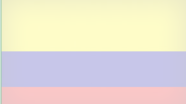
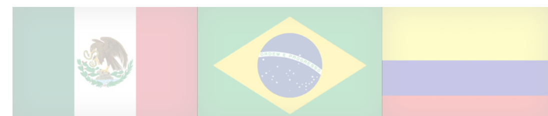
ARBITRATING WITH STATES AND STATE-OWNED ENTITIES IN LATIN AMERICA

Latin America's economic growth over the last five years has positioned it as one of the main destinations for foreign investment. **Rachael Kent** and **Nicolás Costábile** of **WilmerHale** discuss issues arising in arbitrating with states or state-owned entities in three key areas for foreign investment: Mexico, Brazil and Colombia





Despite the region's slowing rate of growth, the number of projects and public-private partnership transactions has continued to increase, with an estimated value in 2014 of USD 56.3 billion.

States and state-owned entities are major participants in national and international business transactions, especially in strategic sectors such as energy, infrastructure, transport and telecommunications. Since states are generally unwilling to submit to a foreign court, and foreign investors often are not prepared to accept the jurisdiction of courts of the state party, arbitration clauses have become increasingly frequent in contracts with states or state-owned entities.

Indeed, statistics show that commercial arbitrations between private parties and Latin American states or their entities have increased in recent years. The number of ICC arbitrations filed involving states and state-owned parties in Latin America and the Caribbean has increased by more than 163% in the last two years, from 11 filings in 2013 to 29 in 2014. In 2014, states or state-owned entities were claimants in only 7% of these cases; in the rest, the state or state-owned entity was respondent.

Mexico

Mexico was the leading destination country for both capital investment and foreign direct investment projects in Latin America in 2013 and 2014, according to the Latin American Trade and Investment Association (LATIA).

Investment in infrastructure, associated with strategic areas such as energy, transportation and communication in Mexico, is foreseen to continue over (at least) the next three years. According to Mexico's National Infrastructure Program, approximately USD 570 billion will be spent on infrastructure in the 2014 to 2018 period. Of this, around USD 180 billion is being allocated to expenditures in oil and gas exploration and production; approximately USD 97 billion is being allocated for development of communications and transportation systems (covering new highways, trains and railroads, and the refurbishment of over 20 airports, among others), and approximately USD 17 billion is being allocated to the continued growth of Mexico's gas and liquids pipeline infrastructure.

As in most Latin American countries, in Mexico these areas are carefully regulated and controlled by the government and its state entities due to their strategic importance for the country. For example, oil and gas, and the electricity sectors were traditionally monopolised and reserved to Mexican state-owned entities (**Petróleos Mexicanos** (PEMEX), and **Comisión Federal de Electricidad** (CFE)). In 2014, Mexico carried out the so-called energy reform which adopted a new regime that allows participation of private investment in these sectors through project agreements based on commercial law – as opposed to the administrative contracts under which they were historically governed.

As a result, foreign investors are able to include arbitration clauses in their contracts with PEMEX or CFE. Although Mexico's arbitration law, governed by articles 1415-1480 of the Mexican Commercial Code, does not expressly provide that the state or state-entities are able to enter into arbitration agreements, various other laws establish that such agreements are allowed. For example, the laws that regulate PEMEX and CFE expressly allow these companies to conclude arbitration agreements for any type of disputes with effects within and outside Mexico's territory. In addition, article 139 of the Public-Private Partnership (PPP) Law, which regulates contracts between the federal government and private parties based on commercial law, also permits arbitration for disputes arising out of contracts entered into under the PPP Law.

While these laws recognise that the state or state-entities can enter into arbitration agreements, there are important limitations on that authority. For example, the PPP Law provides that disputes regarding the revocation of ▶

concessions for breach, any governmental authorisation, and 'acts of authority' (governmental acts including the administrative rescission of a contract by a public entity) cannot be decided by arbitration. These acts, which are considered administrative in character, can only be challenged before a Mexican federal court.

Furthermore, article 139 of the PPP Law states that any arbitrations conducted pursuant to arbitration agreements contained in project contracts must be conducted in Spanish, and the applicable law must be Mexican federal law.

Investors entering into arbitration agreements with state entities in Mexico under the PPP Law should be aware of these requirements and limitations in order to avoid unpleasant surprises, such as parallel proceedings in the administrative courts, or the invalidation of an arbitration agreement that fails to meet these requirements.

Brazil

Brazil is the second-largest emerging market in the world after China, with a nominal GDP of USD 2.2 trillion in 2014. Brazil was the 5th largest recipient of foreign direct investment in 2014. Analysts foresee that between 2012 and 2020, a total of USD 809.4 billion will be invested in the country's energy and oil and gas infrastructure, and in its telecommunications, health and transport sectors alone. Brazil is reported to have spent USD 11-14 billion on preparations for the FIFA World Cup, and more than 65% of the construction work underway for the Rio 2016 Olympic Games is linked to public-private partnerships.

Brazil's legal framework has become increasingly arbitration-friendly in recent years, culminating in the enactment of a new Arbitration Law (the new law) in 2015 which aims to provide greater clarity and certainty. Among the changes provided in the new law, the legislation confirms the view previously endorsed by Brazilian authorities that the state and state-owned entities are able to enter into binding arbitration agreements, as long as they relate to 'disposable patrimonial rights', which are essentially rights of commercial, economic or financial nature.

Under the new law, arbitrations involving state entities or state-owned companies are subject to public disclosure rules, as is any other act involving public administration (under article 37 of the Brazilian Federal Constitution), thus making them non-confidential. The Arbitration Law also provides that arbitrations involving state entities or state-owned companies cannot be decided *ex aequo et bono*.

It remains to be seen how the new law will be applied in connection with other pre-existing laws that contain specific provisions regarding arbitration with the state or state-owned entities in specific contexts. For example, Brazil's Private-Public Partnership (PPP) Law of 2004, and Concessions Law of 1995 expressly permitted arbitration agreements with the state or state-entities provided that the seat of the arbitration is Brazil and the language of the proceedings is Portuguese. The new law does not contain these requirements, which could raise questions about whether they still apply to arbitration agreements in contracts regulated by those acts.

More recently, a presidential Decree of June 2015 governing arbitrations involving the Brazilian port authorities provides that arbitration is permissible, as long as the applicable law is Brazilian law and other procedural requirements are met.

These include (i) in disputes of more than BRL 20 million (approximately USD 6,400,000) the arbitral tribunal shall be formed by a minimum of three members; (ii) the parties must have at least 45 days to submit their respective defences; (iii) preference will be given to institutional arbitration over ad hoc arbitration; (iv) in the case of institutional arbitration, among other requirements, the institution must have offices in Brazil; and (v) in case one or more of the members of the arbitral tribunal is a foreigner, he or she must be authorised to practice in Brazil. This Decree post-dates the new law, which suggests the government intended that these requirements apply to arbitrations involving the port authorities, notwithstanding that they are not included in the new law.

Private parties contracting with Brazil or its state entities should carefully consider not only the Arbitration Law, but also other statutes that regulate the authority of the state to enter into the contracts at issue to be sure that any arbitration agreement in the contract complies with all potentially applicable requirements.

It is worth noting that Brazil is not a signatory of the ICSID Convention and has not ratified any bilateral investment treaty (BIT). Foreign investors therefore stand to gain significant protections by including arbitration agreements in contracts with the Brazilian state or its state-owned entities, which may provide the only basis for seeking legal recourse against Brazil outside of the Brazilian courts.

Colombia

Colombia is the third-largest economy in Latin America and one of the most attractive countries for foreign investment in the region, with investments of USD 16 billion in 2014. According to the **World Bank**, Colombia is ranked first in Latin America and 10th in the world in investment protection. Colombia has entered into 16 regional and bilateral international trade agreements, including regional agreements with Latin America and Europe, and bilateral agreements with the USA, Canada, Turkey and South Korea.

Due to the country's continuing political stability and sustained economic growth, the number of contracts with the Colombian state is expected to grow steadily, especially regarding infrastructure projects that the country will require in order to maintain economic growth. For example, Colombia intends to grow its national highway system by more than 400%: it plans to build road transport infrastructure with an estimated value of USD 22 billion, according to Colombia's fourth generation of road concessions programme. The projects will be carried out through public-private partnership schemes with 20 to 30-year concessions. Foreign investors in such projects are likely to request arbitration agreements in their contracts.

Colombia benefits from having one of the most modern arbitration statutes in Latin America (Law 1563/12, dated 12 July 2012). The Arbitration Law covers national and international arbitration, and is partially based on the UNCITRAL Model Law on international commercial arbitration. Article 62 of Colombia's Arbitration Law permits the state or a state-owned entity to enter into arbitration agreements and provides that a state entity cannot invoke the provisions of Colombia's domestic law to challenge its own capacity to arbitrate or the arbitrability of a dispute in international arbitration.

Although the state and its state-owned entities are able to enter into arbitration agreements, in practice, arbitration agreements are not included in many state-related contracts. The majority of disputes with the state or state entities under such contracts are currently decided by the Colombian administrative courts, where court proceedings are often very slow. The exception is big infrastructure and energy projects, or projects funded by international organisations, such as the **Inter-American Development Bank** or the World Bank, where foreign parties often include international arbitration agreements in the governing contracts.

A recent presidential Directive of November 2014 (presidential Directive 04) imposed a new hurdle for arbitrating with the state or its state-owned entities. Under the Directive, prior to the execution of any arbitration agreement, the directors of the state entity must issue a comprehensive analysis explaining why arbitral jurisdiction would be more favorable than the domestic jurisdiction of the administrative courts in that particular case (Article 1). Thus, every time that a government agency decides to enter into an arbitration agreement, the officers of such agency must include in the contract file adequate documentation justifying the inclusion of the arbitration agreement.

Furthermore, after a dispute has arisen, the directors of the state entity must obtain the president's approval to appoint arbitrators by sending a summary of the arbitral process and the list of potential arbitrators and the CV of each arbitrator to the office of the president's Chief of Staff 10 days in advance of the appointment. The same process must be followed if an arbitrator needs to be replaced (Article 2). Pursuant to Article 3 of the new Directive, no government agency is allowed to appoint as arbitrator any lawyer that acts as opposing counsel in any legal process against any government agency or that is sitting as an arbitrator in more than five proceedings in which the state is a party.

It remains to be seen whether the burdens imposed by the presidential Directive will reduce the use of arbitration agreements in contracts with the Colombian state or state entities, or will deter investors from entering into contracts with the state.

Conclusion

An arbitration-friendly legal regime is generally regarded as crucial for foreign investors, particularly when entering into significant or long-term contracts with a state or state-owned entity. Mexico, Brazil and Colombia have made great strides by expressly permitting the states and their entities to enter into arbitration agreements with private parties. Other states in Latin America can improve their investment climates and better compete for foreign investment by following their lead.

These states should take care, however, not to allow legislative inconsistency to undermine the legal protections they have established for foreign investment. Statutes and executive decrees that impose limitations or burdens on the ability of the state or a state entity to enter into arbitration agreements or that impose arbitrability restrictions or specific procedural requirements for arbitrations with states or state-entities risk deterring foreign investors and unduly complicating the resolution of ordinary commercial disputes. ■

About the authors

Rachael Kent is a partner in WilmerHale's litigation/controversy department, and a vice chair of the international arbitration practice group. She represents clients in a wide variety of commercial and investment disputes in arbitration proceedings, under numerous substantive and procedural governing laws. Her experience includes ad hoc and institutional arbitrations, seated in both common law and civil law jurisdictions.

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