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165 Fleet Street
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CONTENTS

CONTENTS

Trends and Developments

Contributed by:
Leonel Pereznieto
Creel, García-Cuéllar, Aiza y Enríquez S.C. ***see p.298***

The New Normal – Political Risk Insurance in Mexico

A changing landscape for foreign direct investment (FDI)

Public policy has quickly changed in Mexico over the past three years as a result of a government that has delivered on its promise of transformation. The administration of President Andrés Manuel López Obrador assumed power in December 2018 after a landslide victory predicated on change. The brand that President López Obrador and his supporters espoused throughout the electoral campaign, and still refers to his movement, is "*La Cuarta Transformación*" (the Fourth Transformation), or its initials, "4T".

At the core of the 4T's transformational principles is the need to flush out neo-liberal policies and to replace them with policies that have a direct positive impact on the less privileged. This is indeed a ground-breaking change if one considers that public policy, since 1994, had been firmly erected on free-market principles and the shrinking of state intervention in the economy through an aggressive privatisation drive. During this so-called neo-liberal period – spanning almost three decades – the government's promise was that macro-economic growth would spill on to the poor.

The North American Free Trade Agreement (NAFTA) and myriad bilateral investment treaties ratified by Mexico provided the institutional and legal framework for this decades-long trend towards the privatisation of sectors of the economy that had been controlled by the state. In parallel, sectors perennially protected from foreign investment were quickly liberalised. The opening of the oil and gas, and power production sectors to private investment during President Peña Nieto's administration (2012–18) was the epitome of the liberalisation process.

International free trade and open borders for investment have been upheld by President López Obrador's administration with the endorsement of the United States–Mexico–Canada Agreement (USMCA), which replaced NAFTA in 2019, and through active participation in the US–Mexico–Canada presidential summit held in November 2021. By the same token, Mr López Obrador has shown steadfast determination towards regaining government control over the privatised oil and gas, and electricity sectors. This has resulted in adverse government measures and a bill that is currently before the Federal Congress that, if passed, could substantially hinder the investment of many foreign private power producers and private industry participants.

Another schism brought about by the 4T has been embodied by a handful of infrastructure projects that are at the forefront of Mr López Obrador's priorities. These projects include a new Mexico City airport at Santa Lucia, which was preceded by the cancellation of the original airport project for the country's capital city, the building of which had progressed with international funding at the site of Texcoco. Through a presidential accord published on 22 November 2021, these infrastructure projects – and others that may be in the government's pipeline – have been declared of national security or public interest, sending shivers down the spine of private entrepreneurs in Mexico and abroad.

Last but not least, the Mexican federal government has assumed a strong and uncompromising position with respect to its policy goals. Based on the proposition that business interests had corrupted the decision-making process in government, the 4T has been much more unilateral in driving through policy initiatives that are centrally planned and that give little consideration to the views of the private sector. Examples of these policy "U-turns" include a complete rehash of the government healthcare system, including the revised model for the procurement of drugs and medical devices.

Investment protection tools

Leaving all political considerations aside, there is a changing landscape for private investment and, specifically, foreign investment in Mexico. The risk of disruption for FDI resulting from new government policies has increased. This does not mean that the policies of prior federal administrations were sometimes at odds with foreign investors and affected the value of their investment through measures tantamount to expropriations. It is true, however, that the more pronounced policy shifts that are occurring amidst 4T administration will likely place more strain on the business assumptions of foreign investment in Mexico.

There are multiple tools that are embedded into the institutional and legal framework of Mexico for protecting foreign investment in these times of turning tides. The most notorious are multilateral and bilateral international treaties containing investment protection provisions. Mexico has entered into treaties with more than 35 nations worldwide that afford protections to their investment, with the USMCA being perhaps the most notorious. These treaties provide protections against expropriations, measures tantamount to expropriations and measures that fail to afford a standard of treatment. The remedy available for foreign investors whose investment has been hindered by the action of the Mexican government is investor-state arbitration.

Another, less well-known tool available to foreign investors is political risk insurance. The change of circumstances in Mexico warrants a change of mindset with respect to this product, which is available from insurance markets, government agencies and multilateral organisations.

Political risk insurance in a nutshell

Political risk insurance affords coverage against risks that can be brought about by governmental action of the host country that affects investors holding a direct equity participation in an investment or lenders that provide financing to such investors and investment.

The core risks covered by political risk insurance (the "Political Risks") are currency inconvertibility, expropriation and political violence. Evidently, the scope of coverage will depend on the terms and conditions of each insurer but the general categories of risk are well understood in this line of business.

The peril of currency inconvertibility will occur when the host government adopts measures not previously in place that restrict the conversion of local currency funds into hard currency and/or the transfer of the hard currency that can be converted. For example, losses flowing from the impossibility of making interest payments to lenders or paying dividends to shareholders as a result of the restrictions implemented would be covered.

Expropriation coverage indemnifies the insured in the event that the host country seizes its assets or substantially hinders its investment without adequate compensation. Consistent with the evolution of case law in the context of investor-state disputes, certain terms of political risk insurance are not limited to the "taking" of assets but expand cover to governmental action that substantially impairs the value of the investment, including creeping expropriations. The arbitrary cancellation of concessions, licences or permits with the aim of depriving the investor from its investment without compensation may be insured under this more ample concept of expropriation.

Political violence coverage is designed to indemnify the insured when suffering losses caused by violent acts that have a political motivation. This may include damage to tangible assets of the investor caused by politically motivated acts of war, insurrection, rebellion, revolution, civil war, vandalism, sabotage, civil disturbance, strikes, riots and terrorism.

There are other types of risks covered by political insurance that complement the core lines of coverage described above and the availability of which will depend on each underwriter's product offering. For example, business interruption coverage resulting from the insured perils is often available, as are losses caused by embargoes and default by the host country in honouring arbitration awards it issues in favour of the investor.

A universal principle of insurance – that is also present in political risk insurance – is the right of the insurer to subrogate in the claims that the investor may have against the host government. In other words, the political risk insurer has the right to subrogate on to the rights of the investor that claims a loss as a result of government action. Hence the delicate implications of political risk insurance, as the subrogated insurer shall have the right to engage the host government; especially so when the insurer might be an agency of a foreign government, thus violating the sacrosanct Calvo doctrine that Mexico has always taken close to its heart.

The political risk insurance market for Mexico

Political risk insurance protecting foreign investment into Mexico is available from three distinct markets:

- multilaterals;
- government programmes for qualifying investors; and
- commercial underwriters.

Multilaterals

After many diplomatic overtures and skirmishes, Mexico and the Multilateral Guarantee Investment Agency (MIGA) of the World Bank entered into the Agreement on legal protection for guaranteed foreign investments between the Multilateral Investment Guarantee Agency and the Government of the United Mexican States (the "MIGA Convention") in 2013. Pursuant to the MIGA Convention, MIGA may issue a guarantee covering the Political Risks described above in favour of investors incorporated and that have their "principal place of business in a member [state to the MIGA Convention] or its capital is owned by a member or members or nationals thereof provided that the member is not the host country in any of the above cases... and... operates on a commercial basis".

Pursuant to Article 15 of the MIGA Convention, the host country receiving the investment must first approve the issuance by MIGA of the guarantee covering the Political Risks. This approval requirement is a hurdle that, if surmounted, provides a further assurance that the host country (ie, Mexico) will have reviewed the specifics of the investment and that it will honour the guarantee in the event that the insured loss is triggered. In the context of the current federal administration and its reluctance to submit to supranational dispute resolution mechanisms, obtaining the prior approval of a MIGA guarantee from the Mexican government may be a difficult goal to attain. In practice, the project seeking approval for obtaining MIGA coverage would need to be clearly aligned and favoured by the development policies of the 4T.

Government programmes

Many FDI exporting countries have identified the need to accompany and support their qualifying investors in their ventures abroad, and political risk insurance is one of the tools they afford to that end. Government agencies such as Bpifrance (France), Decredere (Belgium), Nexi (Japan) and Sace (Italy) offer political risk insurance coverage to their nationals investing abroad. A particular feature of political risk insurance when issued under a government programme is that upon paying a claim, an agency of a sovereign state can subrogate on to the claims of the investor vis-à-vis the host country, also raising issues under the Calvo doctrine principles.

The US Development Finance Corporation (DFC) (formerly the Overseas Private Investment Corporation, or OPIC), which is the agency of the United States offering political risk insurance, was afforded recognition in Mexico through the US–Mexico bilateral agreement signed in 2003 and that has been in force since 2004 (the "DFC Bilateral Agreement"). The DFC Bilateral Agreement provides for political risk insurance issued by the DFC only or under a co-insurance arrangement with commercial insurers.

The DFC Bilateral Agreement specifically sets forth the right of the DFC to subrogate in the investor's claim against Mexico upon payment of a claim insured under the DFC coverage. Thus, considering that such a subrogation will result in a dispute amongst sovereign nations, Article 4 of the DFC Bilateral Agreement provides for the formation of an arbitration tribunal composed by three arbitrators, one appointed by the United States and another appointed by Mexico, who will then appoint a third-country arbitrator. The substance of the arbitration is to be the action of the Mexican government triggering a loss under the political risk insurance cover issues by the DFC.

Commercial insurance

Commercial insurers are also in the business of issuing political risk insurance that covers investments into Mexico. Unlike multilateral and government-sponsored programmes, where eligibility requires a link of the insured to the state affording the political risk coverage, commercial insurance may be purchased by any investor provided that underwriting criteria are met.

Underwriters, however, will pay close attention as to whether a bilateral or multilateral investment agreement is in place between Mexico and the insured's country of residence. Because the insurer will subrogate into the investor-state claim of the insured, the insurer will want to avail of the protections of such an agreement.

Conclusions

For almost three decades, FDI in Mexico had grown used to a relatively predictable public policy environment. In this context, political risk insurance was perceived as an expensive and complex product, unnecessary in most instances. Now, with winds of change blowing across Mexico's public policy discussion, political risk insurance ought to be revisited and reappraised by FDI.

Contributed by: *Leonel Pereznieto,* ***Creel, García-Cuéllar, Aiza y Enríquez S.C.***

Creel, García-Cuéllar, Aiza y Enríquez S.C. is a leading full-service corporate law firm with more than 80 years of experience. The firm has an established reputation for delivering creative, specialised and responsive legal advice on the most complex and innovative matters in Mexico for the most sophisticated and demanding clients. The insurance and reinsurance practice brings together the talent of four professionals located in the Mexico City offices with substantial experience in the transactional, regulatory and contentious aspects of insurance and reinsurance. The goal is to become a strategic service provider by offering the type of legal advice that gives clients certainty and peace of mind. The team was counsel to the Mexican government on the Joint Multi-Country Floating Rate Earthquake-Linked Capital at Risk Notes, in the first-of-its-kind catastrophic risk transfer transaction resulting in the issuance of floating rate earthquake-linked capital at risk notes.

AUTHOR

Leonel Pereznieto is a partner of Creel, García-Cuéllar, Aiza y Enríquez. Leonel brings together a unique insight into Mexican laws and a global outlook driven by a demanding international clientele. His broad expertise in insurance – including marine insurance – cuts through contentious, transactional and regulatory aspects, with an emphasis on creating structures for innovative business arrangements. He represents reinsurers in connection with contentious and contractual issues in Mexico and in other Latin American countries, as well as global reinsurance brokers on their regional business. Leonel is admitted to practise in Mexico and New York and is a member of the Insurance Committee of the IBA.

Creel, García-Cuéllar, Aiza y Enríquez S.C.

Torre Virreyes
Pedregal 24
24th floor
Molino del Rey 11040
Mexico City
Mexico

Tel: +52 55 4748 0614
Email: leonel.pereznieto@creel.mx
Web: www.creel.mx