract petroleum in a designated area of Lybia, and to sell the oil thus produced. Clause 16 of the Concession provided that "the contractual rights expressly created by this concession shall not be altered except by mutual consent of the parties".[5]

On December 7th 1971, the Lybian Government passed a law nationalizing the activities of the Petroleum Company — claimant in the arbitral proceedings — in respect of this Concession.

In arbitration, the claimant asked the Tribunal to declare that :

(i) The Lybian Nationalization Law was a breach of the Concession;
(ii) the breach was ineffective to terminate the Concession;
(iii) the claimant is entitled to be restored to the full enjoyment of its rights under the Concession;
(iv) the claimant is the owner of its share of any oil extracted from the Concession area after, as well as before, the date of nationalization;
(v) the claimant is entitled to damages.

The Arbitration Court decided that a nationalization is licit, as a sovereign decision of a State, if it is only based on public interest

4. *BP Exploration Company (Lybia) Limited* v. *Government of the Lybian Arab Republic*, 10 October 1983 and 1 August 1974, (1979) 53 *I.L.L.R.* 297.
5. *Id.*, p. 322.

considerations and if the injured party receives a fair indemnity. In the case studied, the Court held that :

> The BP Nationalization Law, and the actions taken thereunder by the Respondent, do constitute a fundamental breach of the BP Concession as they amount to a total repudiation of the agreement and the obligations of the Respondent thereunder, and, on the basis of rules of applicable systems of law [...], the Tribunal so holds. Further, the taking by the Respondent of the property, rights and interests of the Claimant clearly violates public international law as it was made for purely extraneous political reasons and was arbitrary and discriminatory in character. Nearly two years have now passed since the nationalization, and the fact that no offer of compensation has been made indicates that the taking was also confiscatory. [6]

After making some other important considerations, the Court held that :

(i) The Nationalization Law was a breach of the Concession;
(ii) The Nationalization Law was effective to terminate the BP Concession;
(iii) No declaration could be made that the claimant is entitled to be restored to the full enjoyment of its rights under the Concession;
(iv) No declaration could be made that the claimant is the owner of any oil extracted after the date of nationalization;
(v) The claimant is entitled to damages.

Texaco Overseas Petroleum Company & California Asiatic Oil Company v. *Government of the Lybian Arab Republic* [7]

In this case, 14 deeds of Concession were executed between the Lybian Government, and the California Asiatic Oil Co. and the Texaco Overseas Petroleum Co., from 1955 to 1968. In 1973, Law 66, a decree of nationalization, was enacted, whereby 51 % of all property, rights and assets of these companies were to be transferred to the Lybian National Oil Co. (NOC). Law 11 of 1974 nationalized the totality of the properties, rights, assets and interests of California Asiatic Oil Co. and Texaco Overseas Petroleum Co., arising out of the 14 deeds of Concession held by those companies, and transfer had to be made of all properties, rights and assets to NOC.

6. *Id.*, p. 329.

7. *Texaco Overseas Petroleum Company and California Asiatic Oil Company* v. *Government of the Lybian Arab Republic*, 19 January 1977, (1978) 17 *International Legal Materials* 3.

Among other important views, the arbitral award stated that "the decision of a State to take nationalizing measures constitutes the exercise of an internal legal jurisdiction but carries international consequences when such measures affect international legal relationships in which the nationalizing State is involved". [8]

To define the second type of political risk, we present below some other situations, which have occurred in some Latin-American countries, and which are useful examples :

VENEZUELA. After a long period of exchange stability, in 1988 the government decided to adopt a high devaluation of the Bolivar, vis-à-vis the dollar, which caused an immediate impact on all foreign trade transactions.

PERU. In 1987, the government announced the nationalization of the banking system and a moratorium on its foreign debt's payment. These circumstances clearly modified the rules of the game in the financial sector and for lending banks.

II. ASSESSMENT OF POLITICAL RISKS

As stated above, in international business it is crucial for strategic planning to be able to know and assess, and in some way foresee, the political risks that one may face in carrying out its operations in other countries. But, how can this be achieved?

For some analysts, this task is especially difficult precisely because it involves forecasting generally unpredictable future situations, which may not be exactly identified when planning the investment. It is also difficult to measure and assess in advance the economic impact of those unpredictable facts on the enterprises' operations and profits.

It has been considered that "political risk, a topic of growing interest in the academic community and the financial press, is an elusive concept which is not well amenable to empirical measurement". [9]

Debate has also been brought as to the quantitative or qualitative emphasis of risk assessment. "Skepticism regarding quantitative approaches centers on the feasibility of 'counting' behavioral phenomena as a means of analyzing the politics, policies and actions of governments and societies". [10] On this matter, some conclusions have been drawn as to the need of sound assessment of qualitative factors in order to obtain fair quantitative results. [11]

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8. *Id.*, p. 22.
9. J.-C. COSSET and B. DOUTRIAUX DE LA RIANDERIE, *loc. cit.*, *supra*, note 3, p. 22.
10. D. BRUMMERSTED, "Host Country Behavior : Issues and Concepts in Comparative Political Risk Analysis", (1988) 3 *Global Risk Assessments*, p. 81.
11. *Id.*, p. 83.

Besides, due to the broad variety of business sectors and countries, it is unlikely that risk analysis can elaborate a standard model to fit specific corporate needs for specific activities in specific countries. "A single, universal model for assessing political risk has not emerged simply because it is not feasible". [12]

Despite the difficulties stressed above, different risk indexes that cover many countries have been designed by experts and are useful in decision-making processes regarding foreign investment. Examples are the Euromoney Risk Index about trends in international credit markets, and the World Political Risk Forecasts (WPRF).

There are individual approaches carried out by multinational corporations as well, that draw interesting conclusions on the risk assessment issue.

A. THE GENERAL MOTORS' APPROACH

General Motors (GM), for instance, developed its own method for evaluating political risk.

> Entering the 1980's GM management decided that an informal approach was no longer adequate, given the growing range of the Corporation's overseas activities, and the rapid globalization of the auto industry. They wanted a structured, analytical and comparative approach to political change and government policies around the world, for use in strategic planning, new product development, government relations and other activities. [13]

GM created its own Political Risk Index : an annual comparison of the political environment for U.S. automakers in 64 countries around the world.

This company observed, for example, that its main corporate goal, as it is for every business, is profitability and that policy factors (such as the capability to manage modernization of the economy) and regulation (such as profit repatriation restrictions or other local requirements) are more critical to profitability than political events (like coups d'État or ethnic conflicts).

The Political Risk Index reflects the relative level of risks to GM operations, assigning a numerical score to each factor for each country. The more uncertainty surrounding the factor, the lower the score. Totalling the scores for each factor produced a country score on a 100-point scale; the closer to 100, the lower the risk. Based on the scores,

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12. *Id.*, p. 78.
13. G. RAYFIELD, "General Motors Political Risk Ratings : Assessment of a Track Record", (1983) 3 *Global Risk Assessments* 172–186.

countries are assigned one of four risk ratings on the Political Risk Index :

0-40	High Risk
41-60	Medium High Risk
61-80	Medium Low Risk
81-100	Low Risk

The indicators of every country level of risk give GM management an indea of the degree of uncertainty in strategic countries that could lead to adverse changes in the rules of the game for GM overseas operations. According to this analysis, developed countries tend to be concentrated in the Low Risk and Medium Low Risk categories, due to stability of governments and because policy changes come about after public debate and through known processes.

However, as some other studies have pointed out, political risks may well occur in developed countries because change in regulation is not an exclusive feature of Third World countries. [14]

Even though the model was designed for GM in particular, some conclusions may be useful as general guidelines for other firms :

1. Political Risk analysis has to be industry and even project specific. Manufacturing companies, which produce for the local market and create jobs for nationals, do not face the same political sensitivities as a mining company, which can be blamed of taking away the wealth of a nation and selling it overseas.
2. The system has to be dynamic, not static. The goal of the GM system is to alert managers about potential change in the business climate, and to do so with sufficient time in advance, so that they can minimize the company's exposure to risks.
3. The system must be capable of comparisons with other countries, taking into account that multinationals may have concerns in different countries.
4. The system should focus on the policy outcome. Unpredictability in the policy process is the single factor that can have the greatest impact on any firm's profitability.

B. THE UNION CARBIDE VIEW

Union Carbide [15] gives special attention to political risk assessment as a corporate strategy. It developed a "Country Risk Evaluation

14. D. BRUMMERSTED, *loc. cit.*, *supra*, note 10, p. 79.
15. E.G. ROBERTS, "Country Risk Assessment : The Union Carbide Experience", (1988) 3 *Global Risk Assessments* 1-12.

Model" as a pragmatic collection of external and internal informational sources designed to keep track of sovereign affairs and monitor signs of disruption or political change that could affect (for better or for worse) the company's interests abroad.

This company created a team of experts and established contacts with the Association of Political Risk Analysis (APRA), located in Washington, D.C. The team members interviewed a large number of political risk practitioners, consulting firms, banks and members of the academic community.

The recommendations of the study gave senior management, responsible for corporate decision-making, valuable tools and ability to question and probe new overseas investments, so as to insure that the proposed project returns were commensurate with the specific risks. These recommendations were as follows :

1. Make a realistic appraisal of your firm's present abilities to deal with the risks and opportunities of doing business overseas.
2. Strengthen "early warning" capabilities. Forecasting is a difficult task, but it is the name of the game in country risk assessment.
3. Expand existing political/financial intelligence networks.
4. Decide to keep well informed of country developments.

As a conclusion, the purpose and importance of a sound political risk assessment is to decrease the level of uncertainty in business decisions and this analysis should be made according to the particular characteristics of each business and consulting the specific conditions of the host countries.

III. PROTECTION AGAINST POLITICAL RISKS

In spite of the fact that the factors involving political risk are beyond the investor's control and that he cannot stop them from happening, there are some ways to deal with it, minimizing the resulting negative effects.

A. BUSINESS-ORIENTED STRATEGIES

There are business strategies designed to reduce political risks and protect the company from them, that have to do with the investor's attitude toward the host economy, government and its ways to maintain and improve competitiveness and profitability. These are classified by the business literature as integrative and protective techniques. [16]

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16. A. GREGORY, "Integrative and Protective Techniques in Reducing Political Risk : A Comparison of American and Canadian Firms in Indonesia", (1988) 3 *Global Risk Assessments* 98–116.

The integrative techniques are aimed at increasing the integration of the foreign venture into the host society, the premise being that the more integrated a foreign venture is, the less it will be perceived as foreign, and therefore, the frequency of loss will be reduced. Some types of integrative techniques are : cultivating close ties with the government; adopting policies dealing with local sourcing, distribution and employment, and in general, attempting to ensure some compatibility between the firm's and the host government's goals. Nevertheless, investors must keep in mind that overreliance on these techniques can cause damage that will lessen the company's ability to compete effectively in both the world and host country markets.

The protective techniques tend to discourage host government interference, or in the event of interference, minimize the firm's loss. These techniques provide for non-integration of the foreign enterprise with the host society and its economy. Examples are to locate essential research and development facilities and essential parts of the manufacturing process outside the host country, multiple sourcing locations, etc. Although the policies' purpose is to reduce losses, overreliance on them may lead to frequent losses, since the host government will identify the firm as an hostile entity.

Some suggestions have been made as to the need for firms to develop an amalgam of integrative and protective techniques for investment projects in foreign countries.

B. LEGAL PROTECTION

There are important legal mechanisms to manage political risk. Relationships between multinational enterprises and foreign countries are normally governed by contracts. Although the principle of *pacta sunt servanda* is recognized internationally, legal conflicts arise when the investor's statu quo is modified by a government decision. Among the clauses most commonly used to prevent and regulate changes in the rules of the game and to seek objective resolution of disputes are : stabilization clauses and internationalization of conflicts.

International treaties have also been subscribed as a legal means to rule the relationships between countries and foreign investors and as a way to protect the latter against political risk.

There are institutional protections through special types of insurance as well, such as OPIC, for U.S. investment abroad, and MIGA on a multilateral basis. These mechanisms also work within the frame of bilateral or multilateral agreements between States.

Finally, there are other protective measures, such as the transfer of the domicile of legal entities, to avoid expropriation, confiscation or similar political risks within a given country.

We will examine all these legal strategies below.

1. Stabilization clauses

> [These provisions] are inserted in such contracts to ensure that future changes in the laws of the host country do not affect the contract. The freezing of the conditions prevailing at the time of the bargain and their subsequent immutability despite any changes in the economy or the policies of the host government has been the objective of capital exporting countries. [17]

An interesting example of a stabilization clause was contained in the Concession deeds between Lybia and the Texaco Overseas Petroleum Company & California Asiatic Oil Company :

> The Government of Lybia will take all steps necessary to ensure that the company enjoys all the rights conferred by this Concession. The contractual rights expressly created by this Concession shall not be altered except by mutual consent of the parties.
>
> [...]
>
> This Concession shall throughout the period of its validity be construed in accordance with the Petroleum Law and the Regulations in force on the date of execution of the agreement [...]. Any amendment to or repeal of such Regulations shall not affect the contractual rights of the Company without its consent. [18]

The arbitral award in the case states as follows :

> Thus, in respect of the international law of contracts, a nationalization cannot prevail over an internationalized contract, containing stabilization clauses, entered into between a State and a foreign private company. The situation could be different only if one were to conclude that the exercise by a State of its right to nationalize places that State on a level outside of and superior to the contract and also to the international legal order itself, and constitutes an "act of government" [...] which is beyond the scope of any judicial redress or any criticism. [19]

This type of clause is also provided for in some international treaties, such as the Prototype Bilateral Investment Treaty (BIT), formulated by the United States Government in 1981, "not only to protect [...]

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17. M. SORNARAJAH, "The Myth of International Contract Law", (1981) 15 *J.W.T.L.* 188-217.

18. *Texaco Overseas Petroleum Company and California Asiatic Oil Company* v. *Government of the Lybian Arab Republic, supra*, note 7, p. 4.

19. *Id.*, p. 25.

current investments and to reduce the uncertainties associated with them, but also to encourage a freer international flow of capital investment".[20]

Although the international instruments for protection against political risk will be addressed later, it is important to mention the stabilization clauses that are suggested in international treaties. In Article III of the BIT, the parties promise not to expropriate, nationalize, or take any other measure that would be tantamount to expropriation, unless it is 1) done for a public purpose, 2) accomplished under due process of law, 3) not done discriminatively 4) accompanied by adequate, prompt compensation, and 5) not performed in violation of any specific agreement between a national or company of a party and another expropriating party.

Although stabilization clauses are deemed as an effective legal protection against political risk to preserve the investor's statu quo against governmental measures, such as expropriation or nationalization, the truth is that even under "stabilized" contracts, countries have decided to expropriate or nationalize. This is particularly the case in oil and mining exploitations through concessions, when the host country varies its policy regarding natural resources. These conflicts have been usually submitted to international arbitration, such as in the Lybian Concessions already mentioned, but legal opinions vary on this respect.

Recent international literature even questions the validity and fairness of stabilization clauses.[21] According to these views, with the phenomenon of State intervention in the market place, the "sanctity" of contracts has become an outmoded concept. Furthermore, it is accepted as a legitimate trend that Third World countries assume absolute sovereignty over their natural resources. Since 1952, a series of UN General Assembly resolutions have asserted the principle of economic self-determination. Resolution 1803 (December, 1962) expressly declared the inalienable right of all States to dispose freely of their natural wealth and resources in accordance with their national interest. The right to appropriate compensation was also recognized, as well as the duty for States to observe in good faith the foreign investment agreements entered by them.

From the above considerations, several conclusions may be drawn :

— Stabilization clauses alone and for themselves do not guarantee total protection against political risk, namely expropriatio~ or nationalization.

20. K. KUNZER, "Developing a Model Bilateral Investment Treaty", (1983) 15 *Law and Policy in International Business*, n° 1, p. 273.

21. M. SORNARAJAH, *loc. cit.*, *supra*, note 17, pp. 188-217.

— Dealing with overseas projects as oil and mining, foreign investors must be aware that changes may occur in economic policies, whereby the host country decides to assume direct control of natural resources, seeking national welfare. These decisions made in good faith are supported by the international community.

— Host countries must respect acquired rights of foreign investors. Expropriations or nationalizations may be done only for public and legitimate purposes, under due process of law and granting adequate and prompt compensation.

Proposals have been made as to include not "old style" stabilization clauses, but renegotiation clauses in the international contracts, so that under new circumstances, the host government and the foreign investor may agree to new provisions, which are more equitable and fair than simply "freezing legal conditions" for the benefit of one of the parties.

2. Clauses for the internationalization of contract and internationalization of conflicts

Another type of protection against political risk using contractual provisions is to include clauses to internationalize the contract and to internationalize the conflicts that may arise from the fulfilment and the construction of agreements entered into by investors and foreign governments.

The main purpose of these clauses is to relate to international law in all aspects concerning the contract, so no local rules of the host country shall be applied, keeping the investment safe from unpredictable and arbitrary changes in national legislation. Likewise, some contract provisions have been devised to submit all controversies arising from the contract, to international arbitration, so that an impartial and objective decision will be reached, far from local judges and tribunals, that might tend to favor host country interests.

Protection of foreign investment through internationalization clauses has been questioned in a similar way as have been stabilization clauses. Some authors say that, if acquired rights must be respected by States and changes in legislation may occur, it is not clear why, although sovereign, they must subject themselves to international rules and be judged outside their territory. "In constructing a new regime for regulating foreign investment, international lawyers cannot overlook the significance of the rule that people and their state have sovereignty over their natural resources and that any dispute arising from the exploitation of those resources can only be settled by the national courts of the state". [22]

3. Bilateral and multilateral treaties

Despite such criticisms, which are directed particularly to foreign investment in natural resources, international efforts in the form of bilateral and multilateral treaties have been made as to devise some mechanisms to regulate foreign investment and to provide for the resolution of disputes that may emerge thereby.

As examples, we shall mention the following :

a) The Prototype Bilateral Investment Treaty (BIT) formulated by the United States Government, as noted earlier. This instrument has been negotiated already with a number of developing countries (Egypt, Panama, Costa Rica, Morocco, Cameroun, Gabon, Burundi, Zaire, Honduras and El Salvador) and is intended to provide protection of foreign investment owned by the parties to the treaty.

> The Prototype reduces uncertainties by guaranteeing access to the courts for settlement of claims, and guarantees compensation for expropriation and losses due to war or internal insurrection. In addition, it provides settlement procedures for disputes between a foreign investor and the country in which the investment resides. [23]

b) The Convention on the Settlement of Investment Disputes between States and Nationals of other States. This multilateral treaty establishes conciliation and arbitration proceedings administered by the International Center for Settlement of Investment Disputes (ICSID), created by the Convention, which has its seat at the Headquarters of the World Bank in Washington, D.C.

Concerning the advantages of this treaty, it has been said that :

> [I]t is beyond doubt that fear of political risks operates as a deterrent to the flow of private foreign capital to developing countries. The World Bank therefore considered it appropriate to explore whether it could make a contribution to an improvement in the investment climate, by reducing the likelihood of unresolved conflicts between host countries and investors, and in particular by doing so in a manner which would eliminate the risk of confrontation of the host country and the national State of the investor. [24]

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22. *Id.*, p. 208.
23. K. KUNZER, *loc. cit.*, *supra*, note 20, pp. 288-289.
24. A. BROCHES, "The Convention on the Settlement of Investment Disputes between States and Nationals of Other States", (1972) 136 *Collected Courses of the Hague Academy of International Law*, p. 343.

The Convention entered into force on October 14th, 1966 but many developing countries, including Colombia, have not ratified it yet.

4. Institutional protection through special insurance

Some special types of insurance have been designed to protect foreign investment against political risk :

a) OPIC, the Overseas Private Investment Corporation,[25] is a U.S. government-owned corporation, having the sole function of encouraging productive and useful private American investment in developing countries. OPIC offers incentives to American companies planning to invest overseas. The incentive programme includes insurance against political risks of inconvertibility of currency, expropriation of an investment and physical damage to an investment caused by war, insurrection or civil strife.

Inconvertibility refers to the inability of an investor to convert into dollars the local currency received as profits, earnings or return of original investment. Expropriation includes loss of investment due to expropriation, nationalization or confiscation by a foreign government without compensation. OPIC also covers loss of investment or damage to tangible property as a result of politically motivated violent acts by an individual or group, including acts of terrorism or sabotage. The insurance does not include commercial, financial or normal business-type risks.

b) MIGA, the Multilateral Investment Guarantee Agency,[26] created at the initiative of the World Bank, has the same purpose as OPIC, but was conceived on a multilateral basis, and its advantages are available to a larger range of countries, the ones which ratify the International Convention. As of 1989, MIGA has been signed by 73 countries, including Colombia, ratified by 54 of which 13 are industrial countries, and its effectiveness started upon ratification by five industrial countries and fifteen developing countries.

MIGA will protect investors by issuing guarantees against several types of non-commercial risks : (a) host government restrictions on currency conversion and transfer, (b) expropriation of other host government restrictions, actions or inactions, that deprive investors of control or substantial benefits from their investments, (c) repudiation of

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25. A.F. MARRA, "The Overseas Private Investment Corporation", (1983) 2 *International Financial Law Review* 165–174.
26. T. BREWER, "MIGA : A New Organization to Promote and Protect Private Direct Investments in Developing Nations", (1988) 3 *Global Risk Assessments* 36–45.

government contracts, (d) armed conflict or civil unrest, and (e) possibly other types of non-commercial risks that would be approved for coverage in the future.

It has been stated that

> It is reasonable to suppose that host governments will be less likely to undertake actions (or avoid actions) constituting the risks against which MIGA would be issuing guarantees. A host government would be reluctant to become involved in a situation in which MIGA would be having to pay claims as a result of that host government's actions. [27]

5. Transfer of domicile of legal entities

Although important legal issues are involved as to the feasibility of such type of decisions, it must be mentioned as a possible strategy to protect foreign investment.

> In case of war or revolution, threatened expropriation or even in less dramatic crisis, a legal entity could avoid the confiscation of its foreign assets if it had the possibility to transfer its domicile across the border into a host country, while preserving the continuity of corporate existence [...]. A precondition for such a transfer is the provision in the legislation of the home country for such a transfer without the dissolution of the legal entity. [28]

As for the one mentioned, there are other legal protective measures and their effectiveness depends upon regulations of the countries involved.

CONCLUSIONS

Political risk is a type of business risk that must be assessed by firms willing to start or continue projects overseas. It includes a wide variety of situations, arising from the economic, social and political environment of a given country, having potential adverse consequences for the owner of foreign investment in that country. As a result, conflicts often arise from the occurrence of any of such risks, between the host country and the foreign investor.

Even though it is difficult to predict or stop such future events, several methods have been designed to forecast political risks with some accuracy and some strategies have been formulated to deal with their consequences, hopefully to minimize their negative impact over the business operation. Some of these methods intend to measure the risk in

27. *Id.*, p. 41.

28. W. KOLVENBACH, *Protection of Foreign Investments*, Deventer-Boston, Kluwer Law and Taxation Publishers, 1989, p. 275.

a given country or set of countries; different indexes are published around the world for the use of multinational corporations. Other approaches to the assessment problem are more industry and country specific.

An issue in the political risk analysis is the possibility to seek protection against it and in such case, how that protection can be translated into effective formulas.

From a legal point of view, several protective strategies have been exposed by the international lawyers and others have risen from business practice. Stabilization and internationalization clauses, international treaties, institutional insurance, are among some of the answers of the legal community to these conflicts.

Understanding and assessing political risks is not the analysis that lawyers are trained to make. Teams of experts in economics, political science, international business and strategic planning must undertake such a difficult task. But the legal expertise is necessary to translate protection against adverse forecasts and predictions into effective and workable formulas.

> The task that awaits the international lawyer is to discern in the new trends some norms, that would balance the interests of the developing countries that their natural resources be used primarily to benefit their economies, with the interests of foreign corporations that their investments are safeguarded.[29]

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29. M. SORNARAJAH, *loc. cit.*, *supra*, note 17, p. 207.