



Claims and recoveries

Political risk and trade credit

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Political risk and trade

A legal perspective



The private, as opposed to state-sponsored or multilateral, political risk insurance (PRI) placed in the London insurance market comprises, in its wider definition, cover for losses caused to investments and projects by government confiscation, expropriation and nationalisation (CEND), and insurance against contract frustration or repudiation by government obligors (CF).

More recently, structured trade credit has been insured against both political risks and straightforward counterparty default (CR or TCI). Cover may also be provided for losses caused by political violence (PV), including terrorism.

The PRI market has undergone several claims cycles: the Middle East petrodollar boom and the Iranian revolution in the 1970s; the 1980s debt crisis; and the collapse of the USSR and the Balkans crisis in the 1990s, among others.

In 2001-2002 Argentina came to the fore and since 2007 we have seen the resurgence of “resource nationalism”, particularly in South America.

How has the market been affected by the latest recession, and what claims issues have arisen as a result? Most trade banks were not affected by the first phase of the credit crunch in August 2007.

In September 2008, however, with the collapse of Lehman Brothers, the worldwide crisis of confidence had a severe impact on the global economy and by November 2008 global trade had dropped severely. In the private PRI sector the market faced a tsunami

of claims. Estimates vary as to the total number of notifications to date, with the top end hitting US\$4bn. Many of these will not ultimately turn into claims.

Most of those that have are straightforward trade credit insurance claims of the simple “obligor can’t pay” variety, and have been or will be paid in full and promptly. The sheer size, number and complexity of some, however, mean that lawyers will need to be involved.

In this paper we examine this claims environment and the prospects for recoveries, focusing on the legal issues.

The current claims environment

The legal issues that have traditionally arisen in PRI and trade credit disputes are compliance with policy conditions, conditions precedent and warranties, the extent of the coverage provided and misrepresentation and non-disclosure. But what about the claims the market faces? Are the issues the same or is there anything new?

The scale of the problem is undoubtedly bigger, and is not confined to any single country. Nevertheless, we are seeing the same legal issues as before, although the focus is often different.

This time the bulk of the claims have risen out of trade credit insurance, and the majority of the claimant insureds are banks.

Banks, with their “cash against documents” mentality, have a different approach to doing business from either the underwriter or the traditional insured commodity trader. Bankers are used to financial instruments



that respond on presentation of compliant documents or on first demand such as letters of credit. They are not used to the “conditionality”, whether express or implied, of long insurance policy wordings.

Another feature of banking – observed in some countries more than others – is employment instability. Employees leave and they are posted to different departments and countries. Their companies are restructured. This can create a lack of continuity with projects and deals that is not always encountered with other types of insured.

The width of a bank’s interests also has an impact, so that responding to an insured default can have unexpected (and unwanted) results from a bank’s perspective.

These could include reputational damage in an emerging, competitive market or, more concretely, cross-defaults being triggered on other instruments.

How have these features translated into claims issues?

Current claims issues

With trade credit insurance and its basic cover for counterparties that can’t or won’t pay, issues with coverage are likely to be rare. The following problems, however, have continued to arise.

Arguments about what was and should have been told to the underwriter on placement of the risk will always be with us. Increasingly, these relate to policy renewals and amendments.

In a recession, underlying contracts are often re-negotiated and payments rescheduled. In our experience this has not posed a serious problem with insured traders and contractors.

With an insured bank, however, there is a greater risk of disputes arising from underwriters not having been advised or accurately advised of the facts affecting amendment. This is perhaps because the need to do so has not been appreciated or because

the policy has been metaphorically placed in the bottom drawer by an account handler who has moved on.

This could constitute a breach of warranty, or non-disclosure or misrepresentation, undermining the validity of any policy endorsement or renewal.

We have seen problems in the preparation and presentation of claims documentation to underwriters. Again, the banking industry seems less aware of what underwriters require in support of a claim.

Linked with the perennial uncertainty every insured has about the role of the loss adjusters (whom underwriters appoint to investigate claims on their behalf), an imperfectly documented claim delays settlement at best.

At worst, it creates suspicion in the minds of underwriters, leading them to instruct lawyers.


There also seems to have been a lack of understanding among insureds about the purpose of the “Waiting Period”, a provision fundamental for CF, CR and TCI policies.

Insured banks appear to be under the impression that they simply have to wait to get their claims paid, not appreciating that the policy terms impose a continuing duty to avoid or minimise the loss by the exercise of due diligence – in a different sense from that used in the world of finance.

Perceived shortcomings in claims preparation may also have contributed to some underwriters changing their practice by insisting on detailed settlement agreements upon payment of the claim. Provided the insured is only asked to sign a document reflecting the policy wording, that is unobjectionable, but efforts to go further can be problematic.

The impact of the current claims environment

There is reason to be confident that the private sector market will survive this claims cycle and



do so with an enhanced reputation, given its positive response to date.

In the medium term it can take advantage of the collateralised debt obligation – and, more particularly, of the credit default swap – losing credibility as a means to lay off risk.

Indeed, as often happens after a period of intense claims activity, there are new entrants and new capacity, despite some contraction in reinsurance availability and some trade finance banks losing “liquid appetite”. However, while the market is in a state of flux it will no doubt remain cautious about marketing new insurance products, with reduced demand and many parts of the world off risk.

In the TCI field, new policy wordings are unlikely to emerge while Basel II remains under examination.

Recoveries: the legal issues

As the claims tidal wave recedes, the focus turns to recoveries. The concept has several dimensions:

- Recovery by the injured party from the counterparty or, in the context of losses arising from political risk, from the instigator of the political interference;
- Recovery by the injured party from any insurance that they might carry; and
- Recovery by the insurers of any losses for which they may have indemnified an injured party.

When a deal, investment, project or loan goes wrong, the starting point is the relationship with the party that caused the problem.

In the trade credit sector this is the contractual background, and in a political risk context the local or international regulations relevant to the venture.

The natural starting point is the jurisdiction for the resolution of disputes.

Where do you pursue the party responsible for your problems? In trade credit, it would be unusual for there not to be an agreement that directs the parties to go to a particular forum to have their disputes resolved.

This could either be explicit or by reference to standard terms incorporated into the relationship, perhaps even during the course of previous dealings.

It may be that the local courts of one of the parties’ countries is “seised” of disputes; in other words, they will take priority in the event that there are concurrent proceedings in different jurisdictions.

Frequently, however, dispute resolution is referred to the jurisdiction of international arbitration bodies such as the International Chamber of Commerce or London Court of International Arbitration.

The next question is whether the nominated jurisdiction is “exclusive”. If a party does not feel comfortable in resorting to the designated dispute resolution forum, is there somewhere else he can go?

This will depend on a number of factors:

- The wording of the jurisdiction clause.
Does it expressly or impliedly require all disputes to be referred to the nominated jurisdiction?
- Is the forum chosen arbitration? If so, then there are international conventions and treaties which can be invoked, to prevent a party from going elsewhere

Other factors to consider are:

- What alternative forum might accept the dispute resolution despite the express jurisdiction clause?
- Will the other party to the dispute have the means available to prevent one from resorting to another jurisdiction in preference to that contained in the contract?



Occasionally, the contract may not contain an express jurisdiction clause. If so, jurisdiction may be dictated by international treaty; for instance, within the EU there are conventions that determine where disputes are to be resolved.

Failing that, jurisdiction may be dictated by principles of private international law, to the effect that disputes should be resolved where the contract has its closest and most real connection.

This may be determined with regard to the nationality and location of each party (not necessarily the same thing), the subject matter of the contract, the place of performance and the place of contractual breach.

These may establish the “proper law” of the contractual relationship. Often, there may be an express clause in the contract terms that identifies this.

Having established jurisdiction, the next issue is what law governs the dispute. It may not be the law of the country where the forum for resolving disputes is located. Indeed, with international arbitration bodies it frequently is not.

On the other hand, sometimes the general law of the country of the dispute resolution forum will dictate that disputes have to be resolved in accordance with that law rather than, from its perspective, any “foreign” law, even though it may be expressly written into the contract.

The same process of establishing where one can sue and what law will govern the recovery should be gone through for political risks claims that arise from contract frustration (more particularly, repudiation) where the counterparty is a state entity.

There is then, however, an added dimension: the possibility of going outside the actual contract terms and resorting to public international law by pursuing a claim against the offending state entity under a bilateral

investment treaty (BIT).

This also applies to situations where the government entity is not the contract party but the external instigator of the problem, for instance by way of expropriation or discrimination. If one can resort to pursuing a claim under a BIT, then one can again resort to international arbitration, particularly under the auspices of the International Centre for Settlement of Investment Disputes (ICSID).

Once the forum and law have been established, a number of procedural issues need to be addressed:

- Formalities – for instance, is a power of attorney required in order to commence a recovery action? How are the recovery proceedings conducted?
- Costs – what will your local legal representatives charge to pursue the recovery? Will they, perhaps, be interested in acting on a contingency basis? Will any of their costs be recoverable in principle from the target of the recovery action? Conversely, will you as a claimant be exposed to a potential liability to that target’s defence costs? Might there be a requirement to put up security for the target’s legal costs?
- Court procedure – how is factual and, if necessary, expert evidence adduced? What are the rules as to disclosure of documents and information? Will a jury be involved?
- Appeals – can a claim be appealed? If so, in what circumstances?
- Timescale – how long will the whole process take?

Of course litigation per se may not be required with the recent crop of trade credit defaults. The target may accept that there is no defence or it may be insolvent or put into the local equivalent of liquidation or receivership. Nevertheless, many of the same questions with regard to practice, procedure, costs and



timescale will arise, as well as more specific issues such as creditors' priorities and distribution of assets.

These may be described as the "hard" questions. However, when pursuing recoveries abroad it is necessary to have a feeling for more intangible issues.

For instance, what is the local status and reputation of the target company? What are the local courts' attitudes to foreign claimants? How will one rank as a foreign creditor in comparison with the locals?

Besides these issues, when pursuing recoveries in these, or any other, sector, there are two over-arching and overlapping considerations: financial capacity to pay the recovery and enforcement.

It is important not to lose sight of whether the target for any recovery action has the ability to meet the claim, or at least a sufficient amount of the claim to make the recovery exercise worthwhile.

Can a recovery realised from the target be made in hard, transferable currency? Reliable information on the target's assets and future viability is vital.

One instance where this might be relevant is in obtaining security. There are assets that can be attached and jurisdictions where it can be done through legal action.

It is necessary to have an awareness of the possibilities and practicalities of taking such steps, since they strengthen a claimant's hand immeasurably and avoid the risk of deliberate dissipation. However, attachment of an asset may not always be possible even in a jurisdiction that generally allows the obtaining of security.

Courts around the world are particularly loathe to attach sovereign assets in cases where recoveries are being sought in respect of the consequences of political risks, even though the sovereign entity may

have been engaged in commercial activities and has contractually waived sovereign immunity.

Having security is one way to make sure that a successful recovery action is not a pyrrhic victory for lack of anything to enforce a successful judgment or award against.

Even without pre-obtained security, it may be possible to enforce that judgment or award against the target's assets. This will depend on the law of the place where enforcement is sought.

Do the courts have procedures for registering foreign judgments and reciprocal enforcement? Again, however, it must be borne in mind that many jurisdictions will not enforce a judgment or award against a sovereign entity even if it was engaged in commercial activities.

Prospects of recoveries

Traditionally, the market's profitability is supported by the high rate of return on recoveries.

In a strict PRI/CEND context this can be achieved after the attachment of the counterparty's assets, through the awarding of a favourable bilateral investment treaty; or by the use of specialists in unorthodox recovery processes out with the legal process. In this sector recovery rates have historically been of the order of a third.

With the exercise of trade credit insurance subrogation rights by underwriters, however, there needs to be realism. Most of the claims are of the "can't pay", not the "won't pay" variety.

When pursuing recoveries underwriters may find themselves competing with other creditors that often have greater priority.

They may also perhaps be involved in debtor-skewed winding-up processes in jurisdictions that loathe foreign banks.

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