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I. INTRODUCTION

This article examines in detail the process of acquiring political risk insurance and explores the relationships among the principal parties involved: the insured, the insurer, and the broker.

There are several stages to acquiring political risk insurance: filing an application for coverage; negotiating special policy language; restructuring the insured investment to meet the insurer's guidelines if necessary; and issuing the policy. Once the policy has been issued, the insured must be aware of its compliance duties. In the event an insured risk occurs, the relationships are further complicated. While the insured and the insurer must work together to minimize loss, they can be potential adversaries when a claim must finally be paid. This is not a typical insurance policy; for the insured to receive the maximum benefits, he or she must understand both the policy language and the relationships between the parties.

II. ACQUISITION OF POLITICAL RISK INSURANCE

A. Application

The application is completed initially with a broker's assistance and is submitted to the insurer so that the underwriter may perform his or her task. The statements made and the facts provided in the application constitute the basis for issuing the policy. Accordingly, the application must be completed with care.

A typical application begins with basic facts: the name of the insured, the insured's type and place of business, the name of the host country, and the business to be conducted there. Key questions include the following:

- Have all documents necessary for legal operations in the host country been obtained?
- Have all necessary import licenses been obtained?
- What is the insured's past operating history, if any, in the host country?
- Have any unusual or special arrangements been made with, or benefits received from, the host government for operations within that country?
- Does the applicant have any knowledge or information about facts that might give rise to a claim under the policy which is sought?
- Has the applicant been denied coverage for this project by any other insurer?

To the extent that an application contains insufficient information from the persons responsible for the project, the insured risks breaching the obligation to furnish the insurer with material information that might affect the underwriter's judgment in issuing the policy. Consider, for example, an insured who seeks coverage for a loan to be made to a host government-owned entity, backed by a Central Bank guaranty. The insured is aware of a current default by another such entity, as well as the failure of the Central Bank to honor its guaranty. Considering the questions asked in the application, does the insured have a duty to furnish this information to the insurer? A typical application will include the following language:

> The undersigned applicant declares that the information in this application is known by or available to the undersigned, and to the best of his or her knowledge and belief the statements set forth in this application are true, and that no other material information has been withheld, and that the applicant will inform the company of any changes in the information contained herein.[1]

There is, therefore, a continuing duty to update the information provided in the application. It is essential that responsibility for this duty be assigned by the insured or its broker to the appropriate personnel.

Finally, the application will provide that "[t]he undersigned also agrees that the existence of any policy that may be issued will not be disclosed to the host government."[2] As a general rule, a host government might be less likely to settle a dispute if it learns that insurance is involved, because the government may not have the same sort of continu-

1. *See* current political risk application form of Indemnity Insurance Company of North America, an affiliate of CIGNA Corp. [Expropriation and Nationalization Insurance Application (Mobile Assets) Form - 1985].
2. *Id.*

ing relationship with the insurer that the host government may have with the insured investor.

B. Evaluating the Project

Based upon the information furnished, the underwriter must determine whether the particular project is attractive from the insurer's perspective. Special attention is given not only to the nature of the project but also to its structure.

1. Financial Structure

In 1971 the Chilean government expropriated virtually all of the significant, foreign-owned copper mines.[3] One medium-sized mine, however, which was controlled by a United States company, was not nationalized. This was due to the particular debt and equity structure that had been created. The mine had received loans from a Japanese bank, and a portion of the mine's output was sold to Japanese customers. The Japanese lender had required the continuance of the mine's management and operations by the United States controlling interests. In addition, the mining company had received a loan from the International Finance Corporation, an affiliate of the World Bank, which provided that the loan would be immediately in default if management and control of the mine changed. This financial structure created a disincentive to nationalize the mine.

Other financial structures may create incentives for the host government to expropriate the investment. As a result of expropriation concerns, a project is sometimes amortized very quickly. Such a rapid rate of return may make a company high profile in the eyes of the host government, which may result in a taking, and the prophecy is self-fulfilled.

2. Local Partner

The conventional wisdom had been that a local partner provides protection against hostile government action. If the local partner has a high degree of political involvement, however, he or she can become a liability as soon as the government changes. A local partner with special expertise may be different. For example, an underwriter may perceive the Shah's computer expert to be a less vulnerable local partner than the Shah's nephew.

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3. The large copper interests in Chile were nationalized pursuant to the Constitutional Amendment of July 15, 1971, concerning National Resources and their Nationalization [1971] Diario Oficial [D.O.] 2741 (Chile), *translated in* 10 INT'L LEGAL MAT'LS 1067-72.

3. Special Legislation

When special incentives are legislated by a host government to attract investment, future governments may repudiate those arrangements for political or economic reasons. The underwriter will analyze these incentives with great care.

An illustrative case has recently developed in Peru, where a United States oil company, Belco Petroleum Corporation (Belco), was allegedly expropriated by the Peruvian government on December 27, 1985.[4] The prior government had extended certain income tax concessions to Belco and two other foreign-owned companies, thus reducing Belco's taxes from 68.5% to 41.4%, provided that these savings would be reinvested in further exploration in Peru. After the election of a new government and the onset of a severe economic crisis, the new government claimed that the required reinvestment had not occurred. Following unsuccessful settlement negotiations with Belco, the government cancelled Belco's concession contracts and took over Belco's Peruvian assets, which Belco claimed amounted to nearly $400 million.[5]

4. Necessary Licenses

It is imperative that all necessary licenses and permissions be in order before the policy is issued. Consider an insured who contracted with the host government to build a housing project. The land was to be rezoned to permit this use. The only permitted use at the time of the contract's execution was agricultural. When the government decided not to proceed with the project, it relied upon the failure of the developer to obtain proper zoning. Had the proper zoning modification been in place, the government would have been forced either to repudiate the contract or use a less plausible reason for its refusal to fulfill its contractual obligations.

5. Risk Analysis

First a specific and then a more generalized risk analysis is undertaken before issuing a policy. The past record of the insured is important. How long has the insured been in this business? Has the insured been active overseas before? Is it likely that the insured might do something to provoke the host government into taking expropriatory action? The type of project itself can affect the degree of risk. Historically, the vast majority of disputes affecting United States investment overseas

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4. N.Y. Times, Dec. 30, 1985, at D4, col. 4; Wall St. J., Dec. 30, 1985, at 3, col. 1.
5. *See supra* note 4.

have involved natural resources (mining and petroleum), banking, insurance, and communications.[6] Beyond the project risk analysis, a more general risk analysis is undertaken which covers both the host country and the region.

III. THE INSURANCE POLICY

The policy is the written contract which governs the relationship between the insured and the insurer. Political risk insurance policies create different relationships from those in most policies, such as fire or theft. It is essential, therefore, that the parties act out of an awareness of the relationships created.

An example illustrates this point. Under a fire insurance policy, once the fire occurs, the loss has been suffered. Under a political risk insurance policy, however, this is not usually the case. Political risk insurance policies typically have a "waiting period" of days, months, or even years, during which the insured risk must continue in existence before a compensable loss is deemed to have occurred. Thus, if the insured risk is confiscation of assets, and if the waiting period is 180 days, a governmental act of confiscation must last for the entire waiting period for there to be a compensable loss.

The waiting period enables the insurer and insured to test the intention of the host government as well as to try to resolve the dispute without having to trigger the loss provisions under the policy. Because of the waiting period and other policy provisions, the insured and the insurer should work together during the waiting period to minimize loss. If the insured does not recognize its responsibilities during the waiting period, the relationship with the insurer can be undermined.

A. Expectations of the Parties

At early stages of discussion between the insured and the insurer, the broker has the crucial role of explaining policy language and clarifying misconceptions so that when the policy is issued the expectations of the parties will be fulfilled.

Here are some examples of unfulfilled expections:

1. The Overseas Private Investment Corporation ("OPIC") insurance contract provides compensation for property damage due to polit-

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6. *See* BUREAU OF INTELLIGENCE AND RESEARCH, U.S. DEP'T OF STATE, DISPUTES INVOLVING UNITED STATES FOREIGN DIRECT INVESTMENT (periodic reports covering 1982-1984).

ical violence.[7] This compensation may be based upon either the replacement cost or the historical cost of the physical assets that were damaged.[8] In most cases, the current book value of the physical assets of the insured is less than the total amount of investment in the foreign enterprise. Even if the insured's investment is intended for physical assets, this may still occur if the project has not yet acquired all of the assets because of a lack of infrastructure. OPIC has two premium levels, the "current insured amount" and the "standby amount."[9] The latter is essentially an option to buy more insurance and is much less expensive than current coverage. Standby coverage should be maintained until all of the physical assets are in place. Nevertheless, many OPIC insureds do not understand this point. They will carry full current coverage for political damage, even when there is no possibility of a recovery for more than the value of the physical assets which have been installed.

2. In a recent case, a musical group sought confiscation coverage for their instruments while touring abroad. The host country temporarily held the instruments because of a dispute between the group and its tour promoter. The promoter would not sign certain required documents to permit local customs authorities to authorize the re-export of the group's musical instruments. The action by the authorities was taken pursuant to local law, had a valid purpose, and lasted for a short time (less than the appropriate waiting period). Nevertheless, the insured believed there was coverage for temporary deprivation and took the dispute with its insurer to arbitration for resolution. If temporary deprivation was a concern for the insured at the outset, it was incumbent upon the broker to bring this matter to the attention of the insurer for resolution in advance of issuing the policy.

3. The effect of payment defaults under an installment bank loan covered by insurance should also be clarified in advance. Under a loan agreement, normally the failure to pay an installment gives the lender the ability to accelerate the remaining installments. Can the insured lender then accelerate the loan vis-à-vis the insurer and require the insurer to pay the entire loan? Or is the insurer's obligation merely to meet the terms of the original bargain and pay each installment when it comes due? This issue should be resolved prior to the issuance of the policy.

7. Contract of Insurance of Overseas Private Investment Corp. (1985) (Form 234, KGT 12-85, art. VII).

8. *Id.* § 7.01.

9. *Id.* § 1.06.

B. Occurrence of an Insured Risk

What happens when an event that gives rise to an insured risk, such as expropriation, occurs? The insurer and the insured should function as a partnership. Because the insurer usually has considerable resources at its disposal, as well as past experience, it makes sense for both the insured and the insurer to work together to try to settle a dispute. In fact, most of these policies are underwritten with the assumption that the insurer will be able to work with the insured to try to minimize losses.

The waiting period provision of the policy is always a key consideration, and it is during this time frame that the "partnership" should mature. If the dispute cannot be resolved during that time, the insurer will want to take steps to maximize its "salvage" potential or recovery after payment of the claim. The subrogation rights of the insurer must not be tampered with because there is a real likelihood of some recovery in these instances.

According to OPIC:

> [R]ecoveries [on claims totaling $464.9 million] have totaled $212 million without regard to reinsurance reimbursements. An additional $63 million of principal recovery is anticipated. There have been no repudiations on any OPIC-guaranteed host government obligations although certain obligations are rescheduled as part of general external debt rescheduling.[10]

With this record of recovery as an example, insurers cannot tolerate the destruction or loss of their potential rights of subrogation.

Others have recognized the importance of these rights. In one recent example, an insured had contracted with a government in the Middle East to provide clothing and materials for many millions of dollars, a portion of which was covered by insurance. The government was unable to pay for the goods in cash—one of the insured risks under the policy. The insured, without notifying the insurer, negotiated an agreement with the host government whereby the insured accepted payment in crude oil instead of cash. The insured and the government valued the oil at the official government-posted price, but the oil was sold at the spot price so that the insured suffered a loss on the transaction. Coincidentally, the difference between the spot and the posted prices was exactly the total amount of insurance coverage for which the insured filed a claim. The insurer denied the claim because its subrogation rights had been destroyed. There was clearly no recourse with the host government, and

10. *Insurance Claims Experienced to Date: OPIC and its Predecessor Agency*, Press Release RJ/717, (Dec. 31, 1985).

the insurer had not been asked to consent to the deal. It was possible that the insurer could have bargained for a better deal based on its experience with barter and countertrade transactions. Accordingly, the claim was denied, and an arbitration proceeding ensued in which the denial was upheld.

In some instances, the insured may be unable to negotiate with the host government. In these cases, the insurer might be able to step in itself, or fund an intermediary, to try to negotiate a settlement. During the waiting period, the insured is typically required to take reasonable measures to prevent loss and to preserve its remedies, whether administrative or legal. Taking such measures would sometimes impose an unreasonable burden. As mentioned above, in 1971 the Chilean government passed a law expropriating all of the large foreign-owned copper mines.[11] The law provided for a special procedure to deal with issues of compensation and the valuation of nationalized properties. The regulations included a special exorbitant tax for each page of each document that a nationalized party submitted. The process was a farce. It made no sense to expend funds to preserve this remedy. The insureds in these cases sought and received OPIC's approval not to participate in this process.

There are other, less onerous situations. Consider a simple credit risk policy, where the obligor in a foreign jurisdiction does not pay. There is a waiting period under the policy before the insurer becomes subrogated. Should the insured be required to commence suit? At whose expense? Generally this is not covered with precision under the policy language, and so this issue must be dealt with at the worst possible time—when a failure to act swiftly could prejudice future recovery.

III. Conclusion

In 1971 when OPIC received its first large group of claims that arose from the actions of the government of Chile, the OPIC insurance policy had hardly been tested.[12] During the past fifteen years, both the private and the public sector have gained considerable knowledge and experience regarding the use of political risk insurance. In addition, many host governments have concluded settlements of investment disputes in the context of such insurance. For the investor who wishes to

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11. *Supra* note 3.

12. *See* OPIC Press Release, *supra* note 10. The specific risk guaranty program came into existence in 1954. Prior to 1971 OPIC and its predecessors paid only nine claims. Only two of those claims were for expropriation. *Id.*

take capital overseas, this type of insurance, if utilized correctly, can offer considerable protection against many of the different kinds of political risks that have arisen from the greater experience and sophistication of host governments.