BR risk mitigation and dispute resolution options in the coming decade

Six years after its inception, the Belt and Road Initiative (BRI) launched by Chinese President Xi Jinping has been gaining more traction in the沿线国家. However, there are two sides to this particular coin: as the opportunities grow, so do the risks. Risk mitigation and compliance for BRI projects have become top considerations for all parties involved in BRI-related projects, especially after a few cases of losses that highlighted the need to take effective proactive measures.

A new phase

The recent “BRI & Beyond Forecast” produced by Baker McKenzie and Silk Road Associates estimates that BRI-related investments will reach USD 1.32 trillion in the 2020s. In contrast, the Uni-Polar Model takes into account the potential impacts of a significant recession coupled with increasing nationalism and more aggressive competition from other nations, and puts the value of potential BRI-related investments in the 2020s at only USD 560 billion.

Ben Simpindendorf, Founder and CEO of Hong Kong-based BRI consultancy Silk Road Associates, notes that the early stage of the BRI was characterized by projects in relatively small economies with lower incomes. However, Chinese companies have now shifted their focus back to core markets in Southeast Asia such as Indonesia, Thailand and Malaysia because companies have realized that the former approach left them with an international but fragmented platform.

Chinese state-owned enterprises (SOEs) are no longer the exclusive investors of BRI projects. Many non-Chinese companies and financial institutions are now involved because Chinese developers and lenders realized that these specialized experience and knowledge to undertake projects in many BRI countries. As Chinese developers gravitate toward competitive sources of project funding and move away from having to procure loans with parent company guarantees, they start to see the benefits of involving international lenders when borrowing against collateral from local residents. In the same month, Ghana cancelled an agreement on a USD 22 billion railway project due to an alleged breach of confidentiality.

Concluding the key takeaway from Baker McKenzie’s October seminar, Nandakumar Ponniya, Asia Pacific Chair of the Firm’s International Arbitration Practice, notes that the level of enforcement risk, particularly in the second Belt and Road Forum in April this year that the Chinese government would encourage local companies engaged in BRI projects to comply with international rules and standards, in areas such as project construction and procurement. He also reiterated that there would be “zero tolerance” of corruption.

Recent guidance from these government bodies makes it clear that there will be careful scrutiny of transactional projects to determine their risk profile and the adequacy of the risk measures undertaken by companies,” says vandePol.

“We are working closely with both majority and minority BRI JV partners to enhance their anti-bribery and corruption compliance processes, as well as satisfying the demands of various stakeholders, such as the development banks where the funding is dependent on the existence and implementation of a credible compliance program.”

What is becoming clear is that Chinese players are not the only beneficiaries of the BRI. Non-Chinese companies can also enjoy the opportunities brought about by this ambitious global initiative.

Martin David, Asia Pacific Chair of Baker McKenzie’s International Arbitration Practice, says that the development of projects in BRI countries are fundamentally the same as their internal rules and standards, in areas such as project construction and procurement. He also reiterated that there would be “zero tolerance” of corruption.

“The differences, however, lie in the approach to developing the projects and the sources of financing,” he notes.

“Chinese lenders have traditionally sought to mitigate lending risks through more conservative measures, such as providing guarantees or insurance, instead of lending against project risks,” David explains. “But we are seeing more conventional and non-recourse financing structures being pursued,

Navigating the risks along the Belt and Road

Putting in place a risk management plan as part of the overall transaction strategy is an important first step. Another is benchmarking the measures that other companies have taken.

Chinese companies have taken a proactive approach to managing risks associated with project development and execution. A case in point is a pipeline project by Sinopec Oilfield Services that incurred an RMB 3 billion loss in 2016 due to an “unexpected” change in design by the Saudi Arabian project owner. To compound this, Sinopec Oilfield Services had only a limited understanding of the process for obtaining compensation.

There has also been evidence of increasing tensions between stakeholders to manage its interests and the interests of local communities. In June 2019, the construction of a Chinese-financed coal-fired power plant in Kenya was halted over environmental and social concerns. As China’s approach to managing its internal risks and international investments continues to shift, the need to forge new alliances and adapt to local conditions becomes increasingly important. This will also usher the BRI into a new phase, one marked by international and Chinese financial institutions lending alongside one another. This is partly due to debt problems in some BRI countries, but it is also due to a realization among Chinese investors that these mega transactions are often more difficult to implement successfully and quickly because they involve a great deal of public scrutiny and political considerations.

The new landscape of the recalibrated BRI brings a new set of opportunities, but, at the same time, companies need to be vigilant in managing and mitigating the legal risks of these projects. “When you’ve got a long-term contract in place, you need to develop risk management strategies upfront so that you are prepared for the issues when they arise,” said Baker McKenzie’s Asia Pacific Chair of the Firm’s Compliance and Investigations Group.

VandePol notes that compliance in areas such as anti-bribery and anti-corruption, trade sanctions, diligence, and major real estate projects is at the top of the list.

“If you look at all the major countries that are involved in BRI projects and China itself, the compliance issues are actually quite extensive and the risk around various compliance matters, for example, bribery and corruption, is very high,” she says. Almost all the countries involved in the BRI are ranked as “hot countries,” with the greatest perception of corruption by Transparency International.

“These risks can have significant consequences, ranging from a reduction in profitability to heavy legal penalties and criminal convictions,” says vandePol. “So, managing compliance risks cannot be an afterthought, it really does need to be considered right at the front end of the project.”

Although these risks are omnipresent, they are not necessarily deal breakers - it’s all about willingness to invest up front on appropriate risk identification, management and mitigation measures.

Navigating the risks along the Belt and Road

Putting in place a risk management plan as part of the overall transaction strategy is an important first step. Another is benchmarking the measures that other companies have taken.

VandePol warns that commercial solutions that involve taking a shortcut around compliance requirements may create significant long-term risks, even though they are tempting to businesses in short-run.

“For instance, it is extremely high risk for a company to engage a third party to manage government approval and to shorten the compliance process by framing or complexity, without performing adequate due diligence or putting in place controls around the third party’s activities,” says vandePol.

“We have seen corruption tactics by third parties to governments to obtain permits and licenses. This later resulted in a continued demand for improper payments when inspection or audits by government compliance bodies failed, or, in more extreme circumstances, when there were health and safety incidents as a result of the inadequate compliance measures.”

Additionally, the level of enforcement risk, particularly in the second Belt and Road Forum in April this year that the Chinese government would encourage local companies engaged in BRI projects to comply with international rules and standards, in areas such as project construction and procurement. He also reiterated that there would be “zero tolerance” of corruption.

Recent guidance from these government bodies makes it clear that there will be careful scrutiny of transactional projects to determine their risk profile and the adequacy of the risk measures undertaken by companies,” says vandePol.

“We are working closely with both majority and minority BRI JV partners to enhance their anti-bribery and corruption compliance processes, as well as satisfying the demands of various stakeholders, such as the development banks where the funding is dependent on the existence and implementation of a credible compliance program.”

What is becoming clear is that Chinese players are not the only beneficiaries of the BRI. Non-Chinese companies can also enjoy the opportunities brought about by this ambitious global initiative.

Martin David, Asia Pacific Chair of Baker McKenzie’s International Arbitration Practice, says that the development of projects in BRI countries are fundamentally the same as their internal rules and standards, in areas such as project construction and procurement. He also reiterated that there would be “zero tolerance” of corruption.

“The differences, however, lie in the approach to developing the projects and the sources of financing,” he notes.

“Chinese lenders have traditionally sought to mitigate lending risks through more conservative measures, such as providing guarantees or insurance, instead of lending against project risks,” David explains. “But we are seeing more conventional and non-recourse financing structures being pursued,
and Chinese companies not being ready and willing to give such parent guarantees. They are standing up to the Chinese lenders and demanding better lending terms.

Furthermore, the cultural issues that prevent Chinese companies from doing business in a BRI country are often overlooked. “Chinese businesses are not used to what is often a very different approach to project development. Therefore, getting the approach right and making an agreement with the key project stakeholders, such as governments, utilities, regulators, etc., is something that can make the difference between failure and success,” says David.

Fortunately, Chinese companies are now recognizing the value of having strong local partner support throughout the project development. One of the first hurdles Chinese companies have to overcome when they are investing in a new emerging BRI market is the so-called ‘country risk’—put simply, not just the commercial risks like will we get paid but the risks associated with doing business such as the way to navigate opaque plant import regulations. A strong local partner can help but finding a partner and then building the trust and relationship takes time which many Chinese companies are not willing to invest in.

“The end game must be to have a good understanding of the market with a supportive strong local partner. Increasingly this should be a critical part of the overall BRI project offering. A strong local partner can help but finding a partner and then building the trust and relationship takes time which many Chinese companies are not willing to invest in.”

To help companies navigate the risks of BRI projects, Minna van der Poel, Asia-Pacific Chair of Baker McKenzie’s Compliance and Investigations Group, put together a suggested checklist for risk minimization in BRI activities:

• Put strong, decisive, and ethical leadership in place.

Inexperienced and weak decision-making will lead to pressure/temptation to take risky short cuts.

• Get the full picture when it comes to risk assessment and analysis.

Adaptively anticipate all types of risks and ensure they are discussed and provided for in the overall project strategy.

• Understand what is needed to manage complex laws affecting the movement of people and goods.

Approvals for immigration, customs, data movement and tax compliance will enable projects to continue or stop them short. There are no shortcuts on regulatory approvals and licenses. Alternative “faster” paths will lead to major problems and delays in the long term.

• Be vigilant about engaging third-party providers.

Third-party due diligence and ongoing oversight is key to ensure companies have the right and trustworthy partners for the project.

• Prioritize long-term project completion over racing to win opportunities.

Procurement processes should be closely monitored and planning for long-term project success will save companies from incurring additional costs from delays or cancellation of projects due to insufficient upfront due diligence and planning.

• Find advisers who are dedicated to designing ethical solutions that work.

Challenges are inevitable, therefore, to move a project forward, companies have to have the right advisers in place from the start, who know the risk profile and how to protect your contractual rights through the dispute resolution process. The parties may have agreed to negotiation and mediation as part of that process. Whether to refer a dispute to litigation or arbitration is an important consideration that should have been determined at the drafting stage.

Effective contract management and ensuring compliance with contractual obligations and procedures is an important element of risk management. “One of the key things is to make sure that the procedural requirements are clear from the outset, who is responsible for what, and what needs to be done,” Delaney explains.

Dispute resolution options for BRI projects

Delaney echoes David’s view. “One of the challenges that we often see in BRI projects is the cultural misalignment between the parties,” she says. “Arbitration tries to address that to some degree although of course the misalignment may have already been factored in the sourcing of regulatory approvals and licenses. Alternative “faster” paths will lead to major problems and delays in the long term.

• Prioritize long-term project completion over racing to win opportunities. Procurement processes should be closely monitored and planning for long-term project success will save companies from incurring additional costs from delays or cancellation of projects due to insufficient upfront due diligence and planning.

• Find advisers who are dedicated to designing ethical solutions that work. Challenges are inevitable, therefore, to move a project forward, companies have to have the right advisers in place from the start, who know the risk profile and how to protect your contractual rights through the dispute resolution process. The parties may have agreed to negotiation and mediation as part of that process. Whether to refer a dispute to litigation or arbitration is an important consideration that should have been determined at the drafting stage.

• Educate the team on the risks and provide practical tools for risk management and mitigation.

Compliance and legal advisers are necessary guides but it’s the business personnel on the ground and those having regional oversight who need to be comprehensively trained and held accountable for effective risk management.

• Build strong, trusting relationships with your stakeholders.

Strong relationships and effective communication with the various parties involved in the project is a must. The importance of doing business “the right way” needs to be an upfront commitment leading to no doubt as to expectations for the future.

There are new mechanisms being introduced in mainland China to address issues related to dispute resolution.

International Commercial Courts

In 2018, the Supreme People’s Court in China created two branches of the International Commercial Court in Shenzhen and Xi’an that act as both the first instant court as well as the final court. The mission of the court is to resolve all international commercial disputes, particularly, BRI-related disputes.

Singapore Mediation Convention

Chinese parties may also prefer mediation, particularly with the new Singapore Mediation Convention. Once in force, the Singapore Mediation Convention will permit parties to enforce settlement agreements entered into during mediation directly in a State that is party to the convention. Many of the states on the BRI have signed the Singapore Mediation Convention.

Direct Enforcement of Hong Kong Judgments

Earlier this year, the Supreme People’s Court in China signed an arrangement with the Hong Kong Government, which, once effective, will allow for the direct enforcement of legally effective civil and commercial judgments obtained from the Hong Kong courts in mainland China, which covers both monetary and non-monetary relief. This will mean greater certainty and expediency for parties litigating in Hong Kong or China and will benefit BRI investors and the Chinese courts.

Interim Measures from the Chinese Courts

A further landmark arrangement between the Supreme People’s Court in China and the Hong Kong Government came into effect on 1 October 2019, allowing parties to Hong Kong-seated arbitrations administered by certain eligible arbitral bodies to obtain interim measures from the Chinese courts that will be enforceable in mainland China. The interim measures available from the Chinese courts include the preservation of property, evidence and conduct. This arrangement is a game-changer as it offers greater protections for foreign entities that may otherwise hesitate to participate in China’s key policy initiatives due to the lack of urgent relief available.