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Client Alert

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# Recent Nationalizations of Natural Resources Industries in Latin America Continue Wave of Expropriations Threatening Foreign Investors

## Background

With demand rising and natural resources becoming scarce, a wave of nationalism is spreading among certain Latin American countries which threatens US, European and other foreign investments in these countries' mining, oil, and gas industries. Once welcomed with open arms, foreign investors' property rights are now being sacrificed in the name of the public good. Populist leaders in Argentina (Kirchner), Venezuela (Chavez), and Nicaragua (Ortega) have implemented a variety of measures ranging from direct seizures to more subtle legislative and regulatory policies designed to "reclaim the people's natural resources."

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Following their lead, Bolivian President Evo Morales recently dealt another blow to foreign investors by forcing them to "renegotiate" their longstanding energy concession contracts with the Government. Bolivia's "nationalization" program began on May 1, 2006 with Supreme Decree No. 28,701. With the stroke of a pen, President Morales effectively nullified all oil and gas production concession contracts and mandated that the state-owned petroleum company (YPFB) seize a majority interest in the principal oil and gas production, distribution and refining companies, including those owned by British Petroleum, Royal Dutch Shell, Occidental Petroleum, Repsol of Spain, and Total of France. However, President Morales offered no compensation to the foreign investors for these expropriations. Instead, he demanded that the investors "renegotiate" their concession agreements within 180 days of the enactment of Decree No. 28,701.

Left with no reasonable alternative, these foreign investors recently agreed to convert their lucrative production sharing contracts into heavily-taxed operating agreements. The overall tax burden for the oil and gas companies is now expected to be approximately 82 percent, depending on the production volume and exploration costs of each company. Although the new contracts purportedly "guarantee an acceptable rate of return" to the investors, many analysts question whether they will be able to sustain their operations when forced to return eighty-two cents of every dollar to the Government.

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## The Impact on Foreign Investment in Latin America

The Bolivian nationalization of its oil and gas industry follows on the heels of similar expropriations in Venezuela and Argentina. In the last few months, Venezuela has confiscated oil fields operated by E.N.I. of Italy and Total of France. Likewise, numerous investors have asserted claims against Argentina, alleging Argentina's indirect expropriation of substantial foreign investment through the forcible renegotiation of long-standing agreements in its privatized natural gas industry. These expropriations have sent shockwaves through the oil and gas industry, and some pundits predict that other Latin American countries with newly elected governments may implement similar measures.

The recent fever sweeping across Latin America to nationalize strategic resources suggests a fundamental shift in many countries' privatization and foreign investment policies that will likely spread beyond the oil and gas sector. For example, Bolivia has announced a National Development Plan (NDP) to seize control of several private utility companies. These include three electricity distributors, a telecommunications company, and two railroad companies. The NDP subjects these companies to mandatory financial and technical audits, and requires them to pay Bolivian citizens a "solidarity bonus" based on their profitability. Building on these anti-investor policies, the Bolivian government recently turned its sights on the mining industry. Although it is not yet pursuing an outright nationalization program, the Government has announced its intention to increase an export tax on mining products by up to 600 percent.

While no one can accurately forecast how the ever-changing social and economic environment may influence Latin American leaders, an ill political wind is certainly blowing against foreign investors that will undoubtedly increase the risks of doing business in these countries. Ironically, this paradigm shift comes at a time when most global investors believed that nationalizations and other expropriatory actions were far less likely in the modern era of free trade treaties and borderless commerce. However, economic instability, high energy prices, and insatiable demand for dwindling natural resources have encouraged populist leaders like Chavez and Morales to redefine their countries' investment policies. In this dynamic atmosphere, even governments which traditionally have been investment-friendly, such as Brazil and Mexico, may not be immune from investment disputes.

## Mitigating the Political Risks of Foreign Investments

Those wishing to capitalize on the attractive returns offered by Latin American countries must be mindful of the significant political risks, take affirmative steps to mitigate their risks, and aggressively pursue their remedies when the offending countries expropriate their investments. To this end, diligent investors should consult with experienced counsel who can not only advise them concerning their rights and remedies under the various international dispute resolution forums, but also help them mitigate their political risks through various forms of specialized insurance products. Three of the most frequently used methods of mitigating risk are described below.

*International commercial arbitration.* Concession agreements or other state-sponsored investment contracts with a foreign investor may contain a provision requiring that any dispute be resolved through international arbitration. The modality of arbitration chosen may vary from one administered by a leading institution, such as the International

Chamber of Commerce International Court of Arbitration, to *ad hoc* or stand-alone arbitration proceedings governed by a standard set of rules, such as the widely-used Arbitration Rules adopted by the United Nations Commission on International Trade Law. Each set of rules will have its own particular features regarding such crucial aspects as the initiation and the organization of proceedings and the appointment or disqualification of arbitrators. Of fundamental importance will be the selected venue for arbitration, as this will determine which courts are competent to exercise supervisory jurisdiction over the proceedings, including the power to review arbitration awards. Thus, foreign investors should carefully negotiate the dispute resolution provisions in their agreements with the host government.

*Investment treaty arbitration*. Countries have gradually but steadily been entering into bilateral treaties for the promotion and protection of investment (bilateral investment treaties or BITs), which incorporate and expand on the protections that customary international law requires their governments to afford foreign investors. In the Americas, these protections have also been codified in bilateral and multilateral free trade agreements (FTAs). A remarkable innovation of BITs and FTAs is that they allow eligible investors to enforce these protections directly against the host State through international arbitration, regardless of whether they have a contract with the host State. Most BITs and FTAs require that any arbitration be conducted under the auspices of the World Bank's International Centre for Settlement of Investment Disputes. These proceedings are conducted with no intervention from local courts, except for enforcement of awards. Given the uncertainty of litigating in a foreign forum, wise investors should carefully analyze their rights under the governing BIT or FTA before committing capital in the host country. If they do not, they risk foregoing effective international remedies against expropriation or other governmental interference.

*Political risk insurance*. In addition to evaluating their remedies against the offending government, foreign investors should carefully consider obtaining political risk insurance to protect their investment. Private insurers and government agencies such as the Overseas Private Investment Corporation and the Multilateral Investment Guarantee Agency offer a variety of policies covering a range of political risks. These policies typically cover direct and indirect expropriation measures, currency transfer restrictions, arbitrary repudiation of commercial agreements, as well as other government actions. As with any complex insurance product, securing the proper political risk coverage for an investment requires careful analysis of the most salient risks. Once the offending government commits an act that triggers the policy, investors should enlist experienced coverage counsel to navigate the claims process and litigate the dispute should the carrier wrongfully deny the claim.

## Latham & Watkins' Experience in Investment and Political Risk Insurance Disputes

Latham & Watkins' Dispute Resolution Group has a unique capacity to deal with international arbitration and public law matters, ranking the highest among its peer law firms in the Legal 500 (UK) 2006 and Chambers (UK) 2007 directories. In addition, the firm's Insurance Litigation Group, which for years has been recognized as one of the top policyholder practices by Chambers and other publications, is well-positioned to assess various political risk insurance products and prosecute claims against government and private

insurers. These practice groups reflect Latham & Watkins' leading experience in representing clients concerning a variety of international investment issues and disputes.

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