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CONSTRUCTION

SHIELDING MENA CONSTRUCTION PROJECTS FROM POLITICAL RISK

As the Arab Spring unfolds, construction project owners, managers, and investors have doubtless responded to the immediate physical risks. Now, they should look to their medium and longer-term legal protections. This guide outlines where to look and what to look for.

THE RISKS: EVEN IF MENA PROJECTS EMERGE PHYSICALLY UNSCATHED, NEW REGIMES COULD PRESENT POLITICAL RISKS

Volatility in parts of the Middle East and North Africa (MENA) is especially significant to the construction industry because there are a substantial number of large projects active there. In much of the region, the primary risk remains the impact of actual or potential civil unrest upon the project. In Bahrain, for example, a number of significant public works projects are at risk of disruption, including the Qatar-Bahrain Causeway, the Al Dur IWPP plant and an extension to the Bahrain monorail. In Yemen, the construction of a power and irrigation dam is underway and in Syria the mixed-use Khams Shamat development and the Homs Trade Centre are threatened by escalating of violence. If unrest spreads to Algeria, its US$60 billion worth of public works projects will be exposed to similar risks (though this now seems unlikely).

Of the countries that have already witnessed regime change, Egypt has one residential development (known as Hanging Gardens) and one airport upgrade project (at Cairo Airport) underway. More recently, in Libya, work on a large mixed-use development, Tower 69 in Tripoli, is likely to have been disrupted by the violent overthrow of Colonel Muammar Gaddafi; if the development was not physically damaged in the violence, its construction will almost certainly have been stalled by a probable lack of labour and the ongoing shortages of water and electricity in the capital.

Once a regime has changed, the nature of the risks become more numerous. Investors are protected, to some extent, by International law and the principle of continuity of the state against the most obvious risk that, in the political upheaval following the overthrow of the previous regime, a revolutionary government may seek to avoid the obligations of its predecessor. According to this principle, a change of government, even a revolutionary change of government, does not affect the state's obligations in international law; the state always remains bound, so long as the relevant government was exercising sovereign powers over the territory at the time of the act. This principle covers both treaty and contractual obligations.

Other risks are more subtle. Will the new regime undertake nationalization of sectors of the economy? Will the new government be able to maintain security? Will it seek to alter the economic and fiscal environment into which the investment was originally made? Will it seek to modify existing concessions or contracts?

TOOLS TO MITIGATE THE RISKS

Three sets of protections are available to participants in MENA construction projects; contractual protections, political risk insurance, and protections under international law.

1. The Contract

The primary, obvious protections stem from the contracts that govern a given project. Construction projects in MENA countries frequently adopt either a International Federation of Consulting Engineers (FIDIC) contract or a FIDIC-based contract.

In general, for the political risks now facing MENA construction projects (i.e. rebellion, terrorism, revolution, insurrection, military or usurped power, civil war, riot or commotion by persons other than the Contractor's/sub contractor's personnel/employees), the FIDIC contracts tend to favor the Contractor over the Employer/Owner. These events are classed by FIDIC as both "Employer's Risks" and, potentially, as so-called force majeure events.

Allocating the risk of these events to the Employer has two main consequences; (i) the risk of any delay and/or costs of rectifying any damage to the Works,

Goods, or Contractor's Documents caused by these events falls on the Employer/Owner; and (ii) the Employer/Owner must provide an indemnity against "all claims, damages, losses and expenses" for all risks arising from these events. This Employer need not give an indemnity if the risk of these events is not insurable on reasonably commercial terms.

The FIDIC contracts also class these events as the kind of exceptional events or circumstances which may amount to a Force Majeure. Consequently, if any event or circumstance qualifies as a force majeure event; prevents the Contractor from performing, and is correctly notified, the Contractor may: (i) be excused from performance of the obligations affected, and (ii) be entitled to time and costs for delay to completion. Indeed, if the event continues for long enough the Contractor may have the right, upon notice, to terminate the contract.

However, there will be instances where a Contractor may decide to look outside the Contract, to the risk-mitigating tools discussed below. This might happen when for example: (i) the Contractor has failed to comply with the notification provisions in the Contract and therefore cannot seek contractual relief; or (ii) the situation falls outside of the relevant contractual provisions. Two possible examples of situations falling outside the contract illustrate when other risk-mitigation tools are necessary. First, an event may not be force majeure because the Employer/Owner substantially contributed to the event. Second, the loss or damage occurs because of events taking place outside of the country where the contract is performed.

Most basically, however, if the government is not a party to the contract, and it is governmental acts (or omissions) that impair the project, the contract does no good. This is one way the other protections come into play.

2. Insurance

Beyond the usual comprehensive insurance policies, there is also insurance for political risk. There is public-sector insurance: from national-government agencies such as the UK's Export Credits Guarantee Department or the U.S.' Overseas Private Insurance Corporation. In addition, the World Bank-affiliated Multilateral Insurance Guarantee Agency underwrites certain categories of political risk for qualifying entities. There is also private-market political risk insurance, covering many of the perils discussed above.

The details of risk transfer through insurance go beyond this short overview. Those who have political risk insurance will be now considering the notice and other provisions of their policies. For those who are without cover, the lesson is for the future: regardless whether cover is bought, analyzing and pricing political risk cover focuses the mind of the foreign investor.

3. Investment Treaty Protection

The third set of protections comes from a network of over 2,600 investment-protection treaties, called bilateral investment treaties (BITs). An example makes this clear: if a UK company has invested in a project in Egypt, and there is an Egypt-UK BIT (there is), the BIT provides concrete protections for UK investors in Egypt (and vice versa). These protections are largely independent of contractual remedies and of the national law of the host state. Moreover, BITs give an investor access to international arbitration, a neutral forum outside the host country, bypassing the risks associated with litigation in local courts. Finally, BIT awards are enforceable directly against the host state itself under treaties that make it very hard to challenge the arbitrators' decision. Many nation's free-trade agreements also embed BIT-like protections.

The MENA region has been the source of many claims in construction projects. In connection with the risks to construction projects arising from political upheaval or civil

unrest, two typical BIT clauses are immediately relevant (outlined below).

- **War clauses**

  First are so-called war clauses, in many BITs with MENA nations. The Egypt-UK treaty is substantially similar to the Sri Lanka-UK BIT, which was considered at length in an important arbitral award:

  - *Nationals or companies of [Sri Lanka or the UK] whose investments in the territory of the other [country] suffer losses owing to war or other conflict, a state of national emergency, revolt, insurrection or riot in the territory of the latter [country] shall be accorded by the latter... treatment, as regards restitution, indemnification, compensation, or other settlement, no less favorable than that which the latter [country] accords its own companies or nationals or to companies or nationals of any third State.*

  - *Without prejudice to paragraph (1) of this article, nationals and companies of [Sri Lanka or the UK] who in any of the situations referred to in that paragraph suffer losses in the territory of the other [country] resulting from (a) requisitioning of their property by its forces or authorities, or (b) destruction of their property by its forces or authorities which was not caused in combat action or was not required by the necessity of the situation, shall be accorded restitution or adequate compensation... [which shall be] freely transferable.*

  Clauses like this create a two-tiered compensation scheme. Paragraph 2 of the BIT above would give greater compensation if the armed forces of the host state act particularly badly. A tribunal holds the host state to the highest level of protection accorded to other property owners (whether nationals of the host state or third-country investors) in respect of the claimant investor. This second-tier protection, in Paragraph 1, does not require state actors to act badly; it is engaged merely when the investor has suffered losses in the context of war, riot, etc.

  In AMT v Zaire, the war clause was found to provide a remedy to the investor when Zaire's armed forces looted its facilities. Although finding other reasons to require Zaire to pay damages, the war clause would have provided yet another reason to do so. Similarly, the war clause in the Sri Lanka-UK BIT helped an investor in the AAPL v Sri Lanka case. There, AAPL's shrimp farm was destroyed in a battle between the Sri Lankan security forces and Tamil Tigers. The arbitrators had to decide whether Sri Lanka had to pay damages to AAPL for destroying the shrimp farm. The arbitrators held that Sri Lanka had to pay substantial damages, though the analysis turned on the interrelation of the war clause and the so called full protection and security (FPS) clause (see below).

- **Full protection and security**

  Closely related to the war clause in the two cases mentioned above was the FPS clause. This appears more commonly in BITs than war clauses. FPS clauses, and similarly worded protections, were originally aimed at the physical protection of investors' installations. However, in addition to physical security (e.g., protection from local law enforcement officers' taking over a factory) this protection has also been held to cover intangible rights as well, requiring the host state to protect investments from harmful laws or acts perpetuated by its entities.

  In the AAPL v Sri Lanka case, the Tribunal found that it was immaterial whether Sri Lanka's liability was founded on the FPS clause (identical to the Tunisia-U.S. language) or the war clause. The host state's obligation and the amount of damages would be the same either way. In any event, under the FPS clause the host state was required to exercise due diligence; but that duty was not absolute. A further gloss was added in the LESI v Algeria case, in which it was held that the level of diligence required in relation to protected investments was simply that which was accorded to the protection of the property of host state nationals.

  In short, investors in the region may have concrete BIT remedies for property destruction in the course of the unrest this year, but must plan carefully to ensure that the investment is structured so as to attract BIT protection. In the medium term, other BIT protections guard against potential vagaries of regime change.

  If the new order wishes to renegotiate existing contracts in a manner which is at least formally lawful, change tax regimes, or engage in nationalization campaigns, the applicable BIT may still offer some protection against these less dramatic, but equally destructive, changes. The BIT protections of importance to energy projects include protection from the following:

  - Expropriation or measures tantamount to expropriation. BITs protect investors against non-compensated, discriminatory expropriations without due process. The expropriation prohibition extends not only to direct takings of property but also to any series of measures that deprive an investor of a substantial part or all of the value of its investment, called indirect or "creeping" expropriation. Although formulations differ, the nub of expropriation is the effect the measures have on the investor's investment. Expropriation occurs if the measures

deprive "in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property."

- Fair and equitable treatment. This is a broad protection whose contours are still being clarified in individual arbitrations. The wording providing this protection in individual BITs is generally straightforward (see the Tunisia-U.S. BIT quoted ealier). The decisive issue in determining whether an investment has received fair and equitable treatment is generally the impact of the host state's acts on an investor's legitimate expectations. Fair and equitable treatment "requires the Contracting Parties [i.e., the state parties] to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment." A state violates this protection when its acts "eviscerate[e]… the arrangements in reliance upon with [sic], which the foreign investor was induced to invest." As an empirical observation, claims for denial of fair and equitable treatment often succeed as an alternative to expropriation claims that have failed.

- Full protection and security. See above.

- Non-discrimination. Protects investors against state measures which have the effect of adversely affecting the relevant investor in particular. The UK-Jordan BIT provides a common formulation of such a clause: "Neither Contracting Party shall in any way impair by unreasonable or discriminatory measures against the management, maintenance, use, enjoyment or disposal of investments in its territory of nationals or companies of the other Contracting Party." This provision might provide a remedy where, for example, the investor can prove that the government had created a market environment where an enterprise owned by a foreign national could not compete with local enterprises in the same field.

- National treatment and most-favoured-nation treatment. Such provisions are self-explanatory and require the host state to treat investments made by nationals of the BIT counterparty according to a standard which is accorded to its own nationals or to nationals of third states (not necessarily with which the host has a BIT or similar arrangement). A typical formulation is found in the Jordan-U.S. BIT: "With respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of covered investments, each Contracting Party shall accord treatment no less favourable than it accords, in like situations, to investments in its territory of its own nationals or companies or to investments in its territory of nationals or companies of a third country."

- Observance of other obligations (the "umbrella clause"). The effect of clauses, often drafted in terms similar to those in the UK-Egypt BIT: "Each Contracting Party shall observe any obligation it may have entered with regard to investments of nationals or companies of the other Contracting Party" and are intended to bind states to obligations which they undertake in addition to their treaty-based obligations. It is, however, doubtful whether they can elevate every obligation in contracts entered into by organs of state into treaty obligations (see below).

BIT Protections come to those who plan (or who are lucky).

These powerful treaty protections accrue only to investors who fulfill the BIT's requirements. In general, an investor must have (i) the nationality of a country that is a party to the BIT and (ii) a qualifying investment in the host country's territory.

For companies, this frequently entails holding an investment through one or more entities incorporated in countries that are party to BITs with the host state. For construction projects, in general, one planning tool seems well-advised: creating an ownership chain with an in-country contracting or license-holding subsidiary that, in turn, is owned or controlled by one or more intermediate companies (with BITs with the host country), which in turn can be owned or controlled by the ultimate parent in a structure appropriate for the parent's corporate and tax goals.

So, as an example: to enjoy the benefit of the Egypt-UK BIT, at least one company or individual in the ownership chain must be within the jurisdiction of the UK. This usually means, at the minimum, that a company is incorporated or organized under the laws of a jurisdiction in the UK. Under the Egypt-UK BIT, if the majority of shares of a local Egyptian company are owned by the British company, the local Egyptian company is treated as English. Now, if the investor were interested in creating an additional layer of BIT protection, it could create a structure to "stack" treaty protection with respect to Egypt. If there is an appropriate Egypt-Netherlands BIT, a Dutch holding company could own the British company, and so on. There are limits to this practice, addressed elsewhere, but the main point remains that because shares in down-chain companies can qualify as investments (in certain conditions the down-chain company may also qualify as an "investor"), multiple levels of protection under multiple BITs are possible. However, there are some specific pitfalls that arise more often in construction cases than in other BIT cases.

- **The Consortium Caveat**

Many, though not all, BITs require an investor to be a "juridical person." In instances in which the project is performed by a

consortium, this has caused problems. The most common reason for which a tribunal has declined jurisdiction over a construction claim has been when a contractual consortium (formed to carry out the project but not party to the relevant contract) has erroneously brought proceedings in the name of the consortium, rather than each contracting entity bringing a claim in its own right. Contractors should be aware of this basic formal trap and, to the extent they do plan to perform the contract in a consortium, be aware that such consortium may not be the party to the relevant contract, a consideration which is equally important in formal communications during performance (such as force majeure notices, etc.) as in bringing proceedings. Of course, forming a local legal entity, shares of which are held by the consortium members, for example, may well be one solution. Awareness of the consortium caveat will lead to a suitable solution.

- **The Commercial Caveat**

BIT claims are brought by qualifying investors, whose investments have been impaired. Because investments are protected, that implies a category of non protected activities. "Mere commercial contracts" or activities are not protected. In a case against Egypt, for example, there were various guarantees given by an English company in connection with an agreement for the procurement and installation of mining equipment. Certain performance guarantees issued in connection with the contract were withheld in Egypt, by a state-owned company, whilst performance testing of the equipment (necessary for reducing the balance on the bank guarantees) was hindered. There were two salient findings. First, the arbitrators characterized the dispute as essentially the "entitlement of [the investor] to have the bank guarantees released." This entitlement was not an "investment," causing the arbitrators to decline jurisdiction. Second, the terms of the contract pursuant to which the guarantees were issued were "entirely normal commercial terms," and thus were not a qualifying investment either.

The result in that case suggests that contractors may be able to structure sale of complex systems of equipment and services, not as "sales" backed by guarantees that are drawn down as milestones are passed, but rather perhaps as "loans" that are paid off over a time frame mirroring those milestones. The formalistic reasoning of the tribunal in the Egyptian case may give investors some ways to structure a transaction that is more investment-like.

- **The Contract Caveat**

A final set of hurdles, which could be described as the "contract trap," stems from the fact that many construction projects involve a direct contract between the investor and a ministry of the host state government or some other emanation of the host state. The transnational contract structure is different from the situation that obtains in many investment cases where the investment is concretized in a local, host-state-incorporated company. By contrast, in many construction cases, where the contract is directly with the state, the "investment," for practical purposes at least, is the contract itself and the investor's activities thereunder. Contrast this with other typical investment structures where there is a more clearly defined asset (e.g., a permit, licence or concession, or shares in a local company) and that asset is held by a local company and an upstream chain of companies. In these latter cases, the conceptual distinction between an "investment case" and a "breach of contract" is clearer than in the construction context when the two are closely interrelated. In many cases, the same acts may give rise to both a breach of the contract and a breach of an applicable BIT, though tribunals are anxious to avoid finding that the "mere" breach of contract is, itself, a treaty breach.

Arbitral tribunals have wrestled with how best to articulate this distinction, with varying results. Some have made access to investment arbitration difficult in cases in which they perceive the state acts complained of as "mere breaches of contract," not BIT violations. For example, the tribunal in the Salini v Morocco case declined jurisdiction because they discerned no breach of the applicable BIT. In effect, the arbitrators held the claimant should avail itself of the dispute resolution provision in the contract, which would provide an adequate remedy for the state counterparty's breaches of contract. Similar reasoning led a tribunal to make an award in favour of the host state in the Consortium RFCC v Morocco case. In both cases, the tribunal reasoned that it would be improper for a tribunal to permit claims alleging "simple breaches of contract" to be "elevated" to BIT claims, thus bypassing contractually agreed dispute resolution provisions. Another tribunal thought it was necessary to divide cases where the "essential basis" of the claim was a contract or a BIT. This has led to a lack of clarity. Contractors should, therefore, seek to determine whether the essence of the claim involves violations of the treaty, and to understand how those claims differ factually from contractual disputes. In this regard, investors should be especially aware that relying on an "umbrella clause" is unlikely to allow a claimant to elevate a breach of contract to a treaty breach.

Finally, however, there may be one footnote to the contract caveat. If a commercial arbitration award on a state contract is brought, and the investor fails, but the state courts interfere with the enforcement of the commercial arbitration award, there may be a claim under a BIT for a denial of justice. The latter situation arose in the ATA Construction case. The investor had obtained an award in its favour in commercial arbitral proceedings initiated by the Jordanian counterparty pursuant to the relevant contract. The investor prevailed in

the commercial arbitration but the award was subsequently overturned by the Jordanian courts, and the arbitration agreement was voided. Although timing problems limited the investor's BIT remedies, the tribunal acknowledged that the investor could, in principle, have succeeded on its claims that the Jordanian courts' interference with the enforcement of the arbitral award breached Jordan's BIT obligation to treat the investor fairly and equitably in relation to the investment.

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