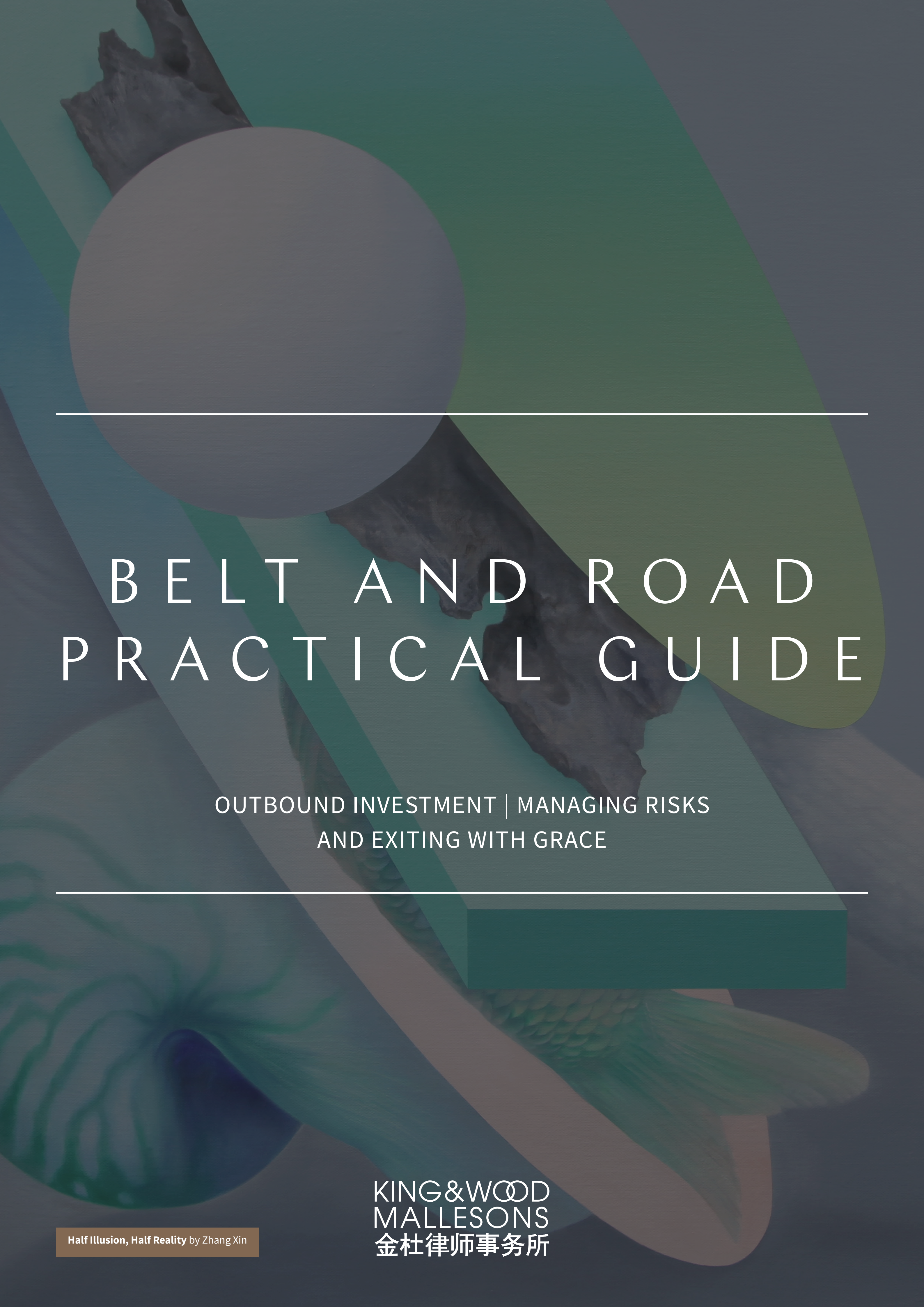

BELT AND ROAD PRACTICAL GUIDE

OUTBOUND INVESTMENT | MANAGING RISKS
AND EXITING WITH GRACE

Half Illusion, Half Reality by Zhang Xin

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OUTBOUND INVESTMENT MANAGING RISKS AND EXITING WITH GRACE

China Mainland's outbound foreign direct investment (FDI) has increased substantially over the past decade. While 2020 - 2024 has seen a decline in Chinese outbound FDI, we expect increasing activities in this sector over the next decade. China Mainland's 14th Five Year Plan continues to encourage acquisitions and investment by Chinese organisations in a wide range of sectors (e.g. high-tech, high-end manufacturing and R&D centres).

With the implementation of the BRI initiative, Chinese investors will continue to play an increasingly significant role in global markets. In this publication, we look at some of the central steps investors can take to mitigate their risks and take advantage of the legal protections available to safeguard their outbound investments.

Many Publications have emerged about the Belt and Road Initiative (BRI). Some focus on applicable laws; others are in country-by-country format providing statistics and other background. Our series of publications aims to fill that gap with practical guides. We will tell you about our own experience with our clients working on the BRI. Within each of our booklets, we will offer practical tips regarding the BRI subject in question.

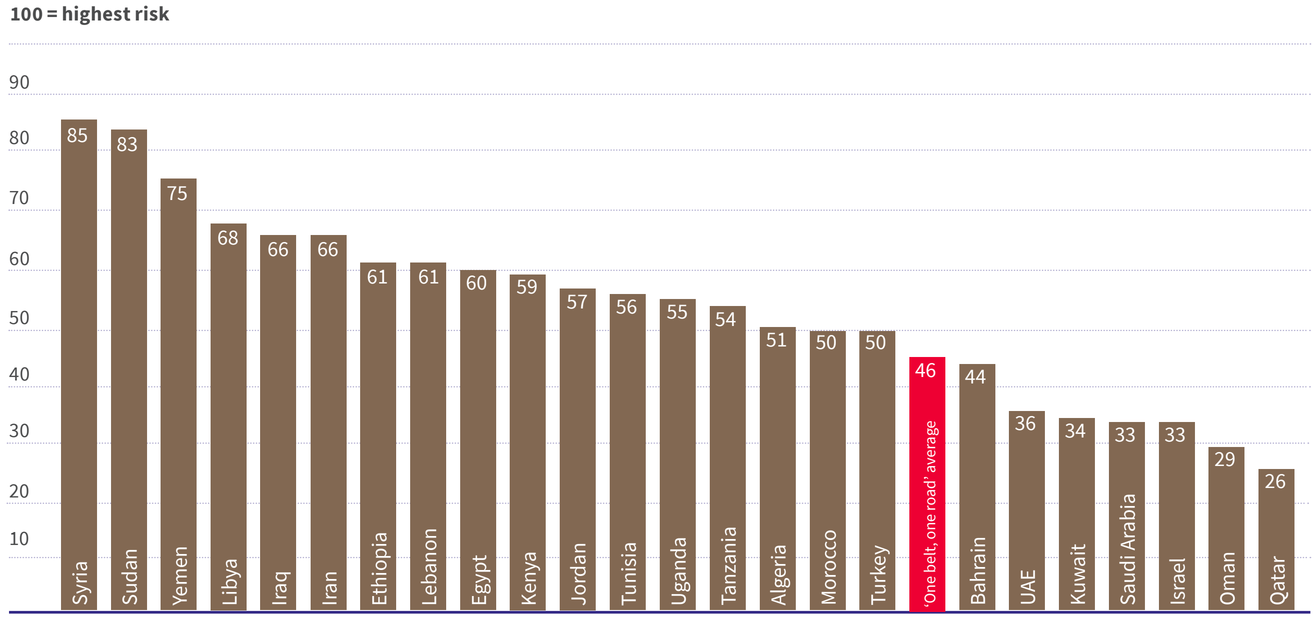
TIP 1 | UNDERSTANDING THE KEY RISKS FOR OUTBOUND FOREIGN INVESTMENT

Appropriate risk assessment and mitigation

As well as providing opportunities, large-scale foreign investment projects face numerous risks. Understanding how to assess, navigate and mitigate these risks is key to project success. Key risks associated with outbound FDI include:

- **Country operational risk** – risks associated with corruption, national security, political stability, government effectiveness, the legal and regulatory environment, the macroeconomic situation, foreign trade and payments, local labour markets, tax policy and the standards of local infrastructure;
- **Political risk** – the risk of policy changes on exchange rate and interest rate controls, international sanctions, changes of regime and economic changes, controls on prices, outputs, currency and remittances, labour quotas and, in some cases, nationalisation or expropriation. Political risk may also result from events outside of government control, such as war, revolution, terrorism, labour strikes, extortion, and civil unrest. Recent examples abound (particularly around sanctions which are seeing increased use in recent years around the world); and
- **Credit risk** – one of the major risks of outbound FDI is the potential for the host country to default on foreign lending and / or investment projects. This risk is particularly high in a number of BRI countries, which lack sound creditworthiness. The graph below sets out the overall country credit risk of certain BRI countries. Investors should also be aware that during periods of financial crisis, governments may be excused from providing the substantive protections granted under bilateral investment treaties (BITs) (see Tip 04).

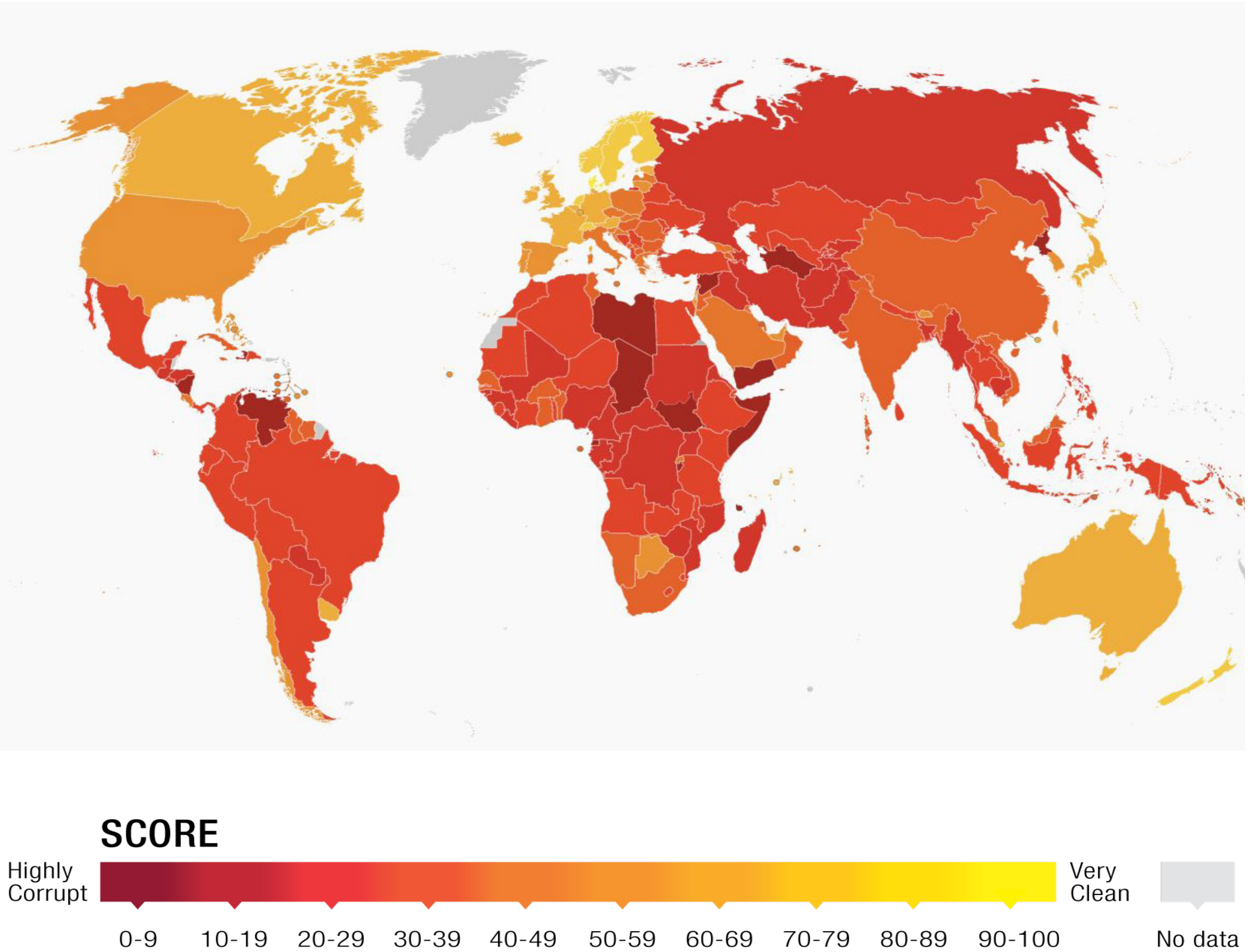
CREDIT RISK | OVERALL COUNTRY CREDIT RISKS IN THE MIDDLE EAST AND AFRICA



Source: Economist Intelligence Unit.

Whether considering new investments or managing existing projects, investors should seek to understand the particular risks which apply and keep abreast of changes.

CORRUPTION IS A SERIOUS RISK IN MANY BRI COUNTRIES:



Source: Transparency International Index 2022

Anti-bribery and corruption laws

Investor countries, such as the UK, US, Australia and China Mainland, have their own laws prohibiting certain offshore corruption practices. Unlike in China Mainland, most such laws do not have a monetary threshold.

China Mainland's Criminal Law Article 164(2)

Offending party	Offending conduct	Monetary threshold	Punishment under the Chinese criminal law
Any individual making bribe	Making a bribe to: a. a functionary of a foreign country; or b. an official of an international public organisation for gaining improper commercial benefits	Any amount over RMB30,000 (cumulative) is a criminal offence	Detainment or imprisonment up to 10 years plus a financial penalty depending on the severity of the violation (at least RMB35,000, biggest penalty imposed so far is RMB3 billion)
Corporate entity and its responsible personnel			

Anti-corruption due diligence

Given the penalties under certain investor state laws and the huge commercial risks of investing in a corrupt entity, it is essential that adequate anti-corruption due diligence is undertaken into:

- the entity's control environment: policies, procedures, employee training, audit environment and whistle-blower issues;
- any ongoing or past investigations (government or internal), adverse audit findings (external or internal), or employee discipline for breaches of anti-corruption law or policies;
- the nature and scope of the entity's relationship with the government (both family and corporate relationships) and the history of significant government contracts or tenders;
- the entity's important regulatory relationships, such as key licenses, permits, and other approvals – with a focus on employees who interact with key regulators; and
- the entity's relationships with distributors, sales agents, consultants, and other third parties and intermediaries, particularly those who interact with government customers or regulators.

Is there an effective anti-corruption programme?

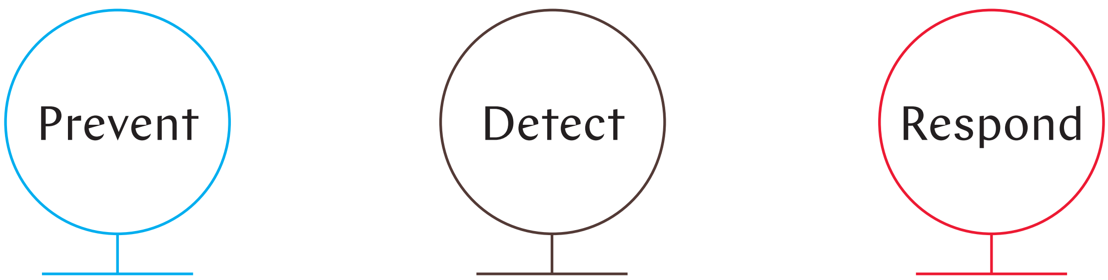
The most effective way to ensure compliance with anti-corruption laws and avoid criminal liability is to establish a robust anti-corruption programme. An anti-corruption programme should have three key pillars covering: prevent, detect and respond.

Corporate culture matters. It is essential that an anti-corruption programme is implemented and enforced by senior management.

Practical compliance: red flags

It is important to remember that prosecutions under anti-corruption laws can happen even if there is ***no actual knowledge*** that bribes are being paid. Red flags to be aware of when undertaking due diligence include:

- family relationships;
- business consultants with political connections;
- unusual payment patterns or financial arrangements;
- high prevalence of corruption in the country;
- business partner rejection of anti-corruption policy or form (or standard anti-corruption warranties);
- unusually high commissions;
- lack of transparency in expenses / accounting records;
- apparent lack of qualifications or resources; and
- recommendations by government officials.



Risk assessment and due diligence: risk profiling operations and third parties

Set tone from the top

Policies and procedures

Training and awareness

Channels for raising concerns: "whistle-blowing" and compliance hotline

Monitoring compliance programmes: in-house and independent reviews and audits

Investigations: evaluating allegations and suspicious activities using internal and external resources

Post-event mitigation: detection and prevention services to minimise the likelihood of future events

Incident management programmes: designing procedures / providing support in response to risks triggered by a corruption event or investigation

TIP 3 | FACTORING IN THE ONGOING COST OF FOREIGN INVESTMENT REGIMES

Regulatory issues

Foreign investors often face unpredictable approval regimes. Navigating government decision-making processes poorly can result in delay and increased costs. Even in historically investor-friendly jurisdictions, foreign investors can face challenges and political opposition when public assets are involved.

Example: Ausgrid

On 19 August 2016, the Australian Government announced that it had blocked the proposed acquisition of a 50.4% stake in Ausgrid (a New South Wales Government-owned electricity distributor) by investors from China Mainland and Hong Kong.

The Australian Government stated that the acquisition would be contrary to the national interest and that security concerns were identified in relation to both the structure of the transaction and the nature of the assets to be acquired (related to Ausgrid's business rather than the identity of the specific bidders).

We have seen this repeated more recently with the Australian Government blocking the acquisitions of:

- Lion Dairy & Drinks (an Australian dairy producer) by China Mengniu Dairy Co in 2020; and
- Probuild (an Australian building company) by a Chinese construction company in 2021.

Foreign investment rules

It's not just caps on ownership. For example, some BRI countries (e.g. the Philippines) prevent foreign nationals from holding executive roles in locally incorporated companies, leading to excessive executive costs associated with engaging a local CEO and a 'real' CEO to shadow their local counterpart.

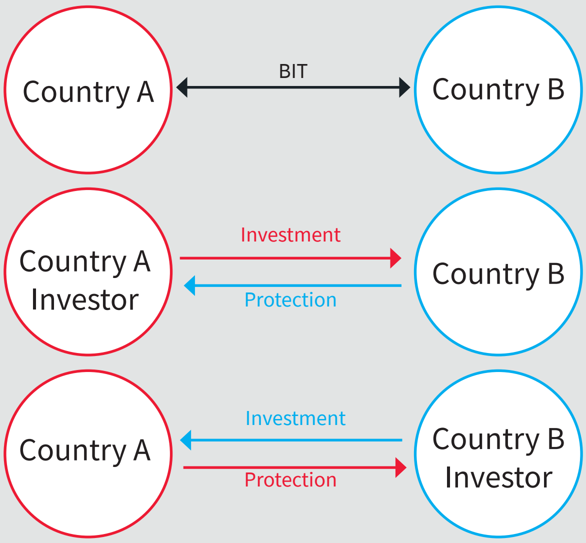
Additionally, some jurisdictions allow initial foreign ownership but require the foreign investor to sell down to a local partner over time, which can lead to a fire sale of assets and depressed pricing. For example, Indonesia requires foreign companies to sell down stakes in local mining operations and increase domestic ownership to 51% by the 10th year of production.

TIP 4 | STRUCTURING THE INVESTMENT TO MAXIMISE TREATY PROTECTIONS

BITs can allow investor entities protection against certain adverse actions by a host state.

What are Bilateral Investment Treaties (BITs)?

An agreement between two countries allowing reciprocal protection of "**investments**" made by "**investors**" from their respective countries in each other's territory:



Qualifying for BIT protections

In order to rely on the protections offered by a particular BIT, the foreign company will need to qualify as an "**investor**" and the investment must fall within the definition of a protected "**investment**" under the BIT.

BITs: Substantive protections

BITs provide a broad range of substantive protections. These include:

- **(Enforcement of rights)** allowing an investor to enforce its rights under the BIT against the host country through independent international investment arbitration (ICSID, UNCITRAL or private arbitral institutions, e.g. International Chamber of Commerce);
- **(Fair and equitable treatment)** entitling all investors / investments to be treated fairly and equitably;
- **(No expropriation without compensation)** protection against government seizure of property (nationalisation), arbitrary termination of contacts or removal of licences without adequate compensation; and
- **(Full protection and security)** protection from physical harm suffered by an investor or an investment.

Defences

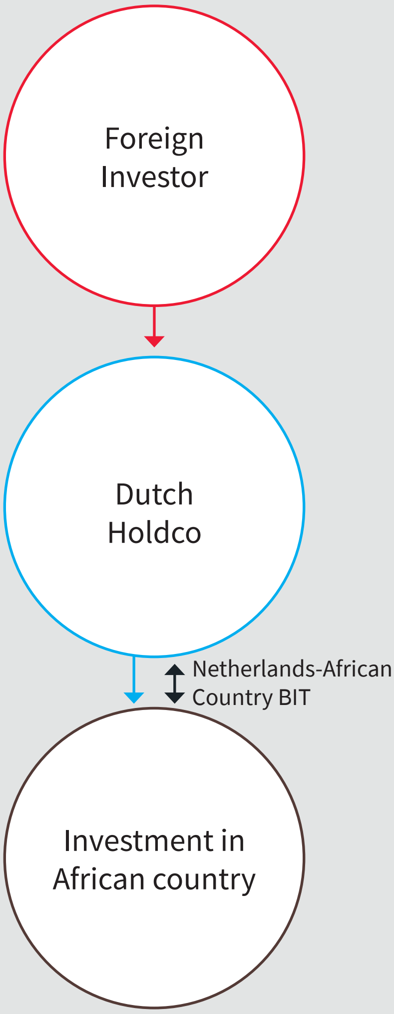
BITs often contain provisions which limit the protections outlined above in circumstances where the host government is acting for a public purpose or can raise a defence in respect of its action.

For more details about the qualifying criteria and the types of protections offered under BITs, see our Belt and Road Practical Guide on "*How to resolve disputes on the Belt and Road*".

BITs: Investment structuring

Investment structuring at the outset is vital to maximise the protections available under the BIT. Investors should consider:

- subject to the restrictions discussed below and relevant tax considerations, structuring the investment through a country with favourable treaty protections (e.g. the Netherlands has more than 25 BITs with African countries which safeguard cross-border investments made through a Dutch Holdco within the particular African country); and
- ensuring that all prerequisites have been satisfied in order to benefit from the BIT (e.g. the relevant vehicle qualifies as an "investor").



Restriction: Forum shopping

Investors often "shop around" by investing through a company in a country which has negotiated a favourable treaty with the host country.

However, it's important to be aware that some treaties contain "denial of benefits" clauses, which entitle the host country to exclude claims by companies:

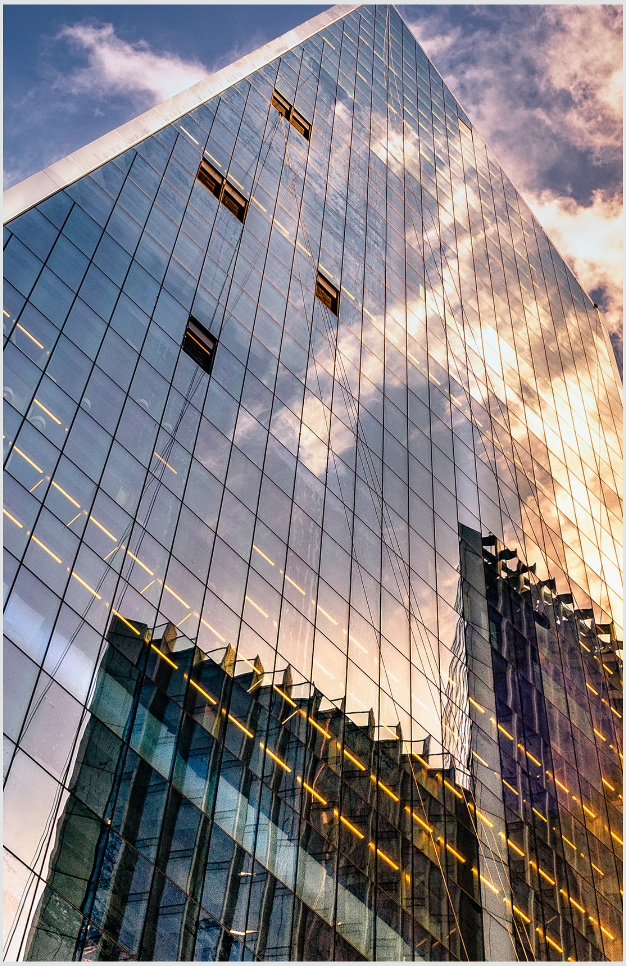
- that are owned or controlled by third party nationals; or
- do not have substantial business activities in the company's place of incorporation.

Restriction: Business restructuring

As a general rule, a company may restructure a transaction to take advantage of international investment agreements concluded by the relevant host country. The key issue is to ensure that the company uses an investment vehicle which satisfies the particular BIT's criteria.

However, remember that courts may refuse a claim on jurisdiction where an investment was restructured at a time when a dispute had already arisen or was sufficiently foreseeable by the investor.

So, it is best practice to choose the correct structure at the start of the investment.



TIP 5 | EXITING WITH GRACE

What if it all goes wrong?

Foreign investors are often required to enter joint ventures with local partners, either due to statutory caps on foreign ownership or for more practical reasons such as sharing capital and expertise and limiting risk. Significant time and effort is usually spent finding the right partner and agreeing how the joint venture will operate on a day-to-day basis, but parties often neglect to ensure there are appropriate mechanisms in place to facilitate a smooth exit if things go wrong.

Deadlock clauses and exit mechanisms

An effective deadlock clause with appropriate exit rights is critical: it can protect investors from being locked in a stalemate, for example, in circumstances where there is an unresolved deadlock with the local partner on a major matter (e.g. failure to agree a new business plan). A deadlock clause should provide for a period of good faith negotiations, and allow the deadlock to be escalated up the ownership chain if necessary.

In circumstances where a deadlock cannot be resolved, there should be an effective mechanism for the parties to exit the joint venture. Exit mechanisms include:

- **Put / call rights:** where one or both parties has the right to require the other party to buy or sell their respective interests in the joint venture at a specified price (e.g. after X number of years or earlier if there is an unresolved deadlock).
- **Russian roulette:** either of the joint venture parties (Party A) may serve a notice on the other party (Party B), offering to transfer Party A's interest to Party B at a price specified by Party A. Party B has the option to buy the shares at that price or sell its own shares to Party A at that price.
- **Sealed offers:** each party provides a sealed offer to the other. The party offering the higher price is required to purchase all shares at that price.
- **Termination for default:** if there is an unremedied, material event of default, the innocent party should have a put or call right.

It is important to remember that exit rights can be illusory for a foreign investor where there are foreign ownership caps (meaning that this issue needs particular consideration in an outbound investment context).

Will technology and service arrangements survive exit?

When drafting exit mechanisms, parties should provide for what will happen to their respective intellectual property rights and rights to receive particular services upon exit. In particular, parties should:

- consider whether, and on what terms the joint venture would be permitted to continue using the trademark or other intellectual property of the exiting joint venture party;
- address what happens to the intellectual property developed by the parties during the course of the joint venture (e.g. who owns, and whether the parties are "free" to use and exploit);
- consider the effect of termination on any intellectual property license agreements between the joint venture and the remaining party or whether such agreements should become royalty bearing (if not already); and
- consider whether the remaining party can secure any ongoing or transitional services from the exiting party (e.g. services, assets, employees), perhaps pursuant to a default transitional services agreement.

TIP 6 | RECOGNISING HONG KONG'S UNIQUE POSITION

As the interface between China Mainland and the rest of the world, and with the benefit of the "one country, two systems" legal regime, Hong Kong provides one of the best platforms for the various multi-national activities involved in the Belt and Road Initiative.

1 Gateway for Chinese outbound investment

2 Global logistics links (freight and maritime)

3 JV / consortium partner

4 Source and distributor of capital

5 Choice of law Rule of law

6 Leading global financial centre

CONCLUSION

Effective planning and management of outbound FDI projects is key to allowing investors to mitigate risks and maximise the protections available. In particular, investors should:

- engage external advisors at an early stage to help evaluate and navigate the risks associated with potential investments;
- structure investments to maximise the protections available under BITs; and
- ensure effective deadlock and exit mechanisms are incorporated in joint venture agreements to allow for a smooth exit in the event that things do go wrong.

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