

Implications of the New Priority Right for Subsoil Investors

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When the President of Kazakhstan signed the amendments to Law on Subsoil and Subsoil Usage (the "Subsoil Law") in December of 2004, the legal framework which regulates subsoil use rights was drastically altered. Prior to the amendments, investors operated under the assumption that should they elect to transfer their subsoil use rights or participating interests in a legal entity holding such rights (the "Subsoil Right"), they were either free to do so or other participants to their subsoil project could use contractual or legislative preemptive rights to acquire the Subsoil Right.

However, now the Republic of Kazakhstan (the "Republic") has a new legislative priority right to acquire Subsoil Right that is being alienated on terms no worse than that offered by other buyers (the "Priority Right"). The amendment to Article 71 of the Subsoil Law states (the "Amendment"):

In order to preserve and strengthen the resource and energy base of the national economy, in both new and previously signed subsoil contracts, the state shall have a priority right over another party to the contract, over participants in a legal entity holding a subsoil use right, or over other persons with respect to the acquisition of a subsoil use right (or a part thereof) and/or a participating interest (shareholding) in a legal entity holding a subsoil use right, that are being alienated, on terms no worse than offered by that of the buyers.

It is no secret that the adoption of the Amendment was expedited by the Republic's desire to assert a priority right with respect to BG's interest in the North Caspian project.

This now raises the question: will every transfer of a Subsoil Right trigger the priority right of the Republic? The Amendment is drafted in relatively imprecise and general language, leading some to conclude that this could justify a broad application of the Priority Right. But our analysis of the Amendment leads us to conclude that it does not provide the Republic with the ability to acquire every Subsoil Right that is being transferred.

In our view, the terms "alienation" (*otchuzhdenie*) and "buyer" are central in determining whether or not a proposed transfer is subject to the Priority Right.

Alienation v. Universal Succession or Reorganization

The Civil Code provides that property rights can be transferred by way of alienation, universal succession or by other means (Articles 115 and 116). Kazakhstan law clearly distinguishes the transfer of an interest by alienation as opposed to by universal succession. Because the Amendment expressly applies to "alienation," the Priority Right should not apply to a transfer by another legally recognized method, i.e. universal succession. Such a conclusion is also supported by Article 14 of the Subsoil Law which explicitly states that the consent of the competent body is not required for the transfer of a "subsoil use right...in the event of universal succession."

Under Kazakhstan law, universal succession occurs, *vis-à-vis* legal entities, in the event of a reorganization. The term "reorganization" is defined broadly to include "merger, accession, division, separation, and transformation" (Article 45 of the Civil Code). Transactions which come within any of these categories are not "acquisitions" as envisioned by the Amendment, and fall outside of the scope of the Priority Right.

Sale v. Non-Sale Transfers

Any sale of Subsoil Rights (being understood broadly to include any transfer for specific consideration) would be subject to the Priority Right. However, a non-sale transfer of Subsoil Right should not trigger the Priority Right. The Priority Right refers to the "acquisition" of subsoil use rights and participatory interests "being alienated." In Russian the word used for "acquisition" is *priobretenie*, and for "alienation" is *otchuzhdenie*, both of which would encompass transfers of property rights from one person to another – whether for consideration or without consideration – and as such would cover a broad range of transfers. However, the Amendment, through its use of the wording "on terms no worse than offered by other buyers," should limit its application to transfers of Subsoil Rights to third party buyers for specific consideration.

Retroactivity

The general principle of non-retroactivity is established by Article 37.1 of the Law on Laws. Specifically, “a normative legal act shall not apply to relations arising prior to the enactment of such act.” Of course, laws can have retroactive effect. An exception to the non-retroactivity principle can be found in both the Law on Laws and the Civil Code. Article 37.2 in the Law on Laws explains the exception:

Where the retroactive force of a normative legal act or of a part of it is provided for in that same act, or in the act on enactment of a normative act ... such cases shall be exceptions from the rule of paragraph 1 [the non-retroactivity principle] of this Article. (Brackets added.)

In order for a new law to have retroactive effect, such law must explicitly state that it will apply retroactively. The Amendment, although not typically worded, fulfills this by stating that the Priority Right applies to “both new and previously signed subsoil contracts.”

Stabilization under Subsoil & Petroleum Legislation

Notwithstanding principles of retroactivity under Kazakhstan law, some legislation and agreements provide for stabilization rights. To override existing subsoil contract rights, the Priority Right must relate to defense, national security, environmental safety or public health. Article 71 of the Subsoil Law states:

Protection of a Subsoil User's rights shall be guaranteed in accordance with existing legislation. Amendments and additions to legislation which adversely affect a Subsoil User's position shall not apply to Contracts concluded prior to the making of such amendments and additions.

The guarantees established in this Article do not extend to amendments to the legislature of the Republic of Kazakhstan in the areas of defense, national security, and environmental safety and public health.

Article 57 of the Petroleum Law contains similar language.

Although the Amendment does not explicitly refer to stabilization exceptions such as national security, it does note that it was drafted, “in order to preserve and strengthen the resource and energy base of the national economy”. This preamble may mark the opening to further justifications for bypassing stabilization guarantees.

But merely invoking defense or national security may not be enough. There are possible arguments against the application of the above second paragraph of Article 71 to a particular transaction. Arguments can also be raised of violation of rights under international investment and other treaties.

Stabilization under Foreign Investment Legislation

The 1994 Foreign Investment Law provided for stabilization against changes in law, its successor, the 2003 Law on Investments is less generous and only guarantees “the stability of the terms and conditions of contracts concluded between investors and state bodies of the Republic of Kazakhstan, except in those cases where contracts are amended by agreement of the parties” (Article 4.3). This merely guarantees contract terms without any reference to changes in law. However, this language can also be interpreted to mean that any change in law that negatively impacts a contract provision is not effective.

The 2003 Law on Investments does provide however that certain changes in law are not protected by stabilization, for example changes to health safety laws. Arguably, if the law establishes that certain changes in law will not be protected by stabilization, then other changes in law might be protected, i.e. the 2003 Law on Investments might indirectly provide protection to investors against harmful changes to other laws.

Conclusion

This is a dynamic area of law. As noted above, the language of the Amendment is ambiguous and there are risks that the Republic will have the authority to apply it broadly. We believe that the Priority Right could reduce the value of existing subsoil projects and will have a negative effect on investment into Kazakhstan. For example, prospective buyers of a Subsoil Right might well be hesitant to make the large investment required to perform due diligence on a prospective project if, in addition to possible pre-emptive rights of other participants, the Republic has the right to step in and purchase the interest after the prospective buyer makes the investment not only to perform the due diligence but to determine the market price for the interest. Some investors may still find protections in the law under principles of non-retroactivity and stabilization – and there are many transactions (non-sale transfers, reorganization, and universal succession) in which the Republic will not have legislative authority to assert its Priority Right. Other investors may find protection under international treaties. □