Covid-19 and the Regulation of Foreign Investment Law: A Necessary Paradigm Shift

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Introduction

The impact of the new killer disease, Covid-19, has been felt globally. It has swept through the world economies ravaging even economic powerhouses such as the U.S.A and China leading to losses worth billions of dollars. The world is in silent prayer and as the dust settles from this killer epidemic its impact will be felt in the legal sphere. This paper discusses the legal effects that Covid-19 has had on the relationship between foreign investors and host states, with one eye on the horizon and what the future will be like after the pandemic is over. The paper will approach the discussion based on perspectives offered by decided cases handed down by international tribunals and established legal principles. These will be applied to the emerging investor related legal issues brought about by the novel Covid-19.

This paper is split into five parts as follows: the first part will examine contractual obligations between a foreign investor and the host state broadly; the second part will examine the possible repercussions COVID related adjustments to national and international legislation will have on investors; the third part of this article deals with taxation policies adopted by governments and their effects on the investor-host state relationship with a focus on measures adopted by Kenya; the fourth part of this article discusses the future and long term legal repercussions Covid-19 will have on foreign investment; the last part of this article posits recommendations on how to restructure the legal relationship between investor and host state in light of the observations made in the preceding sections.

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1.0 The Contractual Dilemma

The novel COVID 19 pandemic has put the defence of force majeure to sharp focus in international investment law. The Force Majeure principle and the common law doctrine of frustration are often invoked as solutions to the ongoing dilemma on how to go on with performance and/or how to discharge the parties to a contract from the contractual obligations.

2.1 Force Majeure

Force majeure is a clause commonly found in commercial and contractual agreements, which states that one or both parties will not be liable for damages occasioned by any delay in performance or non-performance of its obligations, upon the occurrence of certain extraordinary events.[1]

The court in the Kenyan case of *Pankaj Transport PVT Limited v SDV Transami Kenya Limited,*[2] quoting from Goirand's French Commercial Code, 2nd ed., p. 854, he says the term "force majeure" is used with reference to "all circumstances independent of the will of man, which is not in his power to control, and such force majeure is sufficient to justify the non-execution of a contract." It was also seen in the case of *Wuhan Airlines v Air Alaska*, where the same position was reiterated.

Importantly though, in the case above, the court in its ratio stated that, (a sharp distinction from the doctrine of frustration to be discussed herein below), the courts will however give effect to the force majeure doctrine only if parties have expressed it in their contract.

The words *"force majeure"* are also not exact in a fixed universal meaning, rather they are as contemplated by the parties in the wording of that particular clause expressed in the contract. The same goes to the consequences/effects of its occurrence. Therefore, a contract may be avoided, voided, delayed or given any other resultant effect, as contemplated by the clause (another distinction from doctrine of frustration).[3]

[1] *Tennents v Earl of Glasgow* (1864) 2 Macph HL 22.
[2] [2017] eKLR

[3] Ibid

Importantly, the circumstances of 'impossibility' in which a force majeure clause may be invoked, are mainly similar to the circumstances in which the doctrine of frustration maybe invoked, and will be discussed briefly.

2.2 Discharge by Impossibility or Doctrine of Frustration

The doctrine is an exception to the position at medieval common law, which was based on the principle of absolute contractual obligations. Under this principle, parties to a contract must perform their obligations failing which damages are payable by the party in the default as was opined in *Paradine v. Jane*[4] where the plaintiff leased a piece of land to the defendant, but the later could not cross the land or put it into any economic use. When sued for the lease charges he was held liable since the contract had not provided that he would be discharged if it became impossible to use the land.

A contract is said to be frustrated if performance of the obligation is rendered impossible, illegal or commercially useless by unforeseen or extraneous circumstances for which neither party is to blame. When a contract is frustrated, it terminates and the parties are discharged.[5] The Doctrine of Frustration may be justified on various grounds: - The Implied Term Theory, Just and Reasonable Solution Theory, and the Change of Obligation Theory.[6]

2.2.1 Circumstances in which a Contract may be Frustrated

The first circumstance is destruction of subject matter. The destruction need not be total but must affect the commercial characteristics of the subject matter. This was discussed in the Case of *Taylor v Caldwell*[7].

The second occasion is the non-occurrence of an event. If a contract is based on a particular event or state of affairs to obtain at a particular time, its non-occurrence frustrates the contract and discharges the parties. Similarly, for the contract to be frustrated, it must be evident that the event or state of affairs was the only foundation of the contract. However, if a contract has more than one

[4] [1647] EWHC KB J5
[5] Elliot & Quinn, Contracts Law (2011).
[6] Robert Hillman, Principles of Contract Law (2004).
[7] (1863) 3 B & S 826

foundation the mere disappearance of one does not frustrate it, given the other is capable of performance. As was the case in *Herne Bay Steamboat Co. v. Hutton*.[8]

The third instance is illegality. If performance of contractual obligations becomes illegal by reason of change of law or otherwise the parties are discharged as there is no obligation to perform that which has become illegal.[9]

The fourth occasion is death or permanent incapacitation. In contracts of personal service or performance e.g. employment, the death or permanent incapacitation of a party frustrates the contract and discharges the parties as the obligations are not generally transferable.[10]

The fifth instance is government intervention. If a policy act or regulation make it impossible for a party to complete its contractual undertaking the contract is frustrated and the parties discharged e.g. refusal to grant a license as was the case in *Karachi Gas Company v. Isaaq*. The position was reiterated in the Kenyan case of *Hakken Consulting Ltd v Seven Seas Technologies Ltd*[11].

Similarly, a contract would be frustrated if a government takes possession of the subject matter or stops the transaction, as was the case in *Metropolitan Water Board V. Dick Kerr and Co*. where It was held that the minister's act of ordering the respondent to stop the contract and dispose of its equipment, frustrated the contract and thereby discharged the respondent.[12]

The last instance is supervening events. These are events that delay performance and thereby change the commercial characteristics of the contract. The change must be fundamental. As a general rule, additional expenses do not frustrate a contract; however, they may if they render the transaction commercially useless.[13]

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[8] (1903) 2 KB 683
[9] See e.g. Williams G. L The Cambridge Law Journal Vol. 8, No.1 (194 , pp. 51-69
[10] For example, the US Federal Legislation 48 CFR s. 37.104
[11] [2017] eKLR
[12] [1918] A.C. 119
[13] *Tsakiroglou & Co Ltd v Noblee Thorl GmbH* [1962] AC 93.

2.2.2 Effects/Consequences of Frustration

Frustrated contracts are governed by the English Law Reform (Frustrated Contracts) Act (1943) which applies in Kenya as a statute of general application and listed in the 1st schedule to the Law of Contract Act (1961).[14] Under this Act, when a contract is frustrated: it is terminated, money paid is recoverable, money payable ceases to be payable, if a party has suffered loss by reason of performance, the court may order the other to pay to such party a sum of money and if a party has derived benefit other than financial, the court may order such party to pay to the order a sum of money which must be less than the benefit it so derived.

3.0 Comparative law: The Defense Production Act of the USA

This US federal legislation is useful in offering a discussion context. Under section 101 of the Defense (sic) Production Action Act (hereinafter "DPA") the President is authorised to *inter alia* require the performance under contracts or orders which s/he deems necessary to promote national defence.[15] Further the section provides that these contracts shall take priority over performance under any other contract or order by the person the President finds to be capable of their performance. The person who is directed to perform an order has been defined under section 702 to include an individual, corporation, partnership, association, or any other group of persons or legal successors or representative thereof of any State or local government or agency thereof.

The effect of section 101 as read together with section 702 is to bring foreign investors under the ambit of the DPA and consequently leaving them at the mercy of the President who may at his whims direct these investors to perform certain contracts that promote national defence. These contracts usurp the right of foreign investors and other persons obligated to perform them, in their rights under pre-existing contractual arrangements and the right to decline to do business. It is the crux of this section to determine whether this would amount to indirect expropriation.

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[14] Cap 23, Section 2.
[15] https://www.fema.gov/media-library-data/1515074994368-bdc5ff1d7b24e5e60888661aaca15bf1/Defense_Production_Act_(current_thru_2017).pdf. Accessed on 12th June 2020.

International investment agreements (hereinafter "IIA") traditionally guarantee the protection of foreign investors from uncompensated expropriation.[16] There are two forms of expropriation, direct and indirect expropriation. Direct expropriation encompasses the transfer of title or seizure of property.[17] Indirect expropriation on the other hand include the destruction of the economic value of the investment or depriving the owner of its ability to manage use or control the property.[18] There is also non-discriminatory regulatory measures which are acts taken by states in the exercise of their right to regulate in public interest which leads to effects similar to indirect expropriation but does not give rise to the obligation to compensate persons affected by the action.[19]

In the *Starrett Housing*[20] case indirect expropriation was defined as measures taken by the state that interfere with the property rights of the investor to an extent that they are rendered useless. In *Suez v Argentina*[21] the tribunal broadened the definition of indirect expropriation to include an act where "*host States invoke their legislative and regulatory powers to enact measures that reduce the benefits investors derive from their investments but without actually changing or cancelling investors' legal title to their assets or diminishing their control over them*." This holding is broad enough to include measures that reduce the investor's profits, however this has further been qualified by the need for the measure adopted by the government to have a long term effect on the investor.[22]

There are however as earlier discussed certain state measures that are normal and thus non-compensable acts of state. In *Saluka Investments v Czech*

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[16]UNCTAD, *Expropriation: A Sequel* (2012) <http://unctad.org/en/Docs/unctaddiaeia2011d7_en.pdf> accessed 9 April 2020 xi.
[17] Ibid.
[18] Ibid.
[19] Ibid.
[20] *Starrett Housing Corporation et al. v. The Government of the Islamic Republic of Iran,* Interlocutory Award No. ITL 32-24-1 of 19 December 1983.
[21] *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAgua Servicios Integrales del Agua S.A. v The Argentine Republic,* ICSID Case No. ARB/03/17, decision on Liability of 30 July 2010
[22] UNCTAD (n 12).

Republic[23] the tribunal in reference to the above principle stated that "*it is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare*." Discrimination has been defined under Black's law dictionary to mean deny someone the equal protection of the law and to treat people differently.[24] Under section 101 of the DPA persons may be obligated to perform contracts and this does not discriminate against foreign investors.

Further under section 101(b) the President may only invoke the power to require performance under the following conditions: such material is of a scarce nature essential to national defence; and the requirements for national defence cannot be met without creating a significant dislocation of the normal distribution of such resources. Section 101 in its entirety is therefore aimed at enhancing the general welfare of American citizens. The requirement of adequate compensation is also fulfilled by the Government as it compensates businesses under the contracts at reasonable rates.[25] This is in line with the doctrine of fair and adequate compensation for the products. Though the foreign investor may have negotiated a contract with better terms with his buyers he will nonetheless have to supply to the Government at the market value of the goods produced.

On the face of it this presents an infringement on the rights of the foreign investor, though the requirement for a long lasting effect on the foreign investor must also be established. The foreign investor may therefore sue for the difference in profits made in supplying the government with the essential products based on the holding of the tribunal in the *Suez* case where the profits

[23] *Saluka Investments BV (The Netherlands) v The Czech Republic*, UNCITRAL Arbitration, partial Award of 17 March 2006.

[24] Black's Law Dictionary 2nd Ed available at https://thelawdictionary.org/discrimination/ accessed 11 April 2020.

[25] David Dayen, 'Unsanitized: The Gaping Hole in the Defense Production Act' *The American Prospect* (24 March 2020) https://prospect.org/coronavirus/unsanitized-gaping-hole-defense-production-act/ accessed 12 April 2020.

of the investor are reduced over an extended period of time as this amounts to indirect expropriation.

4.0 Taxation Policies

With the corona virus affecting people's ability to work, the government of Kenya through the President, offered taxation incentive proposals to businesses and commodities to enable the reduction of the cost of items. The incentive proposal specifically stated that resident corporate income tax be reduced from 30% to 25%.[26] The Income Tax Act Section 4(a) defines a resident company as one that is incorporated in Kenya and its jurisdiction is based in Kenya. Non-resident companies are taxed at a rate of 37.5% which remains the case despite the pandemic.[27] Most foreign investors would lie under that taxation regime. With the proposal not providing any incentive for foreign investors, this poses the risk of disadvantaging foreign investments.

The concept of national treatment can however be invoked in this case to cushion the blow on foreign investments granted there is a clause in the agreement on National treatment. National treatment means that a foreign investor and its investments will be treated no less than the national standards or the nationals of the host state. What this concept therefore means is that with the Bilateral Investment Treaties, Regional Investment Treaties and Multilateral Investment Treaties between Kenya and a foreign investor that provide a national treatment clause, the foreign investor should get the same treatment as the Kenyan national.

This can therefore be applied in the case of taxation where no incentive is provided for foreign investments, to act as a protective measure for the foreign investments. They can be given the same taxation incentives as local investors to enable them protect their investments. Failure to do so would result in the collapse of said investments. They run the risk of heavy losses by maintaining

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[26] Jackson Okoth, 'Uhuru's Fiscal Plan Needs Parliamentary Approval' (2020) Kenyanwallstreet < https://kenyanwallstreet.com/uhurus-fiscal-plan-needsparliamentary-approval/ > accessed 7th April 2020.

[27] John Mutua, *Citizen's Handbook on taxation in Kenya* (Institute of economic affairs 2011) 21.

high prices on commodities or lowering their prices. This could have serious adverse ramifications on the future of foreign investments even after the pandemic.

5.0 Long Term Repercussions

In the aftermath of a pandemic, trade is effectively disrupted and investments by foreign investors are clouded in uncertainty as countries gear up for the long term economic repercussions. From previous cases of pandemics some common threads do emerge. They generally involve reduced foreign investment opportunities by investors as many investments and production move back to home countries. This arises due to different restrictions involving travel and operation of businesses coming into force in host states. The standard of treatment of foreign investment law regarding full protection and security may be breached through alterations in legal framework in the aftermath of such pandemics.

In the case of *Wena Hotels v Egypt*,[28] the tribunal stated that changes in legal framework constitute a breach of principle of full protection and security. The changes in legal framework could be instituted for a variety of reasons from curbing transmission of virus to allow domestic producers to recoup their losses. The overall effect is that foreign investment may subsequently reduce due to changes in legal frameworks as countries re-evaluate their interests following such events. Additionally, pandemics are known to stagnate the economy with local businesses suffering greatly due to customers' reduced purchasing power. Foreign investment is adversely impacted as governments aim to create favourable conditions for local producers to resuscitate their businesses. Such preference results in cessation of favourable treatment afforded to foreign investors in foreign investment law.

One of the standards of protection afforded to foreign investment is the Most Favoured Nation treatment seen in many BIT and MIT treaties.[29] The clauses in such treaties are aimed to provide foreign investors with the same benefits

[28] *Wena Hotels v Arab Republic of Egypt* ICSID Case No. ARB/98/4
[29] Bloom, Erik, Vincent de Jose, 'Potential Economic Impact of an Avian Flu Pandemic on Asia' [2005]

in investing as local investors to create a 'level playing field'. In the aftermath of the pandemic it is envisionable that such MFN treatment afforded by host state is usually revoked. As governments have increased financial and social burdens they are unable to provide such concessions. However, in other cases pandemics may encourage foreign investment as governments encourage foreign investors to inject capital in local markets.

A possible remedy to revocation of MFN status could involve taking the matter to the ICSID tribunal by the claimant as was the case in *Maffezini v Spain,* the tribunal ruled that by virtue of the MFN clause mentioned in the 1991 Argentina-Spain BIT.[30] The claimant can resort to international arbitration if a BIT is breached no matter the circumstances. Countries are under an obligation to fulfil the terms of their treaties and should be the first stop in event of a disagreement over the terms.

As foreign investors leave, the host state's foreign workers are also expected to leave. This remains a worrying factor in many of the previous pandemics such as the SARS virus which contributed to most of foreign expatriates leaving. Cases of arbitrary and discriminatory treatment become common amongst foreign workers as governments prioritise needs of local workers.[31] This is partly due to the fact that local workers are given preference over foreign workers. Arbitrary and capricious conduct could entail tightening restrictions on foreign workers permit and forbidding temporary residency. This has been extensively discussed in *Siemens v Argentina* which discussed that arbitrary conduct entailed capricious and despotic conduct which in this context can apply to treatment of foreign workers.[32] A possible remedy to this treatment could be reviewing the terms of the treaties and include provisions placing restrictions on foreign workers in consultation with the relevant stakeholders so that foreign investors are not adversely impacted by the host state actions. Therefore, negotiations between foreign investors and the host state need to take place and the outcomes discussed in treaties.

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[30] *Emilio Agustín Maffezini* **v.** *The Kingdom of Spain,* ICSID Case No. ARB/97/7

[31] James Dacosta, The impact of coronavirus https://www.thequint.com/news/world/coronavirus-impact-on-china-foreign-trade> accessed on 10th March 2020

[32] ***Siemens*** *A.G.v. The Argentine Republic*, ICSID Case No. ARB/02/8.

Finally, foreign investment is likely to increase based on a country's growth potential that foreign investors are eager to take full advantage of.

After the COVID 19 pandemic ends there is likely to be a more cautious approach between foreign investors and the host state when deciding to invest. This is due to the fact that pandemics exacerbate the economic woes of a particular country, trade is disrupted and uncertainty exists in the markets. This shall lead to many treaties such as BITs and MITs to be renegotiated to cater for the changing market dynamics. Therefore, future negotiations are likely to be marred with additional concessions made by host states in order to encourage foreign investments to flourish. A vivid example remains the SARS outbreak, which led to global decline in oil production.[33] As the disease was contained, many treaties that existed between Middle Eastern countries and China were renegotiated to enable Chinese foreign investment in the oil sector. Such a scenario remains likely in the aftermath of the COVID 19 crisis as many treaties will require amendments to encourage foreign investors to continue investing.

6.0 Recommendations

With regard to the DPA, an amendment must be made to introduce a provision regulating payment under the contracts. The clause should provide with specificity that the value of the subject matter of the contract will be the value accorded to it under other similar contracts negotiated by the business. This will shield the American government from claims for loss of profits filed by foreign investors at International tribunals.

In the aftermath of the COVID 19 pandemic crisis, there is a need for a re-evaluation of the treaties and other agreements existing between host states and foreign investors. This comes in the wake of the IMF's prediction that the global economy shall shrink by 3%. Undoubtedly, this shall have an adverse effect on the relations between foreign investors and host states as previous conditions and treatments afforded will no longer be applicable. Therefore, all the relevant stakeholders need to be involved in drawing up and amending the

[33] Oona A. Hathaway "Between Power and Principle: An Integrated Theory of International Law" [2

current BITS and MITS that exist. This, shall be in the best interest of maintaining friendly relations between states and avoiding a misunderstanding of any sorts.

The laws on taxation should also be amended to unequivocally include the place of foreign investors in the taxation system. Further the remedies available for foreign investments in such a scenario other than providing the tax incentive would be to extend the incentive for a considerable amount of time after the pandemic. This would enable both local and foreign investments to recover from the effects of a pandemic. A statement by KPMG regarding the directive by the president suggested that in order for the incentive to attain its desired effect, it would need to be carried out for months probably years after the pandemic is over[34].

[34] ibid.

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