SAFEGUARDS FOR FOREIGN INVESTMENT IN MINING

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EXECUTIVE SUMMARY

In reality, the process of making mining investment decisions is as much idiosyncratic as it is scientific. This explains why there are never any absolute or universal standards of legal adequacy for foreign investment in mining; it is always a question of what will satisfy a particular investor in a particular case and whether the project will satisfy the requirements of "bankability". It also explains why there are no universally accepted safeguards.

Some investors are more capable and willing than others to take risks. Sometimes, international mining majors may be marginally less risk-averse than their medium-sized competitors, depending on their assessment of host country attitudes towards their investment proposals. Small mining entrepreneurs may even be quite fearless. However, the vast majority of mining investors remain risk-averse and, in recent years, seem to be more risk-averse than ever.

Satisfying the requirements of bankability (such as the need for credit support, management of completion risk and management of currency risk) can seriously complicate the making of mining investment decisions.

Various safeguards for foreign investment in mining are reviewed in this paper. However, each host country and each project will have a distinctive risk and reward profile and each investor will have a distinctive capacity to accept risk.

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INDEX

1. HOW DO INVESTORS MAKE MINING INVESTMENT DECISIONS?

This paper delineates, by way of generalisation, the main essential legal safeguards which the boards of directors of most international mining investors, and their international bankers, will consider in making a decision to invest in a foreign mining project.

In reality, the process of making mining investment decisions is as much idiosyncratic as it is scientific. This explains why there are never any absolute or universal standards of legal adequacy for foreign investment in mining; it is always a question of what will satisfy a particular investor in a particular case and whether the project will satisfy the requirements of "bankability". It also explains why there are no universally accepted safeguards. [1]

Some investors are more capable and willing than others to take risks. Sometimes, international mining majors, like BHP Billiton and Rio Tinto, may be marginally less risk-averse than their medium-sized competitors, depending on their assessment of host country attitudes towards their investment proposals. Small mining entrepreneurs may even be quite fearless. However, the vast majority of mining investors remain risk-averse and, in recent years, seem to be more risk-averse than ever.

My subjective impression is that this is a consequence not so much of failed investments as it is of generally decreased profit expectations. Most of this has to do with a combination of increased levels of government take, heightened environmental standards (strongly influenced by social demands for "sustainable" development) and a tendency in the direction of more intrusive industry regulation.

Lenders, for their part, have always been much more risk-averse than equity investors, as elaborated in section 2 below.

Intending investors tend to carry out their mining investment decision-making process in three stages:

(i) the commercial prospects and potential profitability of the project are evaluated;

(ii) the risks are assessed; and

(iii) if the potential rewards outweigh the risks, the investors may opt to proceed, subject to the requirements of bankability.

If, however, the risks outweigh the potential rewards, investors will face a dilemma: either to decline the investment opportunity or to proceed without adequate legal safeguards. In some cases, investors may wish to proceed if a particular host country has a good reputation, has good economic policies and is experiencing sustained economic growth.[2] In other cases, investors may proceed if they believe they can influence good government policy in their

[1] Wälde, 1999.

[2] Wälde, 1998.

favour.[3] In very many cases, investors will also have to persuade lenders that the project is "bankable".

This is not to suggest that mining investors are particularly susceptible to government inducements. Typically, if a host country does not provide adequate legal security and stability, a foreign investor will balk at making an investment, no matter how attractive the potential rewards might be or what inducements the government might offer.

When contemplating investment in a project in a foreign country, most mining investors will have certain basic expectations, which they will wish to be legally enforceable. A checklist is set out in Table 1.

If mining companies are not confident of these matters, they are unlikely to invest. Investment safeguards such as investment protection treaties and constitutional and legislative safeguards are helpful in safeguarding foreign investment but are seldom sufficient by themselves. Other safeguards are usually necessary such as investment protection agreements with the host government, joint ventures with good local partners, and measures to combat corruption and other forms of illegality.

Table 1: A Checklist of Basic Expectations of Mining Investors
• Security of tenure over mining titles with the right to freely pledge and alienate them. • A stable taxation regime. • Government approvals to develop and continue to operate the project during its economic life. • The ability to procure equipment and materials from both local and overseas sources. • Access to all necessary assets and services required for operating purposes. • Freedom to engage both local and foreign labour and contractors. • The ability to sell the products of mining into local and exports markets. • The right to obtain payment in a freely convertible currency. • The ability to convert that currency into the currency which was originally invested – and to do this at an adequate conversion rate. • The ability to service loans and to repatriate profits and capital.

2. HOW THE REQUIREMENTS OF PROJECT FINANCE AND BANKABILITY COMPLICATE MINING INVESTMENT DECISIONS

Many energy and natural resource projects are of such a large scale that they require project finance and special-purpose financing structures to undertake them.

[3] As a recent example in the oil and gas sector, in 2002, the China National Offshore Oil Corporation (CNOOC) paid US$585 million to acquire Repsol's oil and gas interests in Indonesia, a time when many investors were treating Indonesia with special caution. CNOOC apparently took the view that it was capable of managing any issues of sovereign risk and of influencing good government policy.

What distinguishes project finance from other types of lending transactions is that the lenders rely primarily on the cash flow of the project itself for repayment, and to a lesser degree on the assets of the project, rather than relying primarily upon the creditworthiness of the investors or project sponsors. Lenders invariably require studying the complete range of project-specific issues, as well as the creditworthiness, experience and track record of the project sponsors and the investment structure proposed for the project, in order to decide whether a project is bankable.

Before considering project-specific issues, it is wise to check the current standing of the host country with international institutions such as the International Monetary Fund, the International Bank for Reconstruction and Development, the International Finance Corporation, the European Bank for Reconstruction and Development, Asian Development Bank, African Development Bank and Inter-American Development Bank. These enquiries will invariably reveal issues of importance to lenders.

Apart from banks, the government export credit agencies of many economies are an important source of finance and financial guarantees for projects which involve exports to other economies. These agencies will sometimes be prepared to accept levels of political and completion risk that banks will not. However, following the Asian financial crisis and a number of loan defaults and project delays, these agencies are today much more risk-averse than they were during the 1990s. For instance, in fiscal years 1998 and 1999, the Export-Import Bank of the United States, although expanding its export credit insurance activities, virtually ceased to write project finance business.

Satisfying the requirements of bankability can seriously complicate the making of mining investment decisions. The main issues which typically arise are:

2.1 Credit Support by Project Sponsors, Product Offtakers and Other Third Parties

The lenders in a project financing generally insist on at least some recourse to the project sponsors.

The lenders also occasionally require part of the credit risk to be borne by interested third parties. Third parties who are likely to be willing to accept credit risk and provide credit support are those who will benefit from the construction and/or the completion of the project, such as project offtakers. They could also include parties who supply materials, products and services in connection with the construction of the project, and those who supply the project once it is in operation. They could also include governmental entities which have an interest in the project.

2.2 Responsibility for Completion Risk

The management of "completion risk" poses the greatest single difficulty for new project financing. In mining projects, as in nearly all economic development projects, the value of the physical assets of the project prior to commissioning will almost always be only a fraction of the monies advanced. Although the lenders will take security over all of the assets of the project, this is usually done as a means of ensuring compliance with negative pledges against dealing with or encumbering the assets of the project, rather than with the expectation that realising on the security will be a realistic means of recouping the monies advanced.

Most lenders will know that, if the project sponsors are unable to construct or operate the project successfully, the lenders will probably experience even more difficulty managing those tasks. Because of this, the bankers, the sponsors and any third parties against whom the lenders have recourse, all rely on the success of the project, including its ability to be completed by a certain deadline and its ability to meet cash-flow projections when it is in operation. Whether the projected cash flows will ever commence invariably becomes the crucial question for the lenders.

In fact, with many new projects, completion risk typically represents such a great risk that many conventional lenders are unwilling to accept it. In such cases, project sponsors will need to obtain "bridging finance" from commercial banks or other sources by providing them with recourse to governmental or corporate balance sheets and/or other collateral security (often at more expensive rates) until all of the lenders' "completion tests" are satisfied. After that, non-recourse or limited-recourse project finance can be substituted. The ability to obtain bridging finance will depend on the project sponsors being highly creditworthy and technically competent entities.

2.3 Realistic Risk Allocation

This necessary reliance on the cash flow of the project brings with it a whole series of potential risks to all parties involved. Before the lenders, sponsors and other interested parties commit to the project, it is necessary for all project risks to be realistically allocated to, and accepted by, the various parties according to their capacity, experience and involvement. The emphasis here must be on realism – it is unrealistic for lenders and their lawyers to stubbornly insist that a particular project risk be allocated to a party that is incapable of assuming it. The most obvious example is currency risk, discussed further below.

The degree of risk which should be allocated to a party should be commensurate with its anticipated return from the project and its stake in the completed project. Balancing the competing interests of multiple parties will often lead to a project financing transaction having a very complex legal structure and requiring extensive documentation. The legal complexity can occasionally be so extreme as to constitute an investment risk in itself, a risk which can be entirely of the parties' own creation.

The real glue that holds successful projects together is mutuality of interest. Putting parties in strait-jackets and holding them hostage to the threat of declaring an event of default under a financing agreement can be self-defeating.

2.4 Joint Venture Risk

If a joint venture is proposed, an incorporated vehicle is, from the lenders' point of view, simpler and more advantageous than a contractual joint venture. The advantages to the lenders are:

- there will not be a complex joint-venture agreement to complicate the lending risk;

- it will be possible to isolate liability solely within the vehicle;
- a single security will be available over all project assets, including product inventory and debtors;
- in the event of default, it will be possible for the lenders to quickly step in to managerial control of the vehicle, and to sell the entire assets of the project.

By contrast, an interest in the assets of a contractual joint venture will only be an acceptable security if, in the event of default, the lenders are able to obtain control of the participant's share of goods produced by the project and the revenue derived from their sale. In mining projects, each joint venture participant may be able to assign to its lenders the benefit of a long-term sales agreement for the disposal of its proportionate share of production.

2.5 Currency Risk

One very serious difficulty in financing foreign projects is almost always currency risk. Even if currency convertibility is guaranteed by the host government, the conversion rate will depend on a range of economic considerations outside the control of the host government and the project sponsors. Exchange rates rarely remain stable for long periods and are frequently volatile.

The use of escrow accounts outside the host country can sometimes overcome or reduce currency risk in cases where the project's output can be sold on international market in a hard currency. Third-party currency hedge products can also be used. However, currency hedges may be unaffordable if they are required to come (as is usually the case) from highly creditworthy institutions and if they need to be matched against long-term loan repayment schedules. Host countries may be able to utilise to some extent the currency risk mitigation projects available from the World Bank; political risk insurance may also be available as referred to in section 9 *infra*. However, the management of currency risk depends crucially on prevailing and projected exchange rates and does not readily admit of easy solutions.

3. THE MOST FEARED LEGAL RISK OF MINING INVESTORS: ADVERSE CHANGE OF LAW

The most widely debated legal risk for mining investors, and the risk of most newsworthiness, is the risk of expropriation. However, legal risks are by no means confined to that; the most pervasive legal risk is the risk of adverse change of law. This is the reason for the widespread use of the so-called "change of law" clause in financing documents, under which bankers require borrowers to indemnify them against the financial consequences of changes in law or other governmental requirements.

In assessing the risk of change of law, the first thing to look for are safeguards which have been proven over time.

The area of the greatest sensitivity for investors is change of the taxation system, followed closely by the imposition of exchange controls (especially if little advance warning is given). Possible increases in environmental and rehabilitation requirements or in labour requirements are always important matters of concern. Another frequent matter of concern is the potential for conflict between different tiers of government or any doubt about the extent of powers delegated to local governments.

The Fraser Island case in Australia (Box 1) serves to remind investors of the risk of failing to fully appreciate the seriousness of these concerns.

In the final analysis, investors are usually powerless to prevent adverse change of law, unless the law amounts to expropriatory conduct which qualifies for compensation under a constitutional or treaty provision. The checklist of safeguards in Table 2 may therefore be of help to investors in deciding whether to run the risk of investing in particular projects.

Evaluating the adequacy of the safeguards offered by a particular country is not a routine task. Although all legal systems evolve from a common basic purpose (regulating social order and determining the allocation of resources), the legal system and business practices of each country are unique, reflecting its political, cultural, social and economic conditions.

To evaluate foreign investment risks in countries which are still undergoing the transition from planned economies to market economies, it is necessary to go back to basics. There is no book explaining exactly how a country makes this transition and what investment risks may need to be overcome along the way. China and Vietnam, for example, have adopted modern constitutions but they retain socialist legal systems which are still in the process of being modified to facilitate the transition.

Host country legislation therefore must always be carefully reviewed for its adequacy in providing safeguards in a wide range of areas.

Box 1: "The Fraser Island Case"

Murphyores v Commonwealth of Australia (1976) 136 CLR 1

This 1976 Australian case involved two mining companies, one Australian and the other American, which for many years had been mining rutile from Fraser Island, an island just off the coastline of the Australian State of Queensland. There was no market for rutile in Australia and the two companies depended on shipping the rutile to export markets in order to make any profit. The mining operations were carried on pursuant to a valid mining concession issued by the State of Queensland, in compliance with State environmental protection laws and all other applicable laws, at both State and federal level.

Community concerns about damage to the fragile environment of Fraser Island caused the Federal Government to become opposed to continuation of the mining operations. It therefore made an administrative decision to withhold further export permits (the control of exports being an exclusive federal power).

The two companies applied to the court for an order that the withholding of export permits was unlawful. They argued that environmental considerations relating to mining of a commodity could not, as a matter of administrative law, be properly taken into account by the Federal Government in deciding whether to grant export permits for that commodity. However, the High Court of Australia (Australia's Supreme Court) unanimously rejected this argument and found in favour of the Federal Government.

Nothing had been confiscated or taken away from the two companies: they still owned their mining concessions; they could still operate their production facilities; they still owned their mineral resources and they could still carry on mining operations under all applicable law. However, the administrative decision had blocked their access to export markets and its effect was to destroy the value of their investment.

Under Australian law, an act of expropriation would give rise to a legal claim for compensation. However, the court held that this was not a case of expropriation (although ultimately the Federal Government offered compensation to the investors, which they accepted).

The Fraser Island case serves to highlight that there were two flaws in the original investment decision:

(i) the investors underestimated the risk of future changes in environmental standards; and

(ii) the investors did not foresee that there would be a conflict between the State and federal governments in Australia.

Although the mining investment was made in a country with a well-established legal system, noted for its reputation of certainty and stability, the value of the investment was destroyed by an administrative decision.

Table 2: A Basic Host Country Legislative Checklist	
Foreign investment law	Can investment approval be obtained and under what conditions?
Mining law	Do mining titles provide security of tenure and can they be freely pledged and alienated?
Land Law	Can foreigners freely acquire, pledge and alienate land?
Land use development law	Under what conditions can development approval be obtained and conditions varied?
Incorporation of companies	Can foreigners establish and control companies?
Taxation	What is the host country tax system? How stable is it and how does it interact with that of the investor's residence country?
Import and export law	What approvals are necessary and what duties apply?
Competition law	Is market power an issue and are mergers allowed?
Consumer protection	What price controls or other consumer safeguards apply?
Environmental protection	What standards must be observed and what penalties apply for failure to do so? Are they international standards?
Intellectual property	How can intellectual property be protected?
Dispute resolution	What law can be used to govern investment agreements and can disputes be resolved in a neutral forum?

Regulation of industry	Is there an industry regulator which is independent of government? Are legal review and appeal processes available against adverse regulatory decisions?
Administrative law	Is there any remedy for improper decisions of government officials?
Regulation of the legal profession	Are lawyers entirely independent of government?

4. ADHERENCE TO THE RULE OF LAW

An important general safeguard to take into account is the host country's adherence to the rule of law.

It is very easy for people accustomed to common law systems to make mistaken assumptions about how other legal systems work. Private property rights and sanctity of contract are essential elements of the common law. In common law countries, the judiciary is an independent institution (as it is in many civil law countries as well). This is part of their legal heritage. Lawyers trained in common law systems, and mining people and bankers who consult them, tend to take private property rights, sanctity of contract, and the prompt and efficient enforceability of contractual obligations for granted. This is not to suggest that common law systems provide an automatic panacea. India, for example, is proud of its long common law tradition but its investment environment is bedevilled by a high level of political risk, by constant federal-State conflicts and by antiquated investment legislation.

Contrast, for example, the legal development of China with that of common law countries. Chinese traditional law was primarily penal in emphasis. Later it absorbed Confucian social values, reflecting the notion that the individual should demonstrate his moral superiority and preserve social harmony by adjusting his "rights" to the forces of nature and to the needs of others.[4] Legal principles never played a substantial role in the Chinese process of social control – moral principles were more important. Essentially, the Chinese had an aversion to law and discouraged its use. Also, an independent judiciary never developed at any stage in China.

After the 1949 Revolution, legal concepts based on Communist ideology, initially derived from the Soviet model, were superimposed on traditional Chinese legal values. This had a profound effect on the Chinese legal systema and how the Chinese conceive of law:

> *Every country has its own national policy. What is called law is the specification of the national policy, and economic law is the specification of economic policy.*[5]

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[4] Bodde and Morris, 1967.

[5] Gu, M, Head of the Economic Legislation Centre of the State Council of the PRC, in a speech to the Conference on Sino-Australian Economic and Trade Law, Beijing, 18 October 1985.

This conception of law took its inspiration from the Leninist view of law as politics, where law was regarded as a tool of socialist modernisation. Law was not regarded as a system for the enforcement of contracts in a market economy.

The Chinese profess great respect for the sanctity of contract but they tend to view a contract as an expression of a long-term, cooperative and friendly relationship, not just as a document recording the enforceable obligations of one party to the other. In legal protection of foreign investment in China, reliance on mutual trust and understanding has been held out as more important than legal safeguards:

> *There is no doubt that the constant perfection of the laws of China is of great significance to the development of foreign attraction for investment and technology transfer. However, this is not the only element. Mutual trust and understanding are more important elements.*[6]

Since 1982, China has embarked on a mammoth programme of constitutional and legislative reforms. China's reforms have been enormously successful in attracting huge foreign investment inflows.

It cannot, however, be over-emphasised: without the rule of law and a market-oriented legal system a market economy just does not operate efficiently and this increases the costs and risks of investment, not only in mining but in all sectors.[7]

5. TREATY PROTECTION

5.1 The General Significance of Investment Protection Treaties

Host countries can attract investors by defining and protecting the rights of the private sector against encroachment by government and by removing special privileges accorded to State-owned enterprises. Host countries can also attract investors by supporting fundamental business relationships between private parties – thus reducing risk and transaction costs between parties.

Although the absence of an investment protection treaty is never an absolute barrier, it throws doubt on a country's commitment to providing a positive investment climate for foreign investment and its commitment to international cooperation.

The absence of an investment protection treaty also means that the domestic legal system has not been subject to the reforming requirements and disciplines of an international treaty. Such externally triggered reform has proven in many cases the major method to remove obstacles in the domestic regulatory and institutional framework. Without a treaty, doubts about the investment climate cause investors either to think twice about investing in a particular country or, if they do, to seek a risk premium. Accession to a relevant treaty therefore signals "quality" to the global markets; non-membership signals "danger".

[6] Gu, *ibid.*

[7] Webb, 1996.

Accession to a legally binding international investment regime brings an additional advantage to participating countries which has nothing to do with giving confidence to investors but has a great deal to do with national and international politics and with increasing the international stature of the participating countries: it effectively depoliticises future differences and disputes over investments. Depolitcisation of the process of foreign investment is of considerable and increasing virtue of the modern world, many of whose citizens have seen in the past enough political confrontation to believe that their governments must make more effective efforts to keep politics out of commercial disputes.

5.2 The World Bank Guidelines

In 1992, the World Bank and the International Monetary Fund published the World Bank Guidelines on the Treatment of Foreign Direct Investment. These guidelines had no binding effect but they influenced the provision on investment which have now appeared in the North American Free Trade Agreement (NAFTA) and the Energy Charter Treaty (ECT), two important multilateral international treaties. Both NAFTA and the ECT are the offspring of market reform in the post-Communist world, NAFTA having come into force in 1994 and the ECT in 1988.

The NAFTA is a trilateral treaty that brought Canada, Mexico and the US into the North-American free trade area. Its chapter XI – direct investment arbitration – was the model for the similar but farther-reaching Article 26 of the ECT and most modern bilateral investment treaties. The ECT is a unique multilateral treaty, limited in scope to the energy sector, which establishes rights relating to both trade and investment within that sector. The ECT breaks away from the mould of other treaties by making governments accountable directly to aggrieved investors for breaches of the treaty before arbitral tribunals.

5.3 The Convention on the Settlement of Investment Disputes

The Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the ICSID Convention), concluded in 1965, established facilities for conciliation and arbitration of investment disputes between a contracting State and nationals of other contracting States.

Parties to a dispute must exhaust all local remedies before submitting to ICSID jurisdiction. The decision to invoke ICSID procedures is entirely voluntary, unless a State Party has specifically undertaken to submit a certain dispute or class of disputes to ICSID arbitration. Such an undertaking, invoking ICSID jurisdiction in a specific range of disputes, may be a feature of bilateral investment treaties or national investment codes. Parties may notify ICSID of particular disputes or classes of disputes which they regard as excluded from the ambit of the Convention. Otherwise, provided both parties agree in writing to submit a dispute to ICSID, its jurisdiction will extend to any dispute arising directly out of an investment-related agreement.

In 1978, ICSID made an Additional Facility available:

- for the resolution of disputes where one party is not a contracting State or a national of a contracting State;

- for the resolution of disputes which cannot be said to have arisen directly from an investment-related agreement; and
- for fact-finding purposes.

The substantive law applicable in a particular dispute is to be selected by the parties. Procedures are embodied in the ICSID Convention and Arbitration Rules. Article 54 provides for the recognition and enforcement of ICSID awards in domestic courts.

For the resolution of disputes relating to mining investment, investors and host States may choose to have recourse to ICSID procedures as a standard measure (for example, under an investment protection treaty), to the arbitration rules of UNCITRAL or the International Chamber of Commerce or to other rules by *ad hoc* agreement as the need arises.

5.4 The Multilateral Investment Guarantee Agency (MIGA) Convention

A host country's membership of MIGA affords prospective investors the opportunity of gaining a level of protection against non-commercial investment risk from a creditworthy multilateral body.

The MIGA Convention, in force from 1988, has as its main objective enhancing the flow to developing countries of capital and technology for productive purposes under conditions consistent with their development needs … on the basis of fair and stable standards for the treatment of foreign investment … complementing national and regional investment guarantee programmes and private insurers of non-commercial risk.

Any investor who is a national of a member country and who operates on a commercial basis is eligible for coverage. Risks of currency transfer, expropriation, war and civil disturbance may be covered. However, indemnity against expropriation does not extend to "non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories". The guarantees offered by MIGA are subject to certain exposure limits and provision is made for cooperation with private insurers. Premium rates for MIGA insurance exceed those of many national political risk insurance programmes but MIGA guarantees endure for between 3 and 15 years and may be extended to 20 years in special circumstances.

5.5 Bilateral Investment Protection Treaties (BITs)

There are now some 2000 BITs in force around the world. Their purpose is to reduce non-economic risk (to protect investments and defend investors against the unilateral exercise of State power by host economies) and to facilitate and encourage investment flows to host countries.

Most BITs are based on a prototype treaty. They ordinarily operate to prohibit expropriation or other forms of dispossession unless some or all of the following conditions are met:

- considerations of public purpose or national interest must be involved;
- prescribed procedures must be followed;

- measures taken must be non-discriminatory;
- adequate and effective compensation (that is, consistent with the real value of the investment affected) must be paid;
- such compensation must be paid in freely convertible currency;
- interest must be paid at a regular commercial rate; and
- provision must be made for some form of judicial review.

6. CONSTITUTIONAL RECOGNITION OF PROPERTY RIGHTS AND RIGHTS OF FOREIGN INVESTORS

A country is always free to change its constitution at its complete discretion. No part of the constitution of a country may be embodied in a contract with a foreign investor. Value must therefore be placed on a constitution which has been proven over time.

Again, take China as an example. By contrast with most developed countries, China's present Constitution is relatively new, having been adopted in 1982, amended in 1988 and further amended in 1993. The preamble to the 1993 constitutional amendments emphasises that China is still only in the initial stage of building "socialism with ”Chinese characteristics". This is an ambiguous term. It really boils down to policy pragmatism and flexibility. It is nevertheless the key to understanding how China now governs itself.

The 1993 constitutional amendments declared that China:

> *practices the socialist market-directed economy. The State improves economic legislation and perfects macro-readjustment and control. The State prohibits disturbance of the orderly functioning of the social economy by any organisation or individual.*[8]

The role of the market in the overall economic equation in China was thus officially moved from one which is supplementary to one which is integral and in which foreign investment is officially permitted.[9]

The Chinese economy remains regulated by a national economic plan. Investors must ensure that their long-term economic goals harmonise with the national economic plan. From the viewpoint of a foreign investor, economic planning in a host country is helpful as an indicator of political rationality – it counterbalances to some extent the uncertainty inherent in an economy which is undergoing a process of socialist modernisation and the uncertainty of a legal system which is undergoing a process of complementary reform.

[8] Constitution of the People's Republic of China (hereinafter Constitution of the PRC), article 15.

[9] Constitution of the PRC, article 18.

7. INVESTMENT AGREEMENTS WITH GOVERNMENTS

Carefully constructed investment agreements with host governments can overcome many of the legal problems inherent in the lack of legislation and can establish a legally secure contractual framework under which an investment can be made.[10]

Governments are understandably reluctant to grant special privileges unless they are warranted by the importance of the project. The negotiation of investment agreements can be an expensive and lengthy process. Often it is only the most substantial investors in the most important projects who can afford the cost and time to see the negotiations through to a successful conclusion.

Prior agreement on environmental standards is of paramount importance in establishing a secure contractual framework. In an age when the principle of sustainable development is universally worshipped, internationally recognised standards offer a much more reliable basis for agreement than domestic standards.

8. JOINT VENTURES

8.1 Sharing of Resources, Technology and Know-How

After an "in principle" decision is made to invest, the challenge remains of designing an investment structure and successfully carrying on business despite any risk of change of law. This is especially challenging in countries where there is no easy method of enforcing contracts.

It is quite possible to invest in a country where contracts are unenforceable – but dealings must be structured and operating risk must be minimised so that the obligations of other parties are self-enforcing. For example, contractual arrangements can provide that:

- the other party could be paid only if you are paid;
- the other party could provide performance bonds to underwrite its obligations;
- the continuation of the project could depend on the continuation of technical support, which can be made conditional on your being paid;
- the other party could share in the risks and rewards of the venture on a proportionate basis.

One way of institutionalising these arrangements is through joint ventures. How to structure a joint venture depends, of course, on the type of project and the strategic business objectives and capacity of each of the parties involved.[11]

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[10] Australia's "State agreements" provide excellent precedents for major resource development projects; see Anne Fitzgerald, "Mining Agreements in the Regulation of the Australian Minerals Sector", infra Chapter 3.1.3.

[11] Pritchard, 1996.

Joint ventures are often the only means of acquiring raw materials, production facilities, technology or know-how.

Joint ventures are often also the only practicable means of market access. Entry into a local market may depend on obtaining access to established distribution channels or operating under an established brand name that is already well-recognised in the local market. For a foreign consumer, the complexity of securing resources from a country with a different culture, different language and different legal system may be beyond his ability. In such situations, a joint venture can be the most profitable way for the two parties to pursue their respective objectives.[12]

In all cases, the management of foreign investment risks should be enhanced by a joint venture with a compatible and respected local partner. The partner, if chosen wisely, should help minimise these risks by having a close familiarity with local business practices, political processes, government procedures, laws and social customs.

8.2 Joint Ventures with Host Governments

Some host governments require a direct stake in the venture, often free-carried. Although host countries are not always the best partners for foreign investors, joint ventures with them can bring advantages as well as disadvantages.

Sometimes the foreign investor is required to allocate to the host government a predetermined share of the joint venture equity. If the host government lacks hard currency, 'soft' contributions are commonly proposed instead. These can comprise land, buildings, equipment, labour, supplies or other services, even government approvals, tax exemptions or tax holidays. This type of requirement can distort the joint venture structure but it does not provide an insuperable obstacle because the foreign investor can make his own assessment of the real worth of soft contributions which he can trade off into his assessment of risk and rate of return requirements.

'Soft' contributions should however be limited to the establishment stage of the venture. If all subsequent inputs of capital and operating costs by the host government are not based on arm's-length, market-based calculations, the economic equilibrium of the joint venture will become distorted and disputes may occur. The host government will also need to provide continuing security or support for borrowings by the joint venture on a proportionate basis with the foreign investor.

The common advantages and disadvantages of joint ventures between foreign investors and host governments are summarised in Table 3.

8.3 Management

Despite the many factors in favour of using joint ventures, their management can often be a nightmare.

[12] Sakurai, 1985.

Joint ventures can expose investors to the risk of disputes which never apply to wholly owned operations, such as competitive rivalry between the partners in marketing the joint venture products. Disputes are more prone to arise towards the end of a project. If the foreign partner has trained the local partner to be its future competitor, this may cause great rivalry. Each of the parties may also dispute the rights to the facilities, the technical or marketing know-how and employees of the venture.

It is important to choose partners wisely in order to anticipate these types of problems and then to develop a process of solving problems harmoniously.

Table 3: Joint Ventures between Foreign Investors and Host Governments	
FOREIGN INVESTOR'S VIEWPOINT	**HOST GOVERNMENT'S VIEWPOINT**
Benefits	
• Moulding a project in a form which is compatible with government policies • Minimising political risk • Improving predictability and stability of operational conditions • Providing a communication channel to the government • Availability of tax or other investment incentives	• Maximising national sovereignty • Receiving subsidised or risk-free participation • Sharing in the rewards of value-added • Minimising environmental impacts • Influencing training, education, labour recruitment and labour policies • Influencing decisions on sourcing and pricing of plant, equipment, production inputs and services • Minimising destination and pricing of products • Minimising any perceived adverse effects of foreign direct investment
Burden / Risks	
• 'Soft' value of host country's capital contributions • Less efficient decision-making and financing structures • Exposure to risk of loss of confidential commercial information and know-how • Incompatibility with government officials • Compulsory sell-down to local party	• Need to contribute capital or other assets • Need to offer tax incentives • Exposure to business risks • Incompatibility with the foreign partner • Compulsory sell-down to foreign party

8.4 Dispute Management

There are many contractual techniques for management of disputes, including disputes over the failure of a joint venturer to meet its obligations. These techniques include:

(i) loss of information rights;

(ii) loss of voting rights at joint venture committee meetings;

(iii) imposition of high interest rates on overdue payments;

(iv) compulsory sale to the non-defaulting participants;

(v) a pre-agreed formula for adjustment of joint venture profits; and

(vi) compulsory mediation procedures.

The last two techniques are far preferable to the first four. It is especially important that the default provisions should be designed to enable the joint venture to continue without interruption, despite any default. The non-defaulting parties (assuming there is more than one) should always bind themselves to pay a proportionate share of the defaulter's unpaid obligations (unless they unanimously decide to abandon the project).

Inadequately drafted default clauses, if triggered, can threaten the life of the venture, allowing the defaulting party to engage in protracted and expensive litigation, which can effectively drain the financial resources of the participants and needlessly delay the project. A defaulting participant should be speedily removed or have its profit entitlements varied, so that the project can go on undisturbed.

8.5 Transfer of Interests

Host country legislation often requires any dealing in a concession, mining lease or licence to be approved by the host government before becoming effective. This creates difficulties if the government has discretion to withhold its approval or to impose additional obligations on the other joint venturers.

Special-purpose vehicles, where ownership of the shares can be changed with minimal formality or government approval, should be used wherever possible to overcome these difficulties.

9. POLITICAL RISK INSURANCE

Political risk insurance coverage is often available from both public and private insurers. Of course, the insurance premiums will always depend on the extent of risk being underwritten and in some economies may not be affordable.

The Multilateral Investment Guarantee Agency (MIGA) can provide political risk insurance cover for direct investments in mining projects if the host economy is a signatory to the MIGA Convention. As a multilateral organisation owned by 154 member countries, and as part of the World Bank Group, MIGA has some distinctive strengths that it can bring to bear for the equity investors and lenders in the project, as well as for the host economy. Additionally, as the host economy will also be a shareholder of MIGA, MIGA can be expected to enjoy good relations with the host government and may be able to serve as a mediator between the government and the investors should this be required.

MIGA's political risk insurance policies are available to address four main risk categories:

- *Expropriation or nationalisation*: Investors may be concerned that a future government could expropriate or nationalise private businesses without adequate compensation. Although outright expropriation might occur very infrequently, "creeping expropriation" (a series of government actions that, over time, have an expropriatory effect) is a more frequent phenomenon. Either form can be insured against.

- *Currency inconvertibility and transfer restrictions*: Investors may be concerned that the host government could undertake actions that limit the repatriation of profits and restrict the conversion of dividends into convertible currencies.

- *War and civil disturbance*: Investors may be concerned about politically motivated acts of violence such as war, revolution, terrorism, or sabotage insofar as they lead to physical damage to tangible assets or to a substantial disruption of business operations.

- *Breach of contract*: There may be concern that the host government defaults on its contractual obligations, or revokes concessions given by previous governments. This is a particular concern in projects where the government is a major supplier of critical raw materials or a principal buyer of the end product (e.g. electricity). In recent history, a number of breaches of contract claims were filed during the Asian financial crisis.

In a 2001 newsletter, MIGA explained its approach to political risk analysis:

> *For each new project, MIGA prepares a comprehensive review of the host country's economic and political situation. This review is a preliminary gauge of how likely the project is to experience disruption and whether this might precipitate a claim situation.*
>
> *…*
>
> *When conducting a country analysis, MIGA evaluates the economic fundamentals and outlook, bearing in mind recent events as well as possible pressures and other effects on the economy over the next few years. These factors are considered within the framework of how well the government manages the economy and its ability to react to potential crisis.*
>
> *…*
>
> *The assessment continues with an in-depth analysis of political structure and stability. This consists of a review of the basic political system, implications of a potential shift in political control, legislative and executive balances, the legitimacy of a government, and links with other political and economic organisations. The review also tracks any violence or war within the country, including ethnic or religious strife, terrorist activity, geopolitical concerns, and whether foreign companies have been targets of violence.*
>
> *Legal systems are also evaluated with an eye toward investment, transparency and consistency, and enforceability of arbitration. The record of other insurers is part of the equation as well, particularly their experiences with recoveries, compensation, and ongoing disputes.*

MIGA political risk insurance is available to cover investors for their equity investment, for shareholder and non-shareholder loans to a project, as well as to cover management contracts and other obligations to a foreign parent. MIGA can also organise insurance syndicates of public and private insurers if it is unable to underwrite the entire risk on its own. However, MIGA can only cover new investments or expansions of existing investments. The annual insurance premium would be based on MIGA's assessment of project risks and the types of insurance coverage sought by the investors.

Where a significant amount of bank financing is planned, MIGA insurance can help to reduce borrowing costs because banks have to allocate significantly less capital to cover MIGA-insured loans under current international capital adequacy rules.

10. THE IMPORTANCE OF UTMOST PROBITY

Mining investors need always to be on guard against becoming involved (even indirectly by association with other parties) in corruption and any other activity which might constitute criminal conduct or give rise to illegality in the host country. This can be the cause of an otherwise secure foreign project collapsing.

Criminal conduct in many countries is not limited to corruption. It may include:

- breach of labour laws;
- illegal import or export of goods or currency;
- tax evasion;
- breach of environmental laws;
- breach of consumer protection laws.

The utmost probity is therefore a prerequisite of every foreign investment. Corrupt practices, irrespective of how orthodox they are claimed to be, are a guaranteed recipe for investment disaster.

Governments nearly everywhere are attempting to stamp out corrupt practices by anti-corruption legislation and are gaoling businessmen for these practices. Apart from the consequences of infringing local laws, foreign businessmen face the additional personal risk that they may be put under house arrest or have their exist visas revoked while official investigations are undertaken by local authorities.

Most importantly, a contract obtained by corrupt practices under most legal systems is not only illegal but unenforceable. This also jeopardises the enforceability of banker's securities.

11. CONCLUSIONS

In the field of mining, as explained in this paper, each host country and each project will have a distinctive risk and reward profile and each investor will have a distinctive capacity to accept risk.

Before making a major mining investment decision, an investor should undertake a comprehensive feasibility study and this should include a comprehensive due diligence investigation. This investigation will in most cases enable the investor to assess whether the legal security and stability of the host country is adequate, to evaluate the legal safeguards proposed for the project, to decide what further safeguards need to be negotiated and to determine whether the project satisfies the requirements of bankability.

After a comprehensive investigation, a decision whether or not to invest can be made on an informed basis. The final investment decision is, as suggested the beginning of this paper, likely to be as much idiosyncratic as it is scientific.

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