

**UNIVERSITY OF PRETORIA  
FACULTY OF LAW  
INTERNATIONAL DEVELOPMENT LAW UNIT**

**MITIGATION OF LEGAL RISKS IN PROJECT FINANCE: LESSONS  
FOR MALAWI**

**By**

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**A Dissertation submitted in partial fulfillment of the requirements of a  
Masters Degree (LLM) in International Trade and Investment Law in Africa  
at the Faculty of Law, University of Pretoria.**

## **Dedication**

To Yowoyani, Tamia, Tawonga and Blessings for being denied quality time with me whilst pursuing this degree. Let this effort “pay”!

## **Acknowledgements**

First and foremost I thank the Almighty God for ever showering his grace and blessings on me and guiding me through the rigours of an intensive LLM programme.

My profound gratitude goes to the International Development Law Unit, Faculty of Law, University of Pretoria for giving me the opportunity to study for this Legum Literatum Magister (LLM) degree. I would also like to thank the Malawi Government for sponsoring my studies for this degree. Special thanks also go to Professor Danny Bradlow for coordinating this programme and his tireless efforts to make it a success. I also extend my sincere thanks to Olufemi Soyaju for tutoring and supervising me when writing this dissertation. Thanks also to Professor Riekie Wandrag for helpful tips during the proposal stage. It will be amiss of me if I do not mention Mrs Emily Laubscher for her motherly support and facilitating many things for me and my classmates. My regards to my classmates and colleagues I have met along the way.

## **DECLARATION**

**I, MIKE CHINOKO, declare that this Mini-Dissertation which is hereby submitted for the award of Legum Magister (LL.M) in International Trade and Investment Law in Africa at International Development Law Unit, Faculty of Law, University of Pretoria, is my original work and it has not been previously submitted for the award of a degree at this or any other tertiary institution.**

Signed

**Mike Chinoko**

**31<sup>st</sup> May, 2012**

## **Preface**

Recent developments in the area of investment in Malawi have been encouraging and have raised hopes of Malawians by projecting tangible economic gains for the country. Malawi is a landlocked country and its economy has been largely dependent on agriculture, with tobacco being the main cash crop. Two particular projects, namely, the Kayelekera Uranium Mine and the Nsanje World Inland Port inspired me to write on this topic. The discovery and further commencement of mining of uranium in Malawi meant an additional source of income for this country's small economy. Also, the construction and possible opening up of the inland port at Nsanje means that landlocked Malawi could have access to the sea through this inland waterway thereby significantly reducing importation costs incurred through road and rail transportation. However, projects of this nature require huge resources to be operational and it was not surprising to see the Malawi government granting concessions to foreign investors to build and operate these facilities more or less on project finance terms. While this was a clever move by government, given its lack of financial capacity to develop such projects itself, there is still a lack of understanding of the various risks that can jeopardize projects of this nature. This is evident in the way the two aforementioned projects have been handled so far.

This study is therefore an effort to expose the various legal risks inherent in a project finance set up and goes further to suggest the ways of mitigating those risks. My approach was to isolate issues that any project developer should consider and take into account throughout the project's life including the planning stages. Only through this way, would we have projects that are developed in a prudent manner and have great prospects of success in Malawi. For the country's economy to grow and for life of Malawians to improve, there is great need to emphasize on infrastructure development. Project finance affords us the means to achieve this. This will lead to further development of other supporting industries and attraction of more foreign investors.

It is therefore my sincere hope that this study will provide an essential legal checklist that will guide project finance developments in Malawi. I take full responsibility for all errors in this work.

**Mike V. Chinoko**

**University of Pretoria,**

**31<sup>st</sup> May, 2012**

## **LIST OF ACRONYMS**

ATCA	Alien Tort Claims Act
BIT	Bilateral Investment Treaty
BOT	Build Operate and Transfer
CDM	Clean Development Mechanism
CSR	Corporate Social Responsibility
EIA	Environmental Impact Assessment
EPFI	Equator Principles Financial Institutions
FPIC	Free Prior and Informed Consent
GDP	Gross Domestic Product
IADB	Inter American Development Bank
ICSID	International Centre for the Settlement of Investment Disputes
IFC	International Finance Corporation
ILO	International Labour Organisation
ISO	International Organisation for Standardisation
LDC	Least Developed Country
MFN	Most Favoured Nation
MGDS	Malawi Growth and Development Strategy
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational Enterprise
NGO	Non Governmental Organisation
PPPA	Public Private Partnership Agreement
SADC	Southern African Development Community
SPV	Special Purpose Vehicle
TNC	Transnational Corporation
UN	United Nations
UNICTRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Commission on Trade and Development
UN Norms	United Nations Norms on Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights

## **LIST OF TREATIES AND INSTRUMENTS**

- Charter of Economic Rights and Duties of States 1974
- Convention Establishing the Multilateral Investment Guarantee Agency (MIGA Convention) 1985
- Convention on Biological Diversity 1992
- Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958
- International Convention for the Settlement of Investment Disputes 1965
- International Covenant on Civil and Political Rights 1966
- International Labour Organization Convention Concerning Indigenous and Tribal Peoples in Independent Countries 1989 (Otherwise known as ILO Convention no.169).
- ISO 14001: 2004 on Environmental Management Systems – Specifications with Guidance for Use
- Rio Declaration (Agenda 21) on Environment and Development 1992
- SADC Protocol on Finance and Investment.
- United Nations Declarations on the Rights of Indigenous People 2007
- Universal Declaration of Human Rights 1948

## **LIST OF CASES CITED**

- Alexkor Ltd v The Richtersveld Community [2003] AU Indig Law Rpr 41; (2003) 8(3) Australian Indigenous Law Reporter 55 (CCT19/03) ZACC 18; 2004 (5) SA 460 (CC); 2003 (12) BCLR 1301
- Biwater Gauff (Tanzania) Ltd v United Republic of Tanzania, ICSID Case no. ARB/05/22
- Centre for Human Rights and Rehabilitation (CHRR) and 5 Others v The Attorney General (AG) and Paladin (Africa) Ltd, Civil Cause No 457 of 2007, High Court of Malawi, Lilongwe Registry (unreported).
- Chorzow Factory Case [1928] PCIJ Series A No.17 @ 29
- Connelly v. RTZ [1998] AC 854
- Dagi v. BHI [1997] 1 VR 428
- John Doe et al v. Unocal 963 F Supp 880 (CD Cal 1997)
- Libyan American Oil Company (LIAMCO) v Government of the Libyan Arab Republic 20 I.L.M (1981)
- Lubbe v. Cape plc [2000] 1 WLR 1545; [2000] 4 All ER 268 (HL)
- Maffezini v Kingdom of Spain ICSID Case No. ARB/97/7, Decision on Jurisdiction, Jan 25, 2000
- Ngcobo v. Thor chemical holdings Ltd TLR 10 November 1995
- Presbyterian Church of Sudan v. Talisman Energy and the Republic of Sudan. 374 F. Supp. 2d 331
- Siemens v Argentina ICSID Case no. ARB/02/08 Decision on Jurisdiction, Feb 3, 2004
- Sithole v. Thor chemical Holdings Ltd TLR 15 February 1999
- Wiwa v. Royal Dutch Petroleum Ltd 226 F 3d 88 (2d Cir. 2000)
- Tecnicas Medioambientales Tecmed S.A. v The United Mexican States. ICSID Arb. Case no. ARB (AF) 00/3. Award of 29 May, 2003
- Texaco v Libya 17 ILM 1 (1978)



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## CHAPTER ONE

### 1.1. Introduction

Africa is host to a number of countries, Malawi included, that are classified by the World Bank and the United Nations Development Program as least developed countries (LDCs). This practically means that the Gross Domestic Product (GDP) of these countries is less than \$800<sup>1</sup> and the majority of people live on less than a dollar per day. These are countries that are lagging behind in terms of the right infrastructure which act as engines and jugular veins for social economic development of any country. Without the right infrastructure, economic development and prosperity of LDCs will remain but a dream and this is the reason most LDCs have placed most emphasis on infrastructure development as a key priority area in their development goals.<sup>2</sup> Yet this is a big challenge to achieve considering the limited resources in most LDCs and their overdependence on foreign aid. As such, project finance can be a proper tool for achieving infrastructure development and at the same time development of viable investment projects that would in the long term generate considerable income to governments and act as catalyst for investment in other supporting industries in a country.

Project finance is a funding structure that relies on future cash flows from a specific development as a primary source of repayment with that development's assets, rights, and interests held as collateral security.<sup>3</sup> Therefore, it is said that the main attraction of project finance is the ability to pass on certain risks to lenders and also the possibility of using project finance to isolate a specific project from an ongoing business of a company and thereby not jeopardize the debt capacity of the organization.<sup>4</sup> This can also be used by governments due to the fact that these governments do not have to put in capital or equity themselves to achieve infrastructure development. Globally, most government, including the very rich, are facing a myriad of economic problems such as funding commitments in armed conflicts, peace keeping missions, financial bailouts, development aid as well as internal commitments in the areas of health,

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<sup>1</sup> <http://hdr.undp.org/en/statistic/indices> Accessed on 28 October, 2011

<sup>2</sup> See for example the Malawi Growth and Development Strategy I & II (MGDS I & II)

<sup>3</sup> R Tinsley, *Practical Introduction to Project Finance*, (2010) 8

<sup>4</sup> Ibid

education and social security. Hence, for countries like Malawi, which mostly depend on foreign aid and have weak resource bases, project finance can be the only viable means for achieving infrastructural development which is a very good tool for achieving social economic development.

Project financing is usually used for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure; and project finance may also take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements.<sup>5</sup> In such transactions, the lender is usually paid solely or almost exclusively out of the money generated by the contracts for the facility's output, such as the electricity sold by a power plant and the borrower is usually an SPV (Special Purpose Vehicle) that is not permitted to perform any function other than developing, owning, and operating the installation. The consequence is that repayment depends primarily on the project's cash flow and on the collateral value of the project's assets.<sup>6</sup>

It is the latter component that would be of interest to countries such as Malawi since they would be able to develop infrastructure and viable business projects in their respective countries using project finance without having to dig deep into their coffers themselves. For example, a road or bridge linking two crucial economic zones in a country or between countries could be constructed by private developers who would in turn be repaid by toll fees that are charged at designated toll gates. Therefore, project finance has a great potential of turning around small economies through infrastructure development.

## **1.2. Problem Statement and Significance of Study to Malawi**

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<sup>5</sup> *Basel Committee on Banking Supervision*, International Convergence of Capital Measurement and Capital Standards ("Basel II"), November 2005. <http://www.bis.org/publ/bcbs118.htm>.

<sup>6</sup> *Ibid*

As a country, Malawi has in the past few years undertaken some infrastructure developments using project finance *vis* the Kayelekera Uranium Mine<sup>7</sup> and the Nsanje World Inland Port<sup>8</sup>. Indeed the Uranium mining project alone was projected to ‘boost the country’s GDP by 10 percent’.<sup>9</sup> Yet, a critical analysis on how these projects have been implemented exposes serious flaws and the lack of use of project finance techniques, including legal risk analysis. Because of this, the Nsanje World Inland Port has hit a standstill<sup>10</sup> and although the Kayelekera Uranium mine is now operational, its viability in terms of responsible social and environmental stewardship and development remains uncertain. Indeed, it was concluded in an independent assessment report that the Kayelekera Uranium mining project “fails to adequately characterize the baseline environmental and radiological conditions of the Kayelekera region and “...it fails to present and justify sound technical approaches to major issues and aspects such as protecting the quantity and quality of water resources, tailings deposition and long-term stewardship, potential radiological releases and associated exposures, etc.”<sup>11</sup> This prompted a coalition of civil society organizations to commence a court action challenging the commissioning of the mine the subject matter of which was the Environmental Impact Assessment (EIA) that was conducted.<sup>12</sup>

There is therefore lack of a clear checklist and rules that should guide project finance in Malawi. These are risks that have been deterring investments because of investor’s unwillingness to

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<sup>7</sup> The Kayelekera Uranium Mine is an investment by Paladin Energy Limited which is an Australian Incorporated Company in a Uranium deposit that was discovered in the northern district of Malawi at a place called Kayelekera. Due to the project’s potential income generation ability, the Government of Malawi welcomed it with warm hands but at the same time did not have the resources to develop the mine itself. Hence, it entered into a contract with Paladin Energy Limited to construct and operate the mine on project finance terms.

<sup>8</sup> The Nsanje World Inland Port is a project funded partially by the Government of Malawi and Motor – Engil Company Limited (a Portuguese incorporated construction consortium company). The aim of the project is to construct an inland port at Nsanje in southern Malawi whereby cargo would be transported through barges using the Shire River which flows out of lake Malawi onto the Zambezi river which in turn connects into the Indian Ocean in Mozambique at Chinde. The idea is to use barges from the Indian Ocean port of Chinde, through the Zambezi river and then the Shire river to the inland port of Nsanje. Since Malawi is a landlocked country, it is projected that this waterway will reduce Malawi’s import transportation costs by 60% and that it would also benefit other neighbouring countries like Mozambique itself, Zambia and the Zimbabwe.

<sup>9</sup> AfDevInfo Report, ‘Paladin (Africa)LtdOrganisationRecord’ <[http://www.afdevinfo.com/htmlreports/org/org\\_61189.html](http://www.afdevinfo.com/htmlreports/org/org_61189.html) Accessed on 3<sup>rd</sup> November, 2011

<sup>10</sup> The trial barge carrying 200 tonnes of fertilizer from the Indian Ocean port of Chinde to Nsanje World Inland Port was detained by the Mozambican government on grounds that Malawi was launching the project without following proper diplomatic channels and without having done an environmental impact assessment.

<sup>11</sup> GM Mudd, “Comments on the proposed Kayelekera Uranium Project Environmental Impact Assessment Report”. (2006) <http://www.users.monash.edu.au/~gmudd/files/comments-kayelekera-EIS-Draft-v3.pdf>. Accessed on 5 October, 2011

<sup>12</sup> *Centre for Human Rights and Rehabilitation (CHRR) and 5 Others v The Attorney General (AG) and Paladin (Africa) Ltd*, Civil Cause No 457 of 2007, High Court of Malawi, Lilongwe Registry (unreported). The matter was however settled out of court.

invest in such a jurisdiction. As such, countries like Malawi continue to lag behind in terms of development because of lack of the necessary infrastructure. This dissertation intends to highlight those risks.

### **1.3. Research Question and Thesis Statement**

Although there are a number of stakeholder specific risks, this dissertation will specifically try to expose the various legal risks associated with project finance especially in LDCs such as Malawi and how they can be mitigated. This dissertation will try to answer the following research question: What are the legal risks in project finance transactions and how can those risks be mitigated? The dissertation will endeavor to answer this by identifying the potential and inherent legal risks in project finance from which countries like Malawi can draw lessons.

Due to the complex nature of projects that qualify for project finance,<sup>13</sup> most projects have extensive cross-border involvement and attract foreign financiers. These foreign investors would only come forward when they have clearly understood all the risks involved, among them being legal risks, and how they can be mitigated. This assessment of legal risks and how they can be mitigated would greatly increase the potential of having viable infrastructural developments in Malawi.

In short, the statement that this dissertation is making is that there are inherent legal risks in project finance that ought to be mitigated throughout the lifecycle of the project in order to achieve successful “project finance” developments.

### **1.4. Overview of Chapters**

Having made introductory remarks, this dissertation will in chapter two discuss the concept of the project finance. This is important for one to understand the peculiar nature of project finance as a funding arrangement and why it is suitable for countries like Malawi. The dissertation will go on to discuss the importance of project finance especially for Malawian having looked at a

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<sup>13</sup> Tinsley, (n 3 above), argues that economies of scale and amortization of the establishment costs make it hardly worthwhile to attempt a project financing below \$10 million.

few facts about its economic situation. This chapter will also give an overview of the key players in project finance.

Chapter three will be about highlighting the various legal risks in a project finance arrangement. In part, this is the crust of this dissertation. It will highlight risks associated with documentation and the various contracts that have to be put together; risks posed by failure to comply with environmental law standards both domestic and international; risks posed by failure to observe human rights standards in infrastructural projects; investor security risks such as political risks and the failure by the host state to observe its obligations; and lastly, risks involved in the dispute settlement process.

Indeed since project finance will generally involve transnational corporations (TNCs), there is now international consensus regarding certain norms and how these TNCs should operate in the host country. The operative term that is used is Corporate Social Responsibility (CSR) of such TNCs in their undertakings and collectively these are called investor obligations. These, among other things, include undertakings to protect and conserve the environment; to respect human rights and to remedy any violations; seeking prior and informed consent of indigenous communities and to guard against complicity on human rights and governance issues.

On the part of the host state, it has to ensure that it accords the TNC at least minimum standards of treatment of foreign investors like fair and equitable treatment, national treatment and Most Favoured Nation (MFN) and also guard against risks of expropriation. These are collectively called host state obligations.

Again, due to the large number of players, complexity and sometimes transnational nature of project finance transactions, there is always high likelihood of disputes arising among the different players. Thus, dispute resolution is certainly a legal risk inherent in project finance, more so in a cross border context. It is said that the importance of various considerations that factor into dispute resolution should be weighed carefully during the initial negotiations between the parties and that preparing for this is basically advance planning for “when things fall apart.”<sup>14</sup> Dispute settlement is therefore a very key legal issue to potential project finance players and

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<sup>14</sup> R Sarkar, *Transnational Business Law: A Development Law Perspective*. (2003) 349



such players are always interested to know how disputes are going to be settled before they make investment commitments especially in uncertain legal environments.

Chapter four will basically be a follow up to chapter three in that it will be discussing the various ways in which the legal risks identified in chapter three can be mitigated. It will thus in a way make recommendations on mitigation of legal risks in project finance drawing lessons from particular examples where necessary so that at the end of it all, there is a clear check list on project finance transactions. Thus, this chapter forms the other crust of this dissertation.

Lastly, in chapter five, this dissertation will make its concluding remarks and commend this dissertation to the Malawi government for consideration when undertaking future project finance developments.

## **1.5. Literature Review and Methodology**

Several scholars have written on the topic of project finance.<sup>15</sup> In their writings, they have acknowledged that there are various legal risks inherent in a project finance set up and they have gone further to suggest ways in which these risks could be mitigated. Whilst these commentators have written generally on project finance, the departing point of this dissertation will be to write specifically on risks that would apply to Malawi or in other words, in a developing country context. Reference has been made to codes of standards that apply in a developing country

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<sup>15</sup> See for example SL Hoffman, *The Law and Business of International Project Finance* (2008); MB Likosky, (ed.) *Privatising Development: Transnational Law, Infrastructure and Human rights*, (2005); MB Likosky, *Law, Infrastructure and Human Rights*, (2006); PT Muchlinski, (2<sup>nd</sup> Ed) *Multinational Enterprises and the Law*. (2007); R Sarkar, *Transnational Business Law: A Development Law Perspective*. (2003); M Sornarajah, (2<sup>nd</sup> edt) (2004) *International Law on Foreign Investment*, (2004); R Tinsley, *Practical Introduction to Project Finance*, (2010); ER Yescombe, *Principles of Project Finance*. (2002); JA Zerk, *Multinational and Corporate Social Responsibility: Limitations and Opportunities in International Law* (2006); SL Hoffman, "A Practical Guide to Transnational Project Finance: Basic Concepts, Risk Identification and Contractual Considerations" (1989) 45 *Bus. Law* 181 n.1; M Kantor, "International Project Finance and Arbitration with Public Sector Entities: When is arbitration a fiction?" (2001) 24 *Fordham International Law Journal*; P Muchlinski, "Social and Human Rights Implications of TNC activities in the Extractive Industries" (2009) *Journal of Transnational Corporations*, Vol.18, No. 1

context<sup>16</sup> but to the extent that they do not form part of international law, they have only been used as examples.

The methodology employed in developing this dissertation has been desk and library literature research. This included the analysis of both primary and secondary sources. Where applicable, both Malawi legislation as well as international law has been used. Secondary sources include books, journal articles, internet sources, Reports and other publications. The approach was to build on this information and come up with recommendations on how legal risks can be mitigated in a project finance arrangement especially in the case of Malawi.

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<sup>16</sup> For example The Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Corporations

## CHAPTER TWO

### 2.1. Introduction

Premised on the introductory remarks, this chapter now discusses the concept of project finance itself and its nature. It will then look at its importance and usefulness to a country like Malawi and will in the end by highlighting the different players that are involved in a project finance arrangement.

### 2.2. Concept of project finance

The term project finance refers to the non recourse and limited recourse financing structure in which debt, equity, and credit enhancement are combined for the construction and operation, or the refinancing, of a particular facility in a capital intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue producing contracts and other cash flow generated by the facility as collateral for the debt.<sup>17</sup> Thus, the basic characteristic of project finance is that the debt of the project company is separate from the project sponsor's direct obligations.<sup>18</sup>

Hence, project finance is different from asset – based finance, such as leasing, where the asset value or its residual value is of primary importance. As such, project finance is a viable machinery for financing infrastructural needs in the world over especially in emerging markets like Malawi where the demand for infrastructure far outstrips the economic resources of the country.<sup>19</sup> Again, the need for enormous debt and capital, coupled with the risks involved in large project development, often make project financing one of the few available financing alternatives in the energy, transportation, and other infrastructure industries.<sup>20</sup>

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<sup>17</sup>SL Hoffman, *The Law and Business of International Project Finance*. (2008) 4. See also SL Hoffman, "A Practical Guide to Transnational Project Finance: Basic Concepts, Risk Identification and Contractual Considerations", (1989) 45 Bus. Law 181 n.1

<sup>18</sup>Sarkar, (n 14 above) 116

<sup>19</sup>Hoffman, (n 17 above) 7

<sup>20</sup>D Hurstel & MA Carpenter – Pecquet, "Privatization and the Public Interest", (1994) 13 International Financial Law Review 34 (1994)

It has been argued that project finance is a three stepped process. The first step is the provision of funding to construct the project, and under this stage, there is need for drawdown procedures that rigorously test that the money has been spent.<sup>21</sup> The second step is the completion of the project where successful completion is measured by a performance completion test i.e. whether the project has been built on time and at budget and is capable of producing the cash flows that were originally projected during the loan application phase.<sup>22</sup> In the third step, the project's cash flows are used for debt service and recourse is limited to those cash flows and collateral security. It is said that it is with this third aspect that true project financing commences.<sup>23</sup>

Project finance can be non recourse or of limited recourse financing. In non recourse project finance, the project sponsor has no direct, legal obligation to repay the project debt or make interest payments on the debt, even where the project cash flow is inadequate to service the underlying project debt.<sup>24</sup> Therefore, the project borrowers rely on the cash flow generated from the project upon completion, like for instance, toll fees on a highway that was constructed through project finance.

In limited recourse financing, the project sponsors agree to undertake certain risks and generally this is determined by the unique risks presented by a project and whether such risks are palatable to the credit markets. Hoffman (2008) exemplifies this with a situation where lenders perceive that a substantial risk exists during the construction phase of a project and require the project sponsor to infuse additional equity if the risk actually materializes.<sup>25</sup> A project finance agreement may either be an "off – take" contract such as a power purchase agreement under which the product produced by the project will be sold on a long term pricing formula<sup>26</sup> or it might be a concession agreement with the government or another public authority which gives the project company the right to construct the project and earn revenues from it by providing a service either to the public sector or directly to the general public.<sup>27,28</sup> In other cases, the project company may

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<sup>21</sup> R Tinsley, (n 3 above) 20

<sup>22</sup> Ibid

<sup>23</sup> Ibid

<sup>24</sup> Sarkar, (n 14 above) 116

<sup>25</sup> The Law and Business of International Project Finance. Supra

<sup>26</sup> ER Yescombe, *Principles of Project Finance*. (2002) 9

<sup>27</sup> Ibid

<sup>28</sup> The just discussed three types of agreements can take several forms like (i) Build-Own-Operate-Transfer (BOOT) projects; or (ii) Build-Operate-Transfer (BOT) where the public nature of the project makes it inappropriate for it to

have a licence to operate under the terms of a particular law for the industry sector such as a mobile phone network provider.

Although players differ depending on the project type, it is said that potentially, there are 19 participants in project finance.<sup>29</sup> Hence, this multiplicity of stakeholders requires very complex legal and contractual relationships and documentation to cover this. It is this facet of project finance that lawyering, legal due diligence is required, especially in putting up a legal framework that would compel the different parties to work in harmony in achieving the project finance objectives. Other project financed developments also require special compliance with certain standards, especially those concerning the extractive industries and those that would require the relocation of community groups. For such projects to qualify for funding, they need to have a corporate and social responsibility (CSR) policy that is in tandem with modern multilateral rules on investment which most financiers and host countries have adopted. Collectively, these sets of standards form what are known as investor obligations.

On the other hand, the host country of the project financed development also has obligations towards the investors and need to give certain guarantees to the investor. Indeed, without these guarantees, most investors are very unwilling to invest in such a host country since due to the nature of project finance; they would be putting a substantial amount of their equity at risk. All these standards and obligations have the potential of posing legal risks that ought to be avoided or mitigated. A comprehensive discussion on these will follow in chapter three.

### **2.3. Importance of Project finance**

There is no doubt that LDCs require infrastructure development to achieve sustainable social and economic development. Malawi for instance, has a poor road infrastructure, a low energy/electricity generating capacity with constant load shedding programmes, limited access to clean water and an almost nonexistent extractive industry even though the country is endowed

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be owned by a private sector company e.g Bridge; or (iii) Build-Own-Operate (BOO) where ownership remains with the project company throughout its life e.g a cell phone network provider.

<sup>29</sup>Tinsley, (n 3 above) 6. These include the sponsors, the borrowers, financial advisors, arrangers, Export Credit Agencies, Agents, Lessors, Independent experts, Lawyers, Government(s), Construction contractors, Management Firms, Insurers, Swap counterparties, Suppliers, Equipment Vendors, Offtakers, Transportation companies, Rating Agencies.

with mineral resources. Malawi has a strategic document that dictates its Policies called the Malawi Growth and Development Strategy II (MGDS II)<sup>30</sup> whose overall objective is to reduce poverty through sustainable economic growth and infrastructure development.<sup>31</sup> Key priority areas in the MGDS II are Agriculture and Food Security; Transport Infrastructure and Nsanje World Inland Port; Energy, Industrial Development, Mining and Tourism; Education, Science and Technology; Public Health, Sanitation, Malaria and HIV and AIDS Management; Integrated Rural Development; Green Belt Irrigation and Water Development; Child Development, Youth Development and Empowerment; and Climate Change, Natural Resources and Environmental Management.

On transport infrastructure, the Policy acknowledges that-

[t]he state of Malawi's transport infrastructure is characterized by poor road network, poor and limited access to ports, limited air links, inadequate freight and rail capacity. The inadequacy of the transportation infrastructure results in high costs of production, where transportation represents 55 percent of costs, compared to 17 percent in other less developed countries.<sup>32</sup>

The Policy further underscores that energy is a crucial input into any industrial processing and serves as the life-blood for any economy and that Malawi is relatively well endowed with a wide variety of energy resources but a full potential of the energy sub-sector remains far from being realized owing to a number of structural, operational and institutional challenges.<sup>33</sup> It goes further to state that the provision of energy in Malawi is inadequate, unreliable and inaccessible to all who need it largely on account of lack of competition in the sector, non-functioning power plants and inability to generate sufficient amounts of energy and hence the objective of the MGDS is to reduce the number and duration of blackouts, increase access to reliable, affordable electricity in rural areas and other targeted areas, improve coordination and the balance between the needs for energy and those of other high growth sectors such as tourism and mining.<sup>34</sup>

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<sup>30</sup> MGDS II follows the successful implementation of the country's medium term strategy, the Malawi Growth and Development Strategy (MGDS) between 2006 and 2011. The objective of MGDS II is to continue reducing poverty through sustainable economic growth and infrastructure development.

<sup>31</sup> See [www.malawi.gov.mw/publications/MGDS/%20November%202006/%20-%20MEPD.pdf](http://www.malawi.gov.mw/publications/MGDS/%20November%202006/%20-%20MEPD.pdf). Accessed on 2 February, 2012

<sup>32</sup> MGDS I pg xvi

<sup>33</sup> Ibid pg xvii

<sup>34</sup> Ibid

On integrated rural development, the Policy dictates that Government will strive to promote the growth of rural growth centers and that emphasis will be placed on infrastructure development such as roads and communications, energy supply, agro-processing and manufacturing, the objective being the promotion of private sector investment that will create employment and improve incomes of the rural people.<sup>35</sup>

On paper, this Policy looks sound and ambitious for it identifies the infrastructure requirements that Malawi needs and also proposes strategies of achieving them. Yet the realization of such objectives remains farfetched considering the resources of the country. Malawi is one of the least developed countries and in 2011 had a GDP growth of 6% and 37% of the population living below the poverty line.<sup>36</sup> The current total budget for Malawi in the fiscal year 2011/2012 is 307.7 Billion Kwacha<sup>37</sup> with a projected budget of 319.3 Billion Kwacha in the 2012/2013 fiscal year.<sup>38</sup> These figures are very low considering the cost of running a country and the infrastructural needs that it has set itself to achieve. With such limited resources, such infrastructural developments could be achieved through project finance transactions as the developmental projects that it has outlined in its strategy fall within projects that qualify for project finance. It is said that project finance can provide funding for additional investment in infrastructure that the public sector might otherwise not be able to undertake because of economic or financial constraints on the public sector investment budget.<sup>39</sup> Project finance also affords a government the ability to transfer risks like project overruns from the public to the private sector.<sup>40</sup> Payments are also only made when specific performance objectives have been met by the project company and hence transferring to the private sector the risk that these objectives would not be met. It can also facilitate the transfer of technology which is crucial for the industrial development of any country. However, project finance players can only be attracted to invest in Malawi and such other countries if their interests are protected and secured.

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<sup>35</sup> Ibid

<sup>36</sup> Summary of socio economic indicators for Malawi as of October 2011. Found at [www.malawi.gov.mw/publications/socio-economic\\_indicator\\_summary\\_table\\_19\\_oct\\_2011.pdf](http://www.malawi.gov.mw/publications/socio-economic_indicator_summary_table_19_oct_2011.pdf). Accessed on 2 February, 2012

<sup>37</sup> US\$1 = 265 Malawi Kwacha.

<sup>38</sup> 2011/2012 Budget Statement by the Minister of Finance delivered on Friday, 3 June, 2011. Available at [www.malawi.gov.mw/publications/2011-2012/budget\\_statement.pdf](http://www.malawi.gov.mw/publications/2011-2012/budget_statement.pdf). Accessed on 2 February, 2012

<sup>39</sup> Yescombe, (n 26 above) 18

<sup>40</sup> Ibid

Thus, in order for a country to effectively use project finance as a tool for achieving infrastructure development, a great deal of attention needs to be paid to the inherent risks associated with project finance and how they can be managed or mitigated. Risk is defined as the uncertainty of result in regard to cost, loss or damage or chance of injury.<sup>41</sup> The uncertainty part is the important aspect of the definition and project finance abhors it.<sup>42</sup> It is said that an important part of project financing is the risk structuring process where risks are identified, analyzed, quantified, mitigated and allocated so that no individual risk threatens the development, construction or operation of the project in such a way that the project is unable to generate sufficient revenues to repay the project debt, pay operating expenses and provide an attractive equity return to investors.<sup>43</sup> This is done primarily through the contracting out process and the various agreements that are entered into which allocate risks among parties in contract form. The unallocated or residual risk is the sponsor's economic risk for the economic return expected from the project operation. To the extent that return is inadequate in comparison to the expected return on investment, the project should be abandoned.

In the case of Malawi, the handling of the Kayelekera Uranium Mining Project and the Nsanje World Inland Port has already exposed serious legal issues that were not addressed to make these projects operational and sustainable. This has a potential of causing investor apathy and thereby putting the country to the risk of remaining in the doldrums of poverty due to lack of appropriate infrastructure.

#### **2.4. Key Players in Project Finance**

Because project finance requires many disciplines and not just analytical prowess, interpersonal and management skills are required to marshal the participants towards sensible documentation and risk allocation. Each player or participant will come with its own agenda and objectives and it is therefore important to appreciate at least the key players in order to mitigate the risks that come with them. It was stated above that potentially, there are 19 participants in project finance and key among them are, project sponsors; project company; the government; the borrower; commercial lender; financial advisers; export credit agencies or Multilateral agencies;

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<sup>41</sup> Garner, BA (ed) *Black's Law Dictionary* (2004) 1353

<sup>42</sup> Hoffman (n 17 above) 27

<sup>43</sup> Ibid



independent experts; lawyers; construction contractors; insurers and off-takers (depending on the nature of the project).<sup>44</sup>

Sponsors would provide such things as land, technology needed for the project, operations management, construction, financial clout, local connections and sometimes off-take. The sponsor, also known as the developer, benefits economically or otherwise from the overall development, construction and operation of the project. The project company is a special purpose vehicle (SPV) that will own, develop, construct, operate and maintain the project. The precise nature of this entity is dependent upon a myriad of factors such as whether local laws permit a foreign entity to do business in the host country; or whether a foreign entity can own real property in the host country; or whether there are requirements for local investor participation in the entity.<sup>45</sup>

The government is involved through an agency, ministry or a regulatory authority either directly through the grant of a concession, permits, licenses, authorizations or indirectly through the provision of services, consent or state party involvement. Government may also be involved in tax and foreign exchange arrangements, financial or performance guarantees, access rights or as an intermediary with local government authorities.<sup>46</sup> Other projects are carried out under legislation specific to that project and may also involve compliance with international treaty obligations which might require government action or intervention. In all this, government stands to benefit in terms of national development, the shedding of risk to the private sector and gaining political leverage having brought about local development. Borrowers garner support for the sponsors and are a key means of isolating recourse to the sponsors after completion. However, a sponsor may be a borrower but sometimes there can be multiple borrowers. An example would be a project financed mine, where the mine owner, the operator and the major off-take purchaser might form a joint venture to develop the project but each could enter into individual borrowing arrangements. Commercial lenders provide debt financing for projects and are mostly strategically selected from a range of countries to minimize the risk of government jeopardizing the project thereby creating sour relations with countries where the commercial lenders are based. Financial advisers would be a diverse group like banks with experience in project

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<sup>44</sup> See Tinsley, (n 3 above) Workbook One 6

<sup>45</sup> Hoffman, (n 17 above) 73

<sup>46</sup> Ibid 10

financing; country risk specialists who know their way around export credit agencies; financial analysts who make projections on project finance cash flows; and accounting firms with a capability to assess cross border tax and corporate issues. Export Credit Agencies or Multilateral Agencies may provide buyer and supplier credits and can also provide political risk insurance. Independent experts provide independent reviews of feasibility studies during the construction, commissioning and operation of the project. Such reviews may be on areas like the market, engineering, environment, tax, accounting and reserves or sustainability. Lawyers would handle the documentation which requires specialist legal skills and an understanding of the risks that are being allocated among the different participants including the cross border legal infrastructure that is typical in project finance. They also provide specialized assistance to participants in risk identification and risk mitigation techniques. Local lawyers also play a crucial role in advising on local legal and political matters.

Insurers bring in packages of insurances during construction, for business interruption, environmental risks, third party and statutory insurances. Off-takers, if taken on board, sell the output of the project such as electricity where the financed project was a power plant.

From the foregoing, it can be observed that the multiplicity of project players has the potential of bringing another multiplicity of risks including those that are legal in nature. Indeed, the full discussion of legal risks in project finance which will follow in chapter three will expose risks that are basically brought about by a number of players stated above. An understanding or background of such players and their roles was therefore essential for purposes of the topic of this dissertation.

## CHAPTER THREE

### LEGAL RISKS IN PROJECT FINANCE

#### 3.1. Introduction

Risk analysis is a very vital aspect in any project financing arrangement. There are various risks in project finance but this chapter interrogates on the various legal risks in project finance. These risks include the risks associated with documentation and contracts; environmental law risks; human rights risks; risks posed by the host government and investment rules; and lastly, dispute resolution.

#### 3.2. Documentation

Project contracts are important because they form the basis of the development, commissioning and operation of the project. One eminent writer on the topic states thus –

While the attainment of...[project financing] objectives leads to a fight of legal ingenuity which one might think could be put to better purpose, it nevertheless explains the background which applies in certain cases to some of the idiosyncratic contracts [used in a project financing...]<sup>47</sup>

A great deal of care needs to be taken when putting the documentation together. Because non recourse and limited recourse project finance are based on the predictability provided in the contract structure, project sponsors and lenders are all interested in the risk allocation and other contract terms.

Firstly, project finance requires transnational contracting because usually players or participants are from different jurisdictions.<sup>48</sup> Hence it would be erroneous to assume that the rules governing contract formation, enforcement and interpretation are identical throughout the world. There are

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<sup>47</sup> P Wood, *Law and Practice of International Finance*, (2007) 43

<sup>48</sup> For example, on the two Malawi projects stated in the previous chapter, the Kayelekera Uranium Mine involves the Malawi government and an Australian Company called Paladin and the Nsanje World Inland Port involves the Malawi government and a Portuguese Company called Mota – Engil.

at least three distinct legal systems in the world namely: the common law system (which is practiced in most commonwealth jurisdictions); the civil law system (practiced in most francophone jurisdictions) and the Roman Dutch Law System (practiced in selected countries like South Africa and Zimbabwe). These systems have different rules in as far as formalities of contracts are concerned. For example, whereas a contract would become valid where there is just offer and acceptance in the Roman Dutch Law system, the Common law would require that there should be offer, acceptance and consideration.

It is therefore imperative to address issues like the governing law otherwise the parties might not receive the benefits of the deal that they negotiated.<sup>49</sup>

Some countries insist on local law as the governing law for public policy reasons. Lenders, who are most of the times from foreign jurisdictions, might require certain exceptions to this rule because for them, resolving conflicting interests in the local jurisdiction might be a legal risk. As a way of mitigating the risk, preference should be given to a country which affords an effective enforcement mechanism. A more thorough discussion on this, including the right forum, will follow when looking at the aspect of dispute settlement in project finance.

Regarding formalities of a contract, in addition to making sure that a valid contract has been executed with regard to the elements of offer, acceptance and perhaps consideration depending on the type of jurisdiction, such other issues like whether contracts should be witnessed or notarized ought to be addressed. Some legal documents like leases only become valid upon being notarized rather than mere 'commissioning' before a Commissioner for Oaths. Some contracts require government approval and a government seal. Failure to analyze and address these legal intricacies has a potential of rendering a contract void and thereby threatening the project financing arrangement.

There is also the aspect of risk allocation and remedies. Some remedies do not apply to certain governments. In Malawi for example, the Civil Procedure (Suits by or Against the Government or Public Officers) Act<sup>50</sup> provides that no suit can be instituted against the government or public officer unless a notice of intended suit was sent 90 days prior to the filling of the action in

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<sup>49</sup> Hoffman, (n 17 above) 114

<sup>50</sup> Cap 3:02 of the Laws of Malawi.

court.<sup>51</sup> In cases where the 90 day notice was given and a suit against government was eventually filled and successfully pursued, there is a protracted procedure that could eventually lead to executing on government assets. The law provides that in a suit instituted against a public officer, the defendant shall not be liable to arrest nor his property attached otherwise than in execution of a decree.<sup>52</sup> Further, where there is a decree against government, a time shall be specified in the decree within which it shall be satisfied and if the decree is not satisfied within the time so specified, the court shall report the case for orders of the government<sup>53</sup> and execution shall not be issued on any such decree unless it remains unsatisfied for a period of three months computed from the date of the report.<sup>54</sup> Recently, the Civil Procedure (Suits by or against the Government or Public officer) (Amendment) Act<sup>55</sup> was enacted with the objective of restricting the grant of injunctions against the government.<sup>56</sup>

Hence where a contract is being executed between one of the project finance participant and the host government, attention has to be paid to the remedies that are available against the host government in order to avoid a situation where risks are practically not remediable and where specific performance under the contract is difficult to achieve.

Another aspect relating to contracts is the language used in the contracts. It is necessary for parties to agree on the language in which the contract will be written and interpreted. Due to the transnational nature of project finance, there is always a temptation to have contracts in different languages to suit the parties to that contract so that one is a translated version of the other. This has a potential risk of bringing disputes arising from the interpretation of the multi language contract which can derail the project finance arrangement. It is advisable therefore, that parties should strive to use one language in project finance contracts.

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<sup>51</sup> Ibid section 4

<sup>52</sup> Ibid section 6

<sup>53</sup> Ibid section 8

<sup>54</sup> In practice, after judgment, the successful litigant files summons for fixing time within which judgment must be satisfied. On hearing the summons, the court will set time within which the debt must be paid. The certificate is then served on the Attorney General and upon the expiry of the period, a sheriff can be sent to execute against a government.

<sup>55</sup> Act 11 of 2011

<sup>56</sup> Section 10 provides that an application for an injunction against the government or public officer shall be heard by the court only when the application is made *inter parte*.

### **3.2.1. Types of Contracts**

Common types of contracts or agreements in project finance include, among others, organizational agreements such as partnerships, joint venture agreements or shareholder agreements; agreements with host country government such as concessions, public private partnership (PPPA) agreements, sovereign guarantees and implementation agreements; real property agreements such as title documents, leases, easements and construction lay outs; construction contracts; off-take revenue agreements such as production sale agreement and energy sale agreements; financing agreements such as loan agreements, inter-creditor agreements and collateral security agreements; and insurance agreements.

### **3.2.2. Contentious Provisions/clauses**

#### *3.2.2.1. Non recourse provision*

In a non recourse project financing, the arrangement does not impose any obligation upon the project sponsor to guarantee the repayment of the project debt if the project revenues are insufficient to cover the principal and interest payments.<sup>57</sup> Thus the non recourse nature provides protection of the sponsor's and other investor's general assets from most difficulties in any particular project. This is the main attraction of project finance and why it is useful to developing countries like Malawi. The risk is transferred to a private entity without recourse to the sponsor's assets. This is the real project financing and failure to incorporate this provision would render the concept meaningless. Hence, this provision ought to be drafted carefully to bring out this expected result.

#### *3.2.2.2. Provisions regarding lenders*

Project contracts must also be negotiated in a way that will satisfy the requirements of the lending community. The problem is that most lenders are not selected before contract finalization. For example, for the infamous Camisea project in Peru,<sup>58</sup> the consortium which was granted the rights to run the mine in 1999, after the pull out of Royal Dutch Shell and Mobil, subsequently sought funding from Export – Import Bank of America (which was refused) and

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<sup>57</sup> Hoffman, (n 17 above) 116

<sup>58</sup> The Camisea is a project in Peru for the extraction, production of gas fields in the Nahua – Kugapakori Reserve and their distribution to local and international markets. It is now over 30 years old.

later from the Inter – American Development Bank.<sup>59</sup> This approach is typical in most project finance arrangements. Yet at this stage, project contracts would have already been executed by the other different players and hence making it difficult to incorporate the interests of the lenders. A good approach to this dilemma is to include a so called “financial cooperation clause” in the project contracts. This provision allows the parties to execute the project contracts and also agree to cooperate with the reasonable demands of a project lender that it imposes as conditions for funding the project. However, this cooperation clause should be drafted in such a way that it does not bring adverse change to the rights and obligations already agreed between the parties.

### 3.2.2.3. *Term/periods*

It is very important in project finance that main contracts like concessions should end after the recourse has been repaid and hence the contracts that affect the project’s feasibility must extend for the term of the financing. Also acting with prudence would mean that the project finance contracts should ordinarily extend beyond the stated maturity date of the debt for this will compensate for any delays or hiccups faced in the project. Most consortium companies will carry out their work both through Concession contracts and BOT contracts. The advantage of BOT is that companies can be sure to recoup sunk costs and capture an agreed profit while the concession is for a fixed number of years and thus a company may or may not have fully recouped costs and captured a reasonable profit.<sup>60</sup> The former is a risk.

However, even though having the above in mind, care should be taken in dealing with contracts involving the host government. It is said that contracts with host governments, for example, should probably not extend beyond a reasonable period of 25 – 30 years and that terms beyond that may provide an attractive target for successor governments to complain that they should have the right to change the transaction.<sup>61</sup>

### 3.2.2.4. *Construction Completion date*

There is a symbiotic relationship between the construction completion date and the various contracts in project finance. Completion of construction has a chain reaction effect on the rest of

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<sup>59</sup> See MB Likosky, “Beyond Naming and Shaming: Towards a Human Rights Unit for Infrastructure Projects” in MB Likosky (ed.), *Privatising Development: Transnational Law, Infrastructure and Human rights*, (2005) 11

<sup>60</sup> Ibid, 10

<sup>61</sup> Hoffman, ( 17 above) 117

the contracts. For example, for construction contracts, completion will determine whether a contractor is liable for liquidated damages for delay or not. On operating agreements, the completion date will determine when an operator will commence work or assume their responsibilities. Debt documents also rely on completion because interest rates or loan amortization are affected by completion with sometimes interest rates decreasing on that date to reflect the termination of construction risk and the commencement of loan repayment and sometimes equity commitment obligations mature on this date. Again, like we have seen in the case of Camisea project above,<sup>62</sup> some banks would only provide financing upon completion of construction.

#### 3.2.2.5. “Come Hell or High Water Clause”

Where the project finance arrangement involves an off-taker, this provision makes it clear that the off-taker has the absolute obligation to pay, and the project company has the absolute right to receive the required payment irrespective of any defence, counterclaim, set-off, frustration of purpose or other right or excuse available to the off-taker.<sup>63</sup> This means that even if no good or service is producible by the project company, it is nevertheless assured of payment, “come hell or high water”. This is a financial risk arising from a contractual provision especially on the part of the off-taker. As a way of mitigating this, to the extent possible, the company’s obligations should be limited in every project contract, thereby limiting available excuses for non performance by other parties.

#### 3.2.2.6. Force Majeure clause

Force Majeure is a term that describes acts of nature and other unforeseeable acts that have an adverse effect on a contract between parties but happen due to no fault of either party. These type of provisions in project finance need to be considered carefully as inconsistencies may pose a great risk to the project. Force majeure may have a significant effect on the project’s schedule and its economics. It is important therefore that what a force majeure clause says in one contract is consistent with what will happen in the other contracts because the occurrence of a force majeure will almost definitely have a chain effect on the other contracts in a project financing.

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<sup>62</sup> n 58 above

<sup>63</sup> Hoffman, (n 17 above) 118



Hoffman (2008) exemplifies this by saying if a construction contract provides an extension of time for the contractor to complete the facility upon the occurrence of a force majeure, the same relief must be available under an off-take sales agreement because if not, and the off-take sales agreement requires that sales begin on a specified date with no extension permitted for a force majeure, the project would be unable to comply with the sales agreement since the project would not be completed on time.<sup>64</sup> This situation can be mitigating by offering the same reliefs or timelines given upon the occurrence of a force majeure to the players whose contracts would also be affected by the force majeure.

Another issue that parties have to understand during negotiations is that what is uncontrollable or unforeseeable (force majeure) in one location, may not be uncontrollable in another location. For example, where force majeure has been caused by adverse weather conditions in some countries with good and well sophisticated early warning systems, this may not necessarily qualify as force majeure. This may not necessarily be the position for Malawi but it nevertheless gives food for thought for those negotiating contracts in projects finance to look at what is uncontrollable and unforeseeable in the particular location. E.g. would a strike by construction staff or operating company qualify as force majeure regard being paid to the particular legal system of the country concerned?

#### *3.2.2.7. Remedies upon breach*

Because project financing will be based on contracts, the law of contract naturally governs the rights of the parties in cases of breach. Having this in mind, contracts should be carefully negotiated since the remedies that are available in contract law are not necessarily preferred in project finance.

For example, the general rule on damages is that the wrong party should compensate the other for the loss suffered which the wrong party should have reasonably contemplated as a consequence of its breach.<sup>65</sup> It is said that this concept is completely unworkable in the project finance context where a breach under an important project “could result in an avalanche of damages.”<sup>66</sup> This is because in project finance, there is no time to wait for the court to decide on

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<sup>64</sup> Ibid, pg 118

<sup>65</sup> WVH Rogers (18<sup>th</sup> edt) *Winfield and Jolowicz on Tort*, (2002) 1007

<sup>66</sup> Ibid, pg 119

whether damages were foreseeable or too remote a consequence of the defendant's act including the concept of mitigation of damages by the complaining party.

On the actual damages and because of the above scenario, liquidated damages are always preferred in project finance yet the courts abhor this approach because to them, it takes away their discretion to assess the damages and consider what is just under the circumstances.

Malawi follows the common law and its legal system is based on English law. Under English law, even though damages are liquidated in an agreement, they should nonetheless be a reasonable estimate of the non-defaulting party's loss and not necessarily punitive looking.<sup>67</sup> Even French law provides courts with authority to revise damage amounts after a finding that the damages are unreasonable.<sup>68</sup> Parties should understand therefore that liquidated damages put in agreements may not necessarily be enforced by the court.

In relation to the remedy of specific performance, as stated before in the example of the legal procedure for bringing suits against the Malawi government, the remedy of specific performance is not always available even though that could have been the easiest option. The difficulty here being that it is in the discretion of the court and most players in project finance prefer replacing the defaulting party rather than asking for specific performance.

This is why other modes of dispute settlement are preferred in project finance which we shall come to in a later topic in this chapter.

#### *3.2.2.8. Outsourcing of services, recruitment and capacity building*

Due to the nature of project financed developments, most LDCs and developing countries do not have the capacity to undertake such projects on their own. They often lack the personnel, equipment and appropriate technology to construct and operate the particular undertaking. Because of this, project financed projects in countries like Malawi are often constructed by foreign contractors, using imported construction materials and installing foreign made technology. The contribution by the host nation in this respect is mainly through the provision of

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<sup>67</sup> MacGregor *on Damages*, (17<sup>th</sup> ed) 241

<sup>68</sup> French Civil Code, Art 1152.

casual labourers.<sup>69</sup> The dilemma here is that local contractors and local personnel might insist on being taken on board and prioritized in terms of tenders relating to the project and the provision of services. For the host country, it may want to prioritize national companies and candidates within the project's sphere or at least negotiate for partnerships with locals that enable the development of institutions and service providers in areas of influence of the project. This may also facilitate easy transfer of technology. Without this, projects might experience delays due to hostile environments and opposition within its location or host country.

At the same time, due to the non recourse nature and high capital investment in project finance, project sponsors might not want to jeopardize the economic feasibility of the project due to poor workmanship and use of inappropriate technology. They would thus insist on using players that have the requisite experience and expertise to deliver on the project's objectives which might not be available locally.

Hence, the negotiation and drafting of this provision becomes crucial in project financing and failure by the parties to apply their minds properly to this aspect could have disastrous effects on a project.

### **3.3. Environmental law related risks**

As hereinbefore stated, project finance is used for big projects such as dams, power generating plants, highways and railroads, mines, ports, oil facilities e.t.c. These are big projects that require substantial amount of investment in order to become operational<sup>70</sup> and hence the need to do proper assessments way before even construction is started. Project sponsors usually do not have the funds to develop these projects and are always attracted to project finance because of its non recourse nature and its ability to pass on risks to other players in the private sector. Lenders have also become extra careful in their disbursement of funds due to the inherent risks in project finance. This is the reason almost all project finance developments nowadays require compliance with environmental standards for them to qualify for funding.

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<sup>69</sup> This is not even the case for Chinese sponsored projects because the Chinese literally bring their own work force to construct the facility.

<sup>70</sup> For example, the Gautrain Rail System in South Africa was built at a cost of over R22 Billion. See [www.gautrain.co.za](http://www.gautrain.co.za)

### 3.3.1. *International standards*

At the international level, financial institutions have come together to establish a set of binding rules called the Equator Principles. These principles apply to all new project financings globally with total project capital costs of US\$10 million or more, and across all industry sectors and in addition, while the Principles are not intended to be applied retroactively, they are applied to all project financings covering expansion or upgrade of an existing facility where changes in scale or scope may create significant environmental and/or social impacts, or significantly change the nature or degree of an existing impact.<sup>71</sup> It is further stated that the Equator Principles Financial Institutions (EPFIs) have consequently adopted these Principles in order to ensure that the projects they finance are developed in a manner that is socially responsible and reflect sound environmental management practices. By doing so, negative impacts on project-affected ecosystems and communities should be avoided where possible, and if these impacts are unavoidable, they should be reduced, mitigated and/or compensated for appropriately.<sup>72</sup>

Particularly, the Equator Principles state that-

For each project assessed as being either Category A or Category B, the borrower has conducted a Social and Environmental Assessment (“Assessment”) process to address, as appropriate and to the EPFI’s satisfaction, the relevant social and environmental impacts and risks of the proposed project (which may include, if relevant, the illustrative list of issues as found in Exhibit II). The Assessment should also propose mitigation and management measures relevant and appropriate to the nature and scale of the proposed project.<sup>73</sup>

The equator principles further require the borrower to (a) develop an Action Plan which describes and prioritizes the actions needed to implement mitigation measures, corrective actions and monitoring measures necessary to manage the impacts and risks identified in the assessment;<sup>74</sup> (b) to consult with project affected communities and ensure their free, prior and informed consent as a means of establishing whether a project has adequately incorporated affected communities concerns;<sup>75</sup> (c) to establish a grievance mechanism as part of the management system which will allow the borrower to receive and

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<sup>71</sup> Preamble to the Equator principles (2006). Found at [www.equator-principles.com](http://www.equator-principles.com) Accessed on 2 November, 2011

<sup>72</sup> Ibid

<sup>73</sup> Principle 2

<sup>74</sup> Principle 4

<sup>75</sup> Principle 5

facilitate resolution of concerns and grievances about the project's social and environmental performance raised by individuals or groups from among project-affected communities.<sup>76</sup>

The principles also require an independent social or environmental expert not directly associated with the borrower to review the Assessment, Action Plan and consultation process documentation in order to assist EPFI's due diligence, and assess Equator Principles compliance.<sup>77</sup>

The International Finance Corporation (IFC)<sup>78</sup> has also adopted what are known as Performance Standards on Social and Environmental Sustainability.<sup>79</sup> The IFC applies the Performance Standards to manage social and environmental risks and impacts and to enhance development opportunities in its private sector financing in its member countries eligible for financing and the Performance Standards may also be applied by other financial institutions electing to apply them to projects in emerging markets.<sup>80</sup>

Performance Standard 1, which is of more general application, 'establishes the importance of (i) integrated assessment to identify the social and environmental impacts, risks, and opportunities of projects; (ii) effective community engagement through disclosure of project-related information and consultation with local communities on matters that directly affect them; and (iii) the client's management of social and environmental performance throughout the life of the project'. It is said that Performance Standards 2 through 8 establish requirements to avoid, reduce, mitigate or compensate for impacts on people and the environment, and to improve conditions where appropriate.<sup>81</sup> While all relevant social and environmental risks and potential impacts should be considered as part of the assessment, Performance Standards 2 through 8 describe potential social and environmental impacts that require particular attention in emerging markets. Where social or environmental impacts are anticipated, the client is required to manage them through its Social and Environmental Management System consistent with Performance Standard 1.<sup>82</sup>

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<sup>76</sup> Principle 6

<sup>77</sup> Principle 7

<sup>78</sup> The IFC was established in 1956 in order to provide direct financial support to the private sector in member countries. It has 175 member states and provides both debt and equity financing to private sector ventures in developing countries in partnership with foreign investors. See The World Bank Annual Report 2009. For more go to [www.worldbank.org](http://www.worldbank.org)

<sup>79</sup> These standards were adopted on 30 April, 2006

<sup>80</sup> Introduction to the IFC Performance Standards for Social and Environmental sustainability.

<sup>81</sup> Ibid

<sup>82</sup> Ibid

Although these corporate codes or standards are regarded as internal policies and practices by these financial institutions which are adopted and implemented voluntarily, they nevertheless guide responsible environmental stewardship in project finance because no borrower can secure funding from EPFIs or the IFC without complying with these standards.

One common feature in the Equator Principles and the IFC Performance Standards is the need to do a Social and Environmental Impact Assessment.<sup>83</sup> In Malawi, it is a legal requirement under the Environmental Management Act<sup>84</sup> that certain projects should not be implemented unless an environmental impact assessment has been carried out.<sup>85</sup>

Hence, environmental issues have taken centre stage in project finance and failure to take them into account spells doom for a project whether it is in a developed or a developing country. Examples are the two projects of Kayelekera Uranium Mining and the Nsanje Inland Port in Malawi discussed above which have faced serious challenges because of failure to take into account environmental law concerns.<sup>86</sup>

This can also lead to tort based litigation in what are called ‘foreign direct liability claims’ where claims are brought in home state courts that target not the subsidiary, but the parent company as the apparent ‘orchestrator’ of company-wide investment standards and policies.<sup>87</sup> For the two

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<sup>83</sup> IFC Performance standard 1 and Principle 2 of Equator principles.

<sup>84</sup> Act 23 of 1996

<sup>85</sup> Specifically the Environment (Specification of Projects Requiring Environmental Impact Assessment) Notice 58 of 1998. Specified projects are in fields of Agriculture, water resource development projects, infrastructure projects, waste management projects, industrial projects, mining and quarrying projects, forestry projects, land development, housing and human settlement projects, remedial flood and erosion control projects, town development projects, tourism development projects, energy generation, transmission and storage projects, inter alia.

<sup>86</sup> The Kayelekera Mine faced a court challenge based on a failure to do a proper environmental impact assessment and the fact that it did not get approval from the International Atomic Energy Agency (IAEA) See IAEA Executive Summary on Roundtable Meeting on the Upsurge of the Uranium Mining and Production Industry <<http://www-ns.iaea.org/downloads/rw/waste-safety/uranium-mining-gc2008-roundtable.pdf>>accessed 4<sup>th</sup> November, 2011. See also M Kachale, “*The Efficacy of International Regulation of Uranium mining: Malawi as a case study*”. Commonwealth Law Bulletin <http://www.informaworld.com/smpp/title~content=t758874679>  
The Nsanje World Inland Port has hit a standstill because there is currently a diplomatic standoff between the governments of Malawi and Mozambique regarding the opening of the port and commencement of operations because the Malawi government did not undertake an environment impact assessment on the effects of commercially navigating on the Shire and Zambezi rivers.

<sup>87</sup> JA Zerk, *Multinational and Corporate Social Responsibility: Limitations and Opportunities in International Law* (2006) 198

Malawi projects of Kayelekera Mine and Nsanje world Inland Port, tort based claims arising from adverse environmental effects on project affected communities could be brought against the parent companies in Australia and Portugal respectively.

For example in the U.K. the landmark case of *Connelly v. RTZ*<sup>88</sup> concerned a claim for damages against the parent company of the operator of a mine in Namibia alleging negligent exposure to uranium dust causing cancer. The cases of *Ngcobo v. Thor chemical holdings Ltd*<sup>89</sup> and *Sithole v. Thor chemical Holdings Ltd*<sup>90</sup> were two separate group actions filed in the U.K. which involved cases of mercury poisoning among workers, including three deaths, at the defendant's South African plant. The two cases were settled out of court after the English courts refused to stay proceedings on grounds of forum non conveniens. The *Ngcobo* claim was settled in 1997 for 1.3million Pounds and the *Sithole* claim was settled in October 2000 for 270,000 Pounds. The case of *Lubbe v. Cape plc*<sup>91</sup> was about asbestos mining and production activities of a wholly owned subsidiary of Cape plc in the Northern Cape of South Africa. The claim was originally commenced in 1997 on behalf of three mine-workers and two local residents who had contracted asbestos-related injuries and, in one case, mesothelioma, an asbestos-related cancer. Further claims were brought and eventually, the consolidated class action was settled out of court on 21 December, 2001 for approximately 27million Pounds.<sup>92</sup>

The Australian case of *Dagi v. BHI*<sup>93</sup> concerned a claim for damages by landowners for pollution of the Ok Tedi River in Papua New Guinea and adjoining land caused by mining activities of a subsidiary of the Australian mining company BHP. The case was eventually settled out of court for A\$150 million in 1997.

The above cases clearly demonstrate the need for project companies to manage and mitigate environmental issues throughout the project's life because failure to incorporate these standards could have serious effects on the project's economic feasibility and sustainability and may also lead to parent company liability for the CSR failures of foreign subsidiaries. The court cases also

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<sup>88</sup> [1998] AC 854

<sup>89</sup> TLR 10 November 1995

<sup>90</sup> TLR 15 February 1999

<sup>91</sup> [2000] 1 WLR 1545; [2000] 4 All ER 268 (HL)

<sup>92</sup> Zerk, (note 87 above) 199

<sup>93</sup> [1997] 1 VR 428

pose a risk of bringing commercial and reputational risks associated with defending large scale negligence actions which could have adverse effects on projected cash flows from the project financing arrangement.

### 3.3.2. *Consent of Indigenous People*

In addition to voluntary codes adopted by financial institutions referred to above, at international law level, there are also norms and conventions that address issues of environment in project finance. There is the United Nations Declaration on the Rights of Indigenous People. This Declaration was approved by the UN General Assembly in 2007. Article 32 of the Declaration requires free, prior and informed consent (FPIC) of indigenous people of any project affecting their lands or territories and other resources, particularly in connection with the development, utilization or exploitation of mineral, water or other resources.<sup>94</sup> It is said that the Declaration is soft law rather than a binding legal document but it is likely to influence national laws and jurisprudence over time.<sup>95</sup>

Interestingly, some non – legal entities such as the inter – American Development Bank (IADB) and the Round Table on Sustainable Palm Oil (RSPO) recently have started to apply the principles of free, prior and informed consent directly to companies. The challenge, however, is how such companies could get the consent as it is not clear who is the rightful person to give the consent in the communities. The requirement of seeking FPIC seems though to be important and the Foley – Hoag LLP report<sup>96</sup> also argues that –

[G]aining indigenous consent now, even if it is not required by law, might reduce future legal risk. It would, for example, protect companies if the law evolves to incorporate FPIC and is applied retroactively -- which is more likely in countries that voted for the Declaration. The law could evolve through court decisions that interpret existing statutes in light of evolving international legal standards or it could change due to statutory developments. Alternatively, the legal rights applied to companies that did not gain FPIC could change in the host country if a populist president who garners votes from indigenous peoples were to come into power. The Declaration on the Rights of Indigenous Peoples calls strongly for redress and

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<sup>94</sup> <http://un.org/esa/socdev/unpfii/en/drip.html>

<sup>95</sup> EIRIS Vedanta Report: “Improving Vedanta Resources governance of Responsible Business Practices. (2010) pg 6. See also AK. Lehr & GA Smith, (2010) “Implementing a Corporate Free, Prior & Informed Consent Policy: Benefits and Challenges” Foley – Hoag LLP Report for Talisman Energy pg 15

<sup>96</sup> Ibid pg 68



restitution where land was taken from indigenous peoples without their FPIC.<sup>97</sup> Companies are likely to bear some of that burden as countries start to implement the Declaration unless they can demonstrate that they obtained the consent of affected indigenous peoples.

The South African case of *Alexkor Ltd v The Richtersveld Community*<sup>98</sup> further illustrates the point made in the Foley – Hoag Report cited above.

The facts of the case were that the Richtersveld community brought a claim against the State and the company Alexkor for the restitution of its land, which the state had given as a concession to Alexkor, a diamond mining company. The State had forcibly removed the Richtersveld people in the 1920s. The South African Constitutional Court found that the Richtersveld people had a “right of communal ownership under indigenous law.” The Court noted that the law that dispossessed the Richtersveld Community of its land had discriminatory impacts because of its “failure to recognize and accord protection to indigenous law ownership while, on the other hand, according protection to registered title. The inevitable impact of this differential treatment was racial discrimination against the Richtersveld Community which caused it to be dispossessed of its land rights.” The court returned the land to the Richtersveld Community and the Community obtained a 49% stake in the company.

Although the ruling of this case was based on interpretations of South African law and did not draw on international standards, it exemplifies how changing social understandings of the customary land rights of indigenous peoples can have very real and retroactive impacts on companies that have concessions to use formerly indigenous land and hence posing a legal risk.

Another Convention in this area is the International Labour Organization Convention Concerning Indigenous and Tribal Peoples in Independent Countries (Otherwise known as ILO Convention no.169). Article 16.2 of the ILO Convention no.169 requires the consent of indigenous people in situations where they have to be relocated. Of particular relevance to the

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<sup>97</sup> “Indigenous peoples have the right to redress, by means that can include restitution or, when this is not possible, just, fair and equitable compensation, for the lands, territories and resources which they have traditionally owned or otherwise occupied or used, and which have been confiscated, taken, occupied, used or damaged without their free, prior and informed consent.” U.N. Declaration on the Rights of Indigenous Peoples, *supra*, Art. 28.1.

<sup>98</sup> [2003] AU Indig Law Rpr 41; (2003) 8(3) Australian Indigenous Law Reporter 55 (CCT19/03) ZACC 18; 2004 (5) SA 460 (CC); 2003 (12) BCLR 1301

extractive industry like the Kayelekera Uranium mine in Malawi, the Convention states that in cases in which the State retains the ownership of mineral or sub-surface resources or rights to other resources pertaining to lands, governments shall establish or maintain procedures through which they shall consult these peoples, with a view to ascertaining whether and to what degree their interests would be prejudiced, before undertaking or permitting any programs for the exploration or exploitation of such resources pertaining to their lands and the peoples concerned shall, wherever possible, participate in the benefits of such activities, and shall receive fair compensation for any damages which they may sustain as a result of such activities.<sup>99</sup>

Other international norms include, the Convention on Biological Diversity which has articles relating to the rights of indigenous peoples.<sup>100</sup> Article 27 of the International Covenant on Civil and Political Rights states that minorities shall not be denied the right... to enjoy their own culture'.<sup>101</sup> The Committee on the Elimination of Racial Discrimination (CERD) has criticized oil companies on the lack of meaningful consultation with indigenous peoples.<sup>102</sup>

Hence, best practice companies are alert to the evolving nature of norms, and Professor Ruggie, has himself suggested that companies should act in a proactive and prudent way regarding human rights...[and environmental standards] rather than taking a narrow view of legal compliance.<sup>103</sup>

### **3.4. Human Rights Risks**

Human rights risk is simply the possibility that a human rights problem will adversely affect the interests of those persons undertaking a project.<sup>104</sup> Human rights risks are strategically constructed since human rights gain their meaning from social practice.

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<sup>99</sup> Article 15.2 of ILO Convention 169

<sup>100</sup> <http://www.cbd.int/convention/convention.shtml>

<sup>101</sup> <http://www2.ohchr.org/english/law/ccpr.htm>

<sup>102</sup> A Xanthaki, *Indigenous Rights and UN Standards*, (2007)

<sup>103</sup> Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprise – Business and Human Rights: Further steps toward the operationalization of the 'protect, respect and remedy' framework, 9 April 2010 [http://www.reports-andmaterials.org/Proff\\_Ruggie-report-2010.pdf](http://www.reports-andmaterials.org/Proff_Ruggie-report-2010.pdf). Accessed on 3 February, 2012

<sup>104</sup> MB Likosky, *Law, Infrastructure and Human Rights* (2006) 47

On June 18, 2008, the United Nations Human Rights Council adopted resolution 8/7 (popularly known as the John Ruggie Report) which is based on three pillars: the state duty to protect against human rights abuses by third parties, including businesses through appropriate policies, regulation, and adjudication; the corporate responsibility to respect human rights, which means to act with due diligence to avoid infringing on the rights of others; and the greater access by victims in effective remedy, judicial and non-judicial.<sup>105</sup>

This UN ‘protect, respect and remedy’ framework, which was unanimously welcomed by the UN Human Rights Council,<sup>106</sup> has won universal acceptance from states, business organizations and many NGOs. It is said that the framework makes it clear that although states have responsibility to protect human rights (and to ensure that all organs of society including companies comply), companies themselves have the responsibility to respect human rights and therefore to ‘act with due diligence to avoid infringing on the rights of others.’<sup>107</sup>

This Resolution has therefore entrenched the need to respect human rights in business ventures including project finance.

Until the Ruggie Report, there has been considerable debate as to whether companies are subject of human rights law which forms part of international law. The emerging view is that business ventures, in addition to states, should be subjects of international law. The Preamble of the 1948 Universal Declaration of Human Rights states that-

[e]very individual and every organ of society, keeping this declaration constantly in mind, shall strive by teaching and education to promote respect for these rights and freedoms and by progressive measures, national and international to secure their universal and effective recognition and observance<sup>108</sup> (emphasis supplied)

From the reading of this provision, the use of the words ‘every organ of society’ entails that the responsibility to promote and respect human rights extends to companies as they are organs of

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<sup>105</sup> J Ruggie, (2010) “*Business and Human Rights: Further steps toward the operationalization of the “protect, respect and remedy” framework.*” Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises. pg 3

<sup>106</sup> <http://www.reports-and-materials.org/Ruggiestatement-to-UN-Human-Rights-Council-1-June-2010.pdf>

<sup>107</sup> EIRIS Vedante Report, (n 94 above) 4

<sup>108</sup> United Nations General Assembly Resolution 217A (III), UN Doc. A/810, 71

the society properly so called. Most governments, both developed and developing, have witnessed shifts towards privatization of state owned entities which were traditionally undertaking infrastructural developments because of inefficiencies in state corporations, government deficits and the organizational advantages of profit-based companies. Hence, increasingly, privatization policies at domestic level in many countries like Malawi have meant that many tasks traditionally performed by government have now been handed over to private operators. This is typical of project finance transactions. Logically, if human rights were historically granted to individuals to shield them against state's abusive action, and some state's functions are taken over by other entities susceptible to violate those rights, it is argued then that these entities should be called upon to respect human rights obligations towards individuals.<sup>109</sup>

Other commentators have said that-

there is simply no reason why TNCs [transnational corporations] should not be obliged to take step along the lines of...typical government function to provide for and promote human rights, when such steps are in their power and jurisdiction...The improvement of the whole human rights situation of the population may indeed be a central purpose of government, but we would add that TNCs not only can, but must, provide collateral and sometimes crucial support to that end.<sup>110</sup>

Others have argued that multinational companies enjoy considerable rights and benefits under international law and it is only proper that they should also be subject to some obligations.<sup>111</sup>

In other words, although human rights law may traditionally have been devised to protect individuals from abuses by states, international law must now respond to shifts in power in the international system away from states and in favour of large corporations.<sup>112</sup>

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<sup>109</sup> S Danailov, "The Accountability of non – State actors for Human Rights Violations: The Special Case of Transnational Corporations. (1998) downloadable from [http://www.humanrights.ch/cms/pdf/000303\\_danailov\\_studie.pdf](http://www.humanrights.ch/cms/pdf/000303_danailov_studie.pdf).

<sup>110</sup> D Kinley and J Tadaki, "From talk to Walk: The Emergence of Human Rights Responsibilities for Corporations at International Law." (2004) 44 Virginia Journal of International Law 931 @ 966

<sup>111</sup> ICHRP, "Beyond Voluntarism: Human Rights and the Developing International Legal Obligations of Companies" (2002) 12-13

<sup>112</sup> P Alston, "The Myopia of the Handmaidens: International lawyers and Globalisation." (1987) 80 European Journal of International Law 435

Consequently, it has now been generally accepted that companies and TNCs are subjects of international law including human rights. Failure to respect human rights by these companies in project finance is therefore a legal risk.

Companies or TNCs involved in project finance may find themselves entangled in human rights violations in a number of ways. First, firms may find themselves implicated in conflicts generated by local competition for control over natural resources and this could lead to the firm's taking sides in the conflict and assisting in the violations of human rights committed by the group it supports.<sup>113</sup> For example, natural resource firms are alleged to have offered assistance to both government and rebel forces in recent years in the Democratic Republic of Congo.<sup>114</sup>

Second, firms may become complicit in human rights abuses where they knowingly benefit from repressive government policies, as where protests against the natural resource project in question are forcibly suppressed; where they obtain benefits from forced labour; or where they gain access to the mineral deposits as a result of the forced resettlement of indigenous populations.<sup>115</sup>

Third, firms may commit violations of human rights through extensive industrial pollution, or other environmental damage to the region in which they operate, resulting to threats to the lives, health and livelihoods of the indigenous population.<sup>116</sup>

A fourth category of abuses arises out of the operations of security forces contracted by the natural resource company to safeguard its assets and employees.<sup>117</sup> It is said instances have arisen where the personnel of such forces have engaged in illegal assaults and killings of persons perceived as a threat to the investment.<sup>118</sup>

For a country like Malawi, which has enjoyed peace and stability over the years, real threats posed by the TNCs in the project finance context would be their complicity in human rights where they benefit from repressive government policies; endemic corruption, culture of impunity, weak rule of law and where they gain access to mineral deposits as a result of forced

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<sup>113</sup> P Muchlinski, "Social and Human rights Implications of TNC activities in the Extractive Industries" (2009) *Journal of Transnational Corporations*, Vol.18, No. 1 Pg 126

<sup>114</sup> See ESCR-NET (2005) 14-15

<sup>115</sup> See *Presbyterian Church of Sudan v. Talisman Energy and the Republic of Sudan*. 374 F. Supp. 2d 331

<sup>116</sup> Muchlinski, (n 113 above) 127

<sup>117</sup> *Ibid*,

<sup>118</sup> The case of BP in Columbia, where security forces carried out human rights violations, including the killing, in 1995, of a local organizer of protests against the environmental effects of BP's investment in the Casanare region

resettlement of indigenous populations. They could also commit human rights violations through pollution and environmental degradation in the areas in which they operate. These issues could be the subject of litigation which can potentially damage the viability of the project as well as damage the reputation of the project. Already, the Kayelekera Uranium Mine faced legal challenges before its commissioning. In the case of *Centre for Human Rights and Rehabilitation (CHRR) and 5 Others v The Attorney General (AG) and Paladin (Africa) Ltd*,<sup>119</sup> a coalition of NGOs brought an action against the Government of Malawi; and Paladin (Africa) Ltd, which is the sponsor and operator of the Kayelekera Uranium Mine, seeking an injunction against the commissioning of the mine on grounds that Paladin (Africa) Ltd did not do a proper environmental impact assessment on the project and that consequently, if the project is allowed to proceed, it would have adverse environmental effects on surrounding community groups including the ecosystem arising from radiation discharged from the facility. The case was however settled out of court after Paladin had made some commitments to address some of the concerns that the NGOs had.

Tort based cases could also find their way in the local courts for occupational diseases and other diseases affecting surrounding communities due to failure of the project company to provide a safe and healthy working environment as well as failure to discharge toxic wastes in a responsible and environmental friendly manner. Foreign direct liability claims could also be instituted against parent companies in foreign jurisdiction just like was the case in the Australian case of *Dagi v. BHI, supra*, which concerned a claim for damages by landowners for pollution of the Ok Tedi River in Papua New Guinea and adjoining land caused by mining activities of a subsidiary of the Australian mining company BHP.

For companies involved in infrastructure projects in developing countries but who have parent companies based in the U.S., there is a different set of litigation going on in U.S. courts for human rights violations under the Alien Tort Claims Act<sup>120</sup> (ATCA). The ATCA confers jurisdiction on the US District Courts in respect of any civil action by an alien for a tort only,

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<sup>119</sup> Civil Cause No 457 of 2007, High Court of Malawi, Lilongwe District Registry (unreported).

<sup>120</sup> 28 USC 1350

committed in violation of the law of nations or a treaty of the United States.<sup>121</sup> Through the ATCA, NGOs and some affected subjects have been able to bring suits against TNCs in US District courts for human rights violations in affected project communities. Prominent among such cases are the cases of *Wiwa v. Royal Dutch Petroleum Ltd*<sup>122</sup>; *John Doe et al v. Unocal*<sup>123</sup>; and *The Presbyterian Church of Sudan v Talisman Energy and the Republic of Sudan*<sup>124</sup>

### 3.5. Investor Security Risks

This is a collection of risks that a foreign investor, even in a project finance set up, could face as a result of failure by the host state to meet its obligations. The host state has a duty to protect the investor's rights. In fact, it is said that the protection of private property has been a traditional part of international law, in particular, on the law on the treatment of aliens.<sup>125</sup> Also in the case of *Tecmed v Mexico*,<sup>126</sup> the Tribunal stated that the host state must provide to the investor treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. Yet now and again, we see a dereliction of this duty by host states that result in such acts as expropriation of private property, different treatment of foreign investors, breach of undertakings by host governments, currency inconvertibility and transfer,

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<sup>121</sup> Ibid

<sup>122</sup> 226 F 3d 88 (2d Cir. 2000). This was action brought by members of the family of Nigerian Ken Saro-Wiwa, in which Nigerian subsidiaries of the Royal Dutch Shell group were alleged to have utilized local security forces to put down opposition to their oil operations in Nigeria and, subsequently, to have instigated the imprisonment, torture and killings of the plaintiffs and their relatives. It was alleged that Royal Dutch Shell Group provided money, weapons and logistical support to the Nigerian military, including the vehicles, ammunition used in the raids on the villages, procured atleast some of these attacks, participated in the fabrication of murder charges against Saro Wiwa and John Kpuinen and bribed witnesses to give false testimony against them.

<sup>123</sup> 963 F Supp 880 (CD Cal 1997). This was a claim for damages by a group of Burmese nationals for human rights abuses suffered at the hands of Burmese security forces in connection with the construction of a gas transportation pipeline. The plaintiffs alleged that, Unocal and Total were party to these abuses, having utilized the services of the Police and Military and having established their activities in the region, in the knowledge of human rights abuses were being employed in connection with the project.

<sup>124</sup> 374 F. Supp. 2d 331; 2005 U.S. Dist. LEXIS 11368. The plaintiff, The Presbyterian Church of Sudan, claims that Talisman Energy, a Canadian Oil company, collaborated with Sudan in "ethnically cleansing" civilian populations surrounding oil concessions located in southern Sudan in order to facilitate oil exploration and extraction activities. This policy of "ethnic cleansing" was aimed at non-Muslim African residents of Sudan, and "entailed extrajudicial killing, forced displacement, military attacks on civilian targets, confiscation and destruction of property, kidnappings, rape, and the enslavement of civilians." According to the plaintiff, Talisman was aware from the outset that military action was needed to secure the oil in the region. The Presbyterian Church of Sudan was located in the area where this alleged genocide took place and their land and parishioners suffered at the hands of the Sudanese militia.

<sup>125</sup> A Reinisch, (ed) *Standards of Investment Protection*. (2008)

<sup>126</sup> Full name: *Tecnicas Medioambientales Tecmed S.A. v The United Mexican States*. ICSID Arb. Case no. ARB (AF) 00/3. Award of 29 May, 2003

civil unrests and, in some cases, wars. These can be grouped into two categories, namely; political risks and host state obligations.

### 3.5.1. Political Risks

These are risks posed by either a change of government policy or the government itself which may cause the cancellation of authorizations, consents, permits, tax concessions or worse still, the expropriation of project assets, or the possibility of general labour unrest or civil disorder interfering with the operations of the project.<sup>127</sup>

One of the worst forms of political risk is expropriation of an investor's property. Expropriation is where the host country, through an arbitrary, discriminatory act and without just compensation, takes over the project assets or rights or the equity ownership of the project. It is said that more threatening to a project is the type of expropriation that can take place over time, in a series of so called creeping acts, where host government uses a combination of taxes, fees, other charges and devices to increase its share of the project's profits.<sup>128</sup> Direct expropriation (i.e. the outright and overt taking of property, often achieved by means of transfer of title) is less common these days because states have recognized the importance of attracting foreign direct investment and thus do not want to be perceived as threatening those investments by means of expropriation. Hence, the typical form in which they occur today is that of an 'indirect expropriation.'<sup>129</sup> Indeed it is widely acknowledged that-

[...] it is not the physical invasion of the property that characterizes nationalizations or expropriations that has assumed importance, but the erosion of rights associated with ownership by state interferences.<sup>130</sup>

Direct expropriation also captures a broad spectrum of intentional and indirect expropriations as much as a variety of inappropriate regulatory acts, omissions, and other conduct that undermines the framework created to protect foreign investments.<sup>131</sup> In the case of *Biwater Gauff (Tanzania) Ltd v United Republic of Tanzania*, the Tribunal looked at the effect of Tanzania's act on

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<sup>127</sup> RM Auerback, "Law of Finance and Foreign Investment in Emerging Countries: (2003) Essays in International Financial and Economic Law no.44 The London Institute of International Banking, Finance and Development Law Limited

<sup>128</sup> Hoffman, (n 17 above) 48

<sup>129</sup> AK Hoffmann "Indirect Expropriation" in A. Reinisch (ed) *Standards of Investment Protection*. (2008) 151

<sup>130</sup> UNCTAD, *Taking of Property*, Series on Issues in International Investment Agreements (2000) 20

<sup>131</sup> AK Hoffman (n 129 above) 152



Biwater's investment and concluded that this was an act of expropriation. In this case, the government of Tanzania made a public announcement terminating Biwater's lease Contract on 13 May 2005; subsequently addressed staff of City Water (a subsidiary of Biwater) on 17 May; withdrew their VAT certificate on 24 May; and seized the assets of City Water, and effected the deportation of City Water's management on 1 June 2005.

It must however be borne in mind that every state reserves the right to expropriate property in its state. Article 2(2) of the 1974 Charter of Economic Rights and Duties of States provides that-

Each state has the right [...] to nationalize, expropriate or transfer ownership of foreign property in which case appropriate compensation should be paid by the state adopting such measures, taking into account its relevant laws and regulations and all circumstances that the state considers pertinent. In any case, where the question of compensation gives rise to a controversy, it should be settled under domestic law of the nationalizing state and by its tribunals unless it is freely and mutually agreed by all states concerned that other peaceful means be sought on the basis of the sovereign equality of states and in accordance with the principle of free choice of means.<sup>132</sup>

Consequently, there is a legal risk of expropriation for investors which comes about as a result of the host state's exercise of its sovereign rights. This risk is more common in projects in the extractive industries, energy production projects, oil and gas pipeline projects, roads, railways, airports and seaports.<sup>133</sup>

The law relating to expropriation demands that appropriate compensation must be paid where the state exercises this right. The principle that compensation must be paid is itself said to be a general principle of law. In the *Chorzow factory Case*<sup>134</sup> the Permanent Court of International Justice said –

*'It is a general conception of law that every violation of an engagement involves an obligation to make reparations'*

The above statement dealt with a treaty obligation but is used indiscriminately to support the payment of compensation in any taking. The text of UN General Assembly Resolution 1803 also

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<sup>132</sup> UN General Assembly Resolution 3281 (XXIX), UN GAOR 29<sup>th</sup> Session, UN Doc. A/9631 (1974). 1962 UN General Assembly Resolution on Permanent Sovereignty over Natural Resources 1803 (XVII), 17<sup>th</sup> Session, agenda Item 39 Para. 4 provides that nationalization, expropriation or requisitioning shall be based on the grounds or reasons of public utility, security or the national interest which are recognized as overriding purely individual or private interests, both domestic and foreign. In such cases, the owner shall be paid appropriate compensation in accordance with the rules in force in the state taking such measures in the exercise of its sovereignty and in accordance with international law.

<sup>133</sup> Hoffman (n 17 above) pg 9

<sup>134</sup> [1928] PCIJ Series A No.17 @ 29

clearly expresses the consensus that expropriation has to be in the public interest and accompanied by compensation. UNCTAD also states that under customary international law and typical international investment agreements, three principal requirements need to be satisfied before a taking can be considered to be lawful: it should be for a public purpose; it should not be discriminatory; and compensation should be paid.<sup>135</sup>

The problem here is the degree of compensation and the circumstances under which this compensation ought to be paid. States again retain the discretion as to how much compensation is payable. In this regard, UN General Assembly Resolution 3171 affirmed that-

[...] that the application of the principle of nationalization carried out by states, as an expression of sovereignty in order to safeguard their natural resources, implies that each state is entitled to determine the amount of possible compensation and the mode of payment, and that any dispute which might arise should be settled in accordance with the national legislation of each state carrying out such measures.<sup>136</sup>

Other states are increasingly taking advantage of this and insert clauses in their international investment agreements that excuse governments from their treaty obligations (including obligations to pay compensation) in circumstances when they have to take measures necessary to protect their essential or national security interests.<sup>137</sup> This was also the case in *Biwater v Tanzania*, supra. The government of Tanzania argued that it could not pay compensation because the measure taken was in the public interest; i.e. the provision of safe drinking water to the residents of Dares salaam. The Tribunal, though it dismissed this argument, still did not order compensation on grounds that Biwater was at the time of the expropriation worth nothing and that therefore there was no “compensable damage suffered by it.”<sup>138</sup>

Therefore, expropriation risk should be analyzed carefully especially in projects that are particularly vulnerable to expropriation. This risk can be mitigated through underwriting projects with political risk insurance offered by multilateral agencies like the Multilateral Investment Guarantee Agency (MIGA), an affiliate of the World Bank Group organized to encourage

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<sup>135</sup> UNCTAD, *International Investment Agreements. Key Issues* (2004) 235. This statement was also acknowledged by M. Sornarajah, (2<sup>nd</sup> ed) *International Law on Foreign Investment*, (2004) 149

<sup>136</sup> UNGA Res. 3171 (XXVIII) UN GAOR 287<sup>th</sup> Session Para 3 1973

<sup>137</sup> International Institute for Sustainable Development: *Belgium’s Model Bilateral Investment Treaty: A Review* 2010. Available at <http://www.iisd.org>

<sup>138</sup> Pg 210 of the Award

foreign investment in developing member countries by providing guarantees (insurance) including coinsurance and reinsurance against non commercial risks.<sup>139</sup> A full discussion on this will follow in chapter four.

Another form of political risk is currency inconvertibility and transfer whereby it becomes difficult to ‘expatriate’ revenue generated from a project to the project lender or sponsor who oftentimes is based in a foreign jurisdiction. The ability to access revenues generated from the project is the most important aspect of project finance and as it has been said elsewhere in this dissertation, this is where true project finance commences. Yet in countries like Malawi (classified as one of the poorest nations on earth), expatriating project revenues to foreign jurisdictions is a great challenge largely due to scarcity of foreign exchange and serious balance of payment problems that the country constantly faces. At the time of writing this dissertation, Malawi was facing a myriad of economic problems, including an acute shortage of foreign exchange. Foreign investors have been affected most due to the inability to convert currency and transfer it abroad.<sup>140</sup> The source of all this seems to be political as there is currently sour relations between the government of Malawi, and Malawi’s traditional bilateral donors who have since frozen aid.

Project finance sponsors and lenders should therefore anticipate this risk when investing in countries such as Malawi. Again this risk can be mitigated through the taking up of political risk insurance as we will later see in chapter four.

Change of law risk also falls under the category of political risk. This is a risk where a government body changes the legal, regulatory or judicial frameworks in which a project was developed which action affects the project’s ability to service a debt or make profits.<sup>141</sup> Typical examples of such actions include import and export restrictions, taxation, changes to environmental standards requiring capital improvements, price controls and privatization of suppliers and purchasers. It is said that because the government action is legal, political risk

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<sup>139</sup> Art. 2 of the Convention Establishing the Multilateral Investment Guarantee Agency.

<sup>140</sup> In early March, 2012, Kenya Airways and Ethiopian Airways announced that they will no longer issue tickets in Malawi because they are failing to convert their Malawian revenues to a tradable world currency and transfer it to their respective jurisdictions.

<sup>141</sup> Hoffman, (n 17 above) p 49

insurers do not typically insure against this risk.<sup>142</sup> Such risk may be remedied through stabilization clauses where the host country contracts with the project sponsor that certain actions will not be taken. A detailed discussion of stabilization clauses will also follow in the next chapter.

### 3.5.2. *Host State Obligations*

In order to attract foreign investment, countries resort to entering into Bilateral Investment Treaties (BITs) with other countries where parties agree to grant foreign investors certain rights and also for them to comply with corresponding obligations. Most BITs contain provisions protecting foreign investors against discrimination in favour of the host country's nationals (national treatment) or nationals of third countries (most favoured nation or MFN protection).

The problem with this is that recently, investors have successfully argued that the MFN clause allows them to import commitments from other agreements to which the host state is a party, including from any BIT that the host country had signed. This happened in the case of *Maffezini v Kingdom of Spain*<sup>143</sup> and might lead to a situation where a hard fought negotiation of a BIT could be made largely irrelevant because an investor could rely on the more favourable provision in another treaty, thereby bypassing the provisions of the applicable BIT.<sup>144</sup> In the *Maffezini case* the claimant sought to avoid a provision in the Argentina – Spain BIT which required that, in the absence of an amicable settlement within six months, disputes were to be settled by the courts of the host country which had a period of 18 months to deal with the dispute before they could be taken to arbitration. The claimant argued that, by reason of the MFN clause in the Argentina – Spain BIT, this provision could be replaced by the provisions used in the Chile – Spain BIT, which allowed recourse to arbitration after the six months period allowed for negotiations had expired. The tribunal accepted the claimant's position that it was being treated less favourably than the Chilean investor in Spain by reason of the additional requirement to submit disputes to a local court.

It is said that case law and certain academics are of the view that not only substantive guarantees could be imported, but also procedural issues, such as the provisions on investor-state dispute

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<sup>142</sup> Ibid

<sup>143</sup> ICSID Case No. ARB/97/7, Decision on Jurisdiction, Jan 25, 2000

<sup>144</sup> International Institute for Sustainable Development: (n 137 above) 12

settlement.<sup>145</sup> This is a legal risk and there will be a discussion on how this risk can be mitigated in the next chapter.

### **3.6. Dispute Settlement in Project Finance**

Due to the large number of players, complexity and sometimes transnational nature of project finance transactions, there is always high likelihood of disputes arising among the different players. Thus, dispute resolution is certainly a legal risk inherent in project finance, more so in a cross border context. It is said that the importance of various considerations that factor into dispute resolution should be weighed carefully during the initial negotiations between the parties and that preparing for this is basically advance planning for “when things fall apart.”<sup>146</sup> Dispute settlement is therefore a very key legal issue to potential project finance players and such players are always interested to know how disputes are going to be settled before they make investment commitments especially in uncertain legal environments. It is very important then for parties to agree at the onset on when to litigate or when to arbitrate or indeed use other forms of dispute settlement mechanisms like renegotiating the contract, mediation, conciliation, mini-trials or expert reviews or diplomacy. Investors will be interested in a mode of dispute resolution that would not only be fast but also makes a binding decision at the end which is enforceable. Lack of this aspect in a particular jurisdiction would therefore pose a legal risk to project finance. Investors in an international commercial agreement may also have reservations about litigating in the courts of their opponent’s country and would generally prefer to litigate in a neutral forum<sup>147</sup>.

#### **3.6.1. Modes of Dispute Settlement**

##### *3.6.1.1. Litigation*

This is a method of resolving disputes through judicial means by using the conventional court system. It is adversarial in nature and normally focuses on the determination of the respective legal rights of the parties and the attendant remedies. The courts base their decisions on facts and the law and not compromise.

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<sup>145</sup> See also *Siemens v Argentina* ICSID Case no. ARB/02/08 Decision on Jurisdiction, Feb 3, 2004

<sup>146</sup> Sarkar, (n 14 above), 349

<sup>147</sup> P Ramsden, *The Law of Arbitration, South African and International Arbitration*, (2009) 1

#### 3.6.1.2. *Arbitration*

This is a system of resolving disputes where parties agree to refer their disputes to a neutral, private and independent person or body for adjudication and the decision made therefrom is usually final. Unlike, the court system, this mode of dispute resolution is faster and more confidential.

#### 3.6.1.3. *Renegotiation*

This is where parties sit down again and discuss the terms of the contract after a problem has arisen. This could be useful where the underlying agreement between the parties has not been finalized and significant problems materialize. The agreement may be redrafted to meet any unforeseeable or unanticipated conditions. This is common in situations where there is absence or delays in obtaining approvals or permits for a particular project.

#### 3.6.1.4. *Conciliation*

This is a method for the settlement of international disputes according to which a Commission set up by the parties proceeds to the impartial examination of the dispute and attempts to define the terms of settlement susceptible of being accepted by the parties.<sup>148</sup> Conciliators make non – binding recommendations to the parties for resolving disputes.

#### 3.6.1.5. *Mediation*

Mediation is designed to enable the parties to reach a quicker solution that is forward looking, relatively inexpensive and one that reaches an outcome that tends to preserve the relationships of the parties.<sup>149</sup> It is mostly composed of expert mediators.

#### 3.6.1.6. *Industry based Expert Review*

This involves the engagement of a third party such as a mediator, dispute review board or expert panel. Even though the process requires a consensus among the panelists, it nevertheless requires the issuance of a report or expert opinion rather than a negotiated agreement. The non adversarial

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<sup>148</sup> Sarkar,(n 14 above) 350

<sup>149</sup> Ibid, 352

nature of this approach may be an attractive feature in project finance and use of experts is handy especially in relation to technical information.<sup>150</sup>

### **3.6.2. Common Methods in Project Finance**

The amount of political risk associated with international project financings in unstable developing countries causes project participants to seek efficient and unbiased forms of dispute resolution.<sup>151</sup> Due to the transnational nature of project finance, litigation and arbitration are the most tempting options available to project finance participants when it comes to dispute resolution. This, however, depends on the preferences of the particular project participant. It is said that lenders would prefer litigation, contractors would prefer arbitration and states would prefer diplomatic negotiations or mediation.<sup>152</sup> Lenders or financial institutions abhor arbitration and prefer access to courts where they can obtain strict and literal enforcement of loan and collateral documents. The court system also affords lenders with remedies such as attachment of property and interlocutory injunctions/interdicts.<sup>153</sup> The Project Company and contractor prefer arbitration because of the desire to resolve disputes efficiently and timely and due to the delays inherent in judicial proceedings and the lack of confidentiality of the process.<sup>154</sup> In fact, arbitration clauses are common in construction contracts.

Host states prefer negotiations, mediation and mostly, litigation using the judicial system of the host state where there is a chance of influencing the outcome of the decision and also the possibility of winning sympathy from the local courts over the foreign investor in the name of patriotism.

#### **3.6.2.1. Arbitration v Litigation: Pros and Cons**

It is said that commonly cited advantages of arbitration are the quick and efficient resolution of disputes; lower legal fees; minimal pre-hearing discovery and motions; neutrality of the forum (which is particularly attractive in a multinational dispute); arbitrators can be selected who have expertise over highly technical and complicated subject matter; one party cannot force dispute

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<sup>150</sup> Ibid pg 354

<sup>151</sup> International arbitration and Project Finance in Developing Countries: Blurring the Public/Private Distinction (2003) 26 B.C. International and Comparative Law Review 355

<sup>152</sup> M Kantor, "International Project Finance and Arbitration with Public Sector Entities: When is arbitration a fiction?"(2001) 24 Fordham International Law Journal, 1122

<sup>153</sup> Hoffman, (n 17 above) 407

<sup>154</sup> Ramsden (n 147 above) 1

resolution into a local court; flexible and informal proceedings and the privacy and confidentiality of proceedings.<sup>155</sup> But these advantages only exist to the extent that they are preserved in the arbitration clauses drafted for the contract and to the extent the arbitration clauses are not challenged by litigation.<sup>156</sup>

In addition, foreign arbitration awards can be enforced easily under various conventions and bilateral treaties than is the case for the enforcement of foreign judgments from the courts.

At the international level, there is the Convention on the Recognition and Enforcement of Foreign Arbitral Awards shortly known as the New York Convention.<sup>157</sup> This Convention applies to the recognition and enforcement of arbitral awards made in the territory of a State other than the State where the recognition and enforcement of such awards are sought, and arising out of differences between persons, whether physical or legal and it also applies to arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought.<sup>158</sup> However, Malawi is not a member of this Convention and that is in itself a legal lacunae in as far as settlement of investment disputes is concerned.

There is also the International Convention for the Settlement of Investment Disputes also known as the ICSID Convention or the Washington Convention.<sup>159</sup> Under this Convention, disputes between states and private investors can be referred to the International Centre for the Settlement of Investment Disputes (ICSID), an organ of the World Bank group established under the Convention. This applies to disputes between a government entity and a national of another signatory state.<sup>160</sup> This has indeed become the popular forum for the settlement of investment disputes as evidenced by the large number of cases that have been brought for adjudication in the last decade. So far ICSID has concluded 233 cases.<sup>161</sup>

Malawi is a member of the ICSID Convention which means claims can be brought by or against it directly before ICSID for arbitration. The advantage of using ICSID is that parties do not have

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<sup>155</sup> Hoffman, (n 17 above) 405

<sup>156</sup> PM Torrado, "Political Risk Insurance and Breach of Contract Coverage: How the intervention of Domestic Courts May Prevent Investors from claiming Insurance." (2005) 17 PACE International Law Review 301

<sup>157</sup> Signed at New York in 1958 and currently has 144 members

<sup>158</sup> Article I of the New York Convention

<sup>159</sup> Entered into force on 18 March, 1965

<sup>160</sup> Article 1(2) of the ICSID Convention

<sup>161</sup> <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=GenCaseDtIsRH&actionVal=ListConcluded>.

Accessed on 27 March, 2012



to exhaust local remedies before filing claims before it. However, at regional level for Malawi, the position is different. Malawi is a member of the Southern Africa Development Community (SADC). SADC block of countries require exhaustion of local remedies before investment disputes can be referred for arbitration<sup>162</sup> but this can only be applicable if both parties are members or nationals of SADC.

Hence, these investment treaties that states have entered into allowing foreign investors to advance foreign claims against states in international tribunals have given arbitrators the authority to resolve regulatory disputes between investors and the state and this authority is sometimes more powerful than that of any court because the system piggybacks on the rules and structure of international commercial arbitration instead of adopting a more conventional court based model.<sup>163</sup> In addition Gus Van Harten states that –

[F]irst, as with the public law competence of the courts, arbitrators have comprehensive jurisdiction to review sovereign acts of the state by applying broadly worded standards of review that are open to a range of interpretations and, as such, they are empowered to resolve core matters of public law. Second, because treaties utilise the enforcement structures of the New York Convention and ICSID Convention, the awards of the arbitrators are more widely enforceable than any other adjudicative decision in public law....Finally, arbitrators are able to award damages as a public law remedy without having to apply the various limitations on state liability that evolved in the domestic legal systems to balance the objectives of deterrence and compensation against the competing principles of democratic choice and government discretion.<sup>164</sup>

Nevertheless, arbitration undermines the basic tenets of judicial accountability, openness and independence. Unlike Judges, arbitrators lack security of tenure and may be perceived as having a stake in interpreting investment treaties for without claims they would have no work to do.

With regard to litigation, courts base decisions on the facts and the law and not compromise; and that even if arbitration is used, judicial recourse may still be necessary such as to compel arbitration or to enforce an arbitral award. Interim relief are more readily available in litigation

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<sup>162</sup> SADC Protocol on Finance and Investment.

<sup>163</sup> GV Harten, *Investment Treaty Arbitration and Public Law*. (2007) 4

<sup>164</sup> Ibid, pg 5

and court rules, such as those relating to evidence which have been developed over a long time and which are universally accepted, apply. Arbitration also has a limited or complete lack of discovery proceedings.<sup>165</sup>

However, in Malawi, litigation is a long and protracted process. Apart from the quick grant of interim reliefs, the finality of the proceedings remain uncertain and cases may take as long as three years to be finalised due to procedural requirements and time periods that have to be complied with before the matter can be listed for trial.<sup>166</sup> Of course recently, a Commercial Division of the High Court was established with the aim of resolving commercial disputes in an expedited manner using a fairly expedited process. Still, this is a litigation based approach and might not be ideal for project finance.

Hence, dispute resolution is a key legal issue in project finance that has the effect of jeopardising projects, future and present, in Malawi and this dissertation will endeavour to suggest recommendations in the following chapter on the best modes of resolving disputes in a project finance set up.

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<sup>165</sup> Hoffman, (n 17 above) 405

<sup>166</sup> Malawi still uses the old English Supreme Court Practice Rules contained in the book popularly known as the White Book.

## CHAPTER FOUR

### WAYS OF MITIGATING LEGAL RISKS IN PROJECT FINANCE

#### 4.1. Mitigation of risks associated with documentation

During the discussion on documentation in the preceding chapter, much has already been said about the ways in which legal risks associated with documentation can be mitigated. This was because the mitigating strategies could not have been properly separated from the discussion of the legal risks. While adopting the recommendation already mentioned in the preceding chapter on this topic, the following discussion just highlights some of the issues on the topic.

Just as is the case with provisions relating to dispute resolution, it is important that the various contracts that are executed in the project finance arrangement have a governing law. As alluded to in the preceding chapter, formalities for contracts defer from system to system, that is, whereas a particular jurisdiction might require consideration as an element of a contract, another system might not. Therefore, where the parties are from two different legal systems (which is common in project finance) there is need to reach an agreement as to what would be the governing law for the various contracts that would be executed.

Proper execution of documentation is also key in project finance. Some documentation would require notarization, others require mere commissioning while others would require government seals for them to be said to be valid. Thus, attention has to be paid to these legal requirements depending on the *lex loci contractus*.

Before executing contracts, there is also need to analyze the practical remedies that would ordinarily be available in the project location country or indeed in the domicile state of the other parties. It was pointed out in the preceding chapter that in the case of Malawi, certain remedies are practically not obtainable against government.<sup>167</sup> Parties should therefore take care to analyze

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<sup>167</sup> See notes 50 – 54 above

the laws of the project site and decide on appropriate remedies in case of breach of commitments by parties.

Another aspect is the avoidance of multilingual contracts in project finance. Parties should strive at every opportunity to execute contracts in one language to avoid risks of disputes arising from multiple and varying interpretations of contracts.

The actual terms of the contract themselves also pose great risks to the project finance arrangement.

The non recourse provision is at the centre of true project finance. In a non recourse project financing, the arrangement does not impose any obligation upon the project sponsor to guarantee the repayment of the project debt if the project revenues are insufficient to cover the principal and interest payments.<sup>168</sup> Failure to incorporate this provision renders the concept of project finance meaningless.

In relation to lenders, provisions have to be drafted in such a way that would take care of their interests. The difficulty is that lenders come after the project has already been conceptualized and after key stakeholders have already agreed and formalized on certain arrangements. We reiterate that a good approach to this dilemma is to include a so called “financial cooperation clause” in the project contracts which allows the parties to execute the project contracts and also agree to cooperate with the reasonable demands of a project lender that it imposes as conditions for funding the project. However, this cooperation clause should be drafted in such a way that it does not bring adverse change to the rights and obligations already agreed between the parties.

Regarding time periods for contracts in project finance, parties should make sure that that concessions should end well after the recourse has been repaid. This also allows investors to get some profit out of their investments. It is however said that contracts with host governments, for example, should probably not extend beyond a reasonable period of 25 – 30 years because terms

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<sup>168</sup> Hoffman, (n 16 above) 116

beyond that may provide an attractive target for successor governments to complain that they should have the right to change the transaction.<sup>169</sup>

The dissertation also highlighted in the preceding chapter that the definition of a completion date has an effect on the various contracts in project finance because the completion date of one thing might signify the start of another thing. Therefore, because of the significance of the completion concept throughout the project documents, it is important that the definition of completion be thoroughly considered and used consistently in project contracts.

Regarding a force majeure clause, we adopt what was stated in the preceding chapter that it is important that what a force majeure clause says in one contract is consistent with what will happen in the other contracts because the occurrence of a force majeure will almost definitely have a chain effect on the other contracts in a project financing. Another strategy is to offer the same reliefs or timelines given upon the occurrence of a force majeure to the players whose contracts would also be affected by the force majeure.

To sum it all, the peculiar nature of project financing requires that its contracts be negotiated and drafted in a unique way to address the particular intricacies that come with project finance.

#### **4.2. Mitigation of Environmental risks**

Environmental concerns have taken centre stage in project finance because of their link to the concept of economic growth and sustainable development which projects in this area seek to achieve or bring to a country. Sustainable development has been defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs.<sup>170</sup> Environmentally sound development is seen as a necessary prerequisite for economic growth but the methods and the processes of economic growth must ensure the survival of a sustainable ecosystem that can last for generations.<sup>171</sup> At the international level, three principles tend to guide sound environmental stewardship *vis* the ‘precautionary principle’, the ‘preventive principle’ and the ‘polluter pay principle’.

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<sup>169</sup>Ibid 117

<sup>170</sup> World Commission on Environment and Development: “Our Common Future” (1987) 43

<sup>171</sup> PT Muchlinski, (2<sup>nd</sup> Ed) *Multinational Enterprises and the Law*. ( 2007)

The precautionary principle is a product of the United Nations Conference on Environment and Development (UNCED) otherwise known as the Rio Declaration (Agenda 21) on Environment and Development 1992. One of the principles states that-

[i]n order to protect the environment, the precautionary approach should be widely applied by states according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost effective measures to prevent environmental degradation.<sup>172</sup>

The preventive principle is to the effect that-

[a]n enterprise that is the user of hazardous industrial process or the dissemination of harmful products or waste, has a responsibility to ensure that the process, product, or waste as the case may be, does no harm.<sup>173</sup>

The polluter pay principle requires that the costs of pollution should be borne by the person responsible for causing the pollution.<sup>174</sup>

The precautionary and preventive principles should be particularly relevant in as far as mitigating environmental risks is concerned while the polluter pays principle should act as a deterrent to firms of the consequences of failing to discharge their wastes properly.<sup>175</sup>

The Rio Declaration (Agenda 21) was reaffirmed at the World Summit on Sustainable Development (WSSD) in Johannesburg, South Africa in 2002.

There is also the Clean Development Mechanism (CDM) established by article 12 of the Kyoto Protocol to the United Nations Framework Convention on Climate Change.<sup>176</sup> The CDM allows for developed countries to enter into investments aimed at reducing carbon emissions in developing countries and credit these to their emission limitation and reduction commitments under article 3 of the Protocol.

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<sup>172</sup> Principle 15 of the Rio Declaration.

<sup>173</sup> Principle 11 of the Rio Declaration

<sup>174</sup> Principle 16 of the Rio Declaration. See also P Sands, (2<sup>nd</sup> ed) *Principles of International Environmental Law*. (2003) 263 -66

<sup>175</sup> For example, BP, in addition to footing the bill for the clean up which was around \$8Billion, agreed to create a \$20Billion fund to help the victims of the Gulf of Mexico oil spill which occurred in 2010. See

<http://www.bloomberg.com/news/2010-09-03/bp-s-gulf-of-mexico-oil-spill-response-costs-rise-to-8-billion.html>.

Visited on 16 April, 2012

<sup>176</sup> Came into force on 10 December 1997

Another strategy of mitigating this risk is through regulation by states or by non state actors. This can be done through traditional command and control regulations through laws, regulations, and administrative practices which carry mandatory force. It is said that the use of environmental impact assessments under national laws and international environmental arrangements would fall under this category.<sup>177</sup> This should be backed up by effective enforcement measures. Over time, this has changed corporate behavior in how they approach projects of this nature. For example, the introduction of more stringent carbon dioxide emissions standards in national laws has led to the development of new technologies in the car industry that reduce such emissions and to the development of more fuel efficient cars.<sup>178</sup>

However, the problem with official regulation or leaving this in the hands of the state is that the regulation itself might be overbearing and might require too much from firms. Consequently, they could shy away from investing in such investment destinations.

Another way of mitigating this risk is through informal regulation, also known as civil regulation. This is undertaken by firms themselves through the use of innovative environmentally friendly production processes or products which have a competitive advantage on the global market. This might include the adoption of the International Standards Association (ISO) 14000 Series of environmental management standards<sup>179</sup> which represent a hybrid private and public regulatory regime.

The ISO 14000 Series covers six main areas including environmental management systems, environmental auditing, environmental labeling, environmental performance, evaluation, life cycle assessment and terms and definitions.

Although the ISO 1400 standards have been criticized,<sup>180</sup> they nevertheless offer good guidelines for sound environmental management which substantively mitigate or alleviate environmental risks in project financing.

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<sup>177</sup> D Hunter and S Porter “ International Environmental Law and Foreign Direct Investment” in D Bradlow & A Escher (eds) *Legal Aspects of Foreign Direct Investment*. (1999) 177 - 78

<sup>178</sup> DL Levy “Business and the Evolution of the Climate Regime: The Dynamics of Corporate Strategies” in DL Levy & P J Newell (eds) *The Business of Global Environmental Governance*, (2005) 87

<sup>179</sup> ISO 140001: 2004 on “Environmental Management Systems – Specifications with Guidance for Use”. These are however for sale and the cost as of 10 April, 2012 was CHF108. See [www.iso.org/iso/iso\\_catalogue/catalogue\\_tc/catalogue\\_detail.htm?csnumber=31807](http://www.iso.org/iso/iso_catalogue/catalogue_tc/catalogue_detail.htm?csnumber=31807). Accessed on 10 April, 2012

<sup>180</sup> Hunter & Porter in Bradlow & Escher (eds) (n 177 above) have criticized the standards for failing to incorporate public interest concerns in the ISO process; for failing to allow public access to data concerning corporate

Another form of civil regulation is through the involvement of environmental NGOs in the process of Policy development, implementation, compliance and monitoring.<sup>181</sup> These NGOs tend to fill the regulatory gap that is common in LDCs like Malawi as a result of such states pursuit of ‘market based economic policies that emphasize on liberalization, privatization and deregulation.’<sup>182</sup> In that way, states are no longer environmental “watchdogs” leaving much to self regulation by firms and this is a problem for countries like Malawi that have little or no experience as environmental regulators and which have few resources to devote to such tasks. This gap is then filled by various civil society groups, including the major environmental NGOs to create a sense of accountability that may have been lost in the process of deregulation. Thus, in the case of Malawi regarding the Kayelekera Uranium mine, we saw the intervention of NGOs when they brought up a case against the mine developer Paladin in the case of *Centre for Human Rights and Rehabilitation (CHRR) and 5 Others v The Attorney General (AG) and Paladin (Africa) Ltd*,<sup>183</sup>

Partnerships have also developed in this context where there are environmental implications. For example, the French Water Company, Vivendi Environment (Generale des Eaux) works with the international NGO Water Aid and the World Bank to provide access to water in urban areas and to the poor in developing countries.<sup>184</sup>

### **4.3. Mitigation of Human Rights Risks**

From what we observed in chapter three, there is no doubt that TNCs have obligations to respect human rights in modern day human rights discourse. However, the underlying issues should apply *mutatis mutandis* to national firms and companies since the applicability of human rights standards to private corporate actors does not depend on the mere fact that their business operations cross borders. Reference to both TNCs and other business enterprises may be said to

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compliance with standards; and for relying too much on self accreditation by enterprises who set low minimum standards so as to pre-empt more forceful command and control regulation and make compliance easy.

<sup>181</sup> J Bendell and D F Murthy “Towards Civil Regulation: NGOs and the Politics of Corporate Environmentalism.” in P Utting (ed) *The Greening of Business in Development Countries*. (2002) 268 @ 282-84

<sup>182</sup> Ibid

<sup>183</sup> Civil Cause No 457 of 2007, High Court of Malawi, Lilongwe District Registry (unreported).

<sup>184</sup> See M Finger “The New Water Paradigm: The Privatisation of Governance and the Instrumentalisation of the State” in Levy & Nowell (eds) (n 178 above)



avoid the risk that an inadequate definition could allow companies to use financial and other structures to conceal their transnational nature and to appear as a domestic company thereby avoiding responsibility for human rights violations.<sup>185</sup> Thus, in framing human rights obligations for companies, they should be drawn in such a way that they apply to both national and transnational corporations.

As regards the actual responsibilities, most of these are provided for in the UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights (UN Norms).<sup>186</sup> From these UN Norms, at least five different types of provisions can be identified, *vis* the right to equal treatment;<sup>187</sup> the right of security of persons as concerns business engagement in, or benefit from, ‘war crimes, crimes against humanity, genocide, torture, forced disappearance, forced or compulsory labour, hostage taking, extrajudicial, summary or arbitrary executions, other violations of humanitarian law and other international crimes against the human person as defined by international law;<sup>188</sup> rights of workers dealing in particular, with those rights listed in Article 2 of the ILO Declaration on Fundamental Principles and Rights at Work 1998, namely, the prohibition on forced labour;<sup>189</sup> the rights of children to be protected against economic exploitation;<sup>190</sup> and freedom of association.<sup>191</sup>

Although the violation of some of these rights seems to be farfetched in the Malawian context due to democracy and peace currently prevailing in Malawi, they nevertheless ought to be taken into account by any project finance participant to avoid legal risks emanating from their occurrence.

The UN Norms also contain provisions reflecting the main economic social and cultural rights namely; the provision of a safe and healthy working environment;<sup>192</sup> compensation of workers

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<sup>185</sup> Muchlinski, (n 171 above)

<sup>186</sup> UN Doc. E/CN.4/sub.2/2003/12/ Rev 2(2003) 13 August 2003 Available at <http://www.business-humanrights.org>.

<sup>187</sup> UN Norms Section B para 2

<sup>188</sup> Ibid Section C para 3

<sup>189</sup> Ibid Section D para 5

<sup>190</sup> Ibid Section D para 6

<sup>191</sup> Ibid Section D para 9. The UN Norms also require respect for other civil and political rights, such as privacy, education, freedom of thought, conscience and religion, and freedom of opinion and expression. See Section E para 12.

<sup>192</sup> UN Norms Section D Para 7,

with remuneration that ensures an adequate standard of living for them and their families;<sup>193</sup> protection of collective bargaining;<sup>194</sup> respect for the social, economic, and cultural policies of the countries in which they operate;<sup>195</sup> respect for the rights to health, adequate food and adequate housing and other social and economic cultural rights and to refrain from actions which obstruct the realization of those rights.<sup>196</sup>

Another norm deals with security arrangements by multinational companies. It is said that such arrangements ‘shall observe international human rights norms as well as the laws and professional standards of the country or countries in which they operate’.<sup>197</sup> Also business enterprises are further urged to not to supplant the state military and law enforcement services but only provide for their own preventive or defensive services and not to hire individuals known to have been responsible for human rights violations.<sup>198</sup>

This is exactly what TNCs did in the cases of *Wiwa v. Royal Dutch Petroleum Ltd*<sup>199</sup>; *John Doe et al v. Unocal*<sup>200</sup>; and *The Presbyterian Church of Sudan v Talisman Energy and the Republic of Sudan*<sup>201</sup> which were discussed in chapter 3 above.

As evidenced by the above cases, failure to observe the above principles led to the companies’ liability under the Alien Tort Claims Act of the USA regardless of the fact that the company in question did not ‘actively participate’ in the violations. Indeed in the USA, the case of *Joe Doe v Unical Corporation*<sup>202</sup> held that a corporation may be liable even if it has not directly taken part in the alleged violations but has given practical assistance and encouragement to the commission

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<sup>193</sup> Ibid para 8

<sup>194</sup> Ibid para 9

<sup>195</sup> Ibid Section E Para 10

<sup>196</sup> Ibid Para 12. Most of these rights were adopted from the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy 1997 as amended at the 279<sup>th</sup> Session of the ILO Geneva, 17<sup>th</sup> November, 2000: 41 ILM 186 (2002)

<sup>197</sup> UN Norm Section C para 4. See also Amnesty International UK Business Group: Human Rights Guidelines for Companies. London: Amnesty International, (1998) 8-11. This general principle is also found in UN Principles on the Use of Force and Firearms by Law enforcement Officials; the UN Code of Conduct for Law Enforcement Officers, the UN Convention against Torture, and the Rome Statute of the International Criminal Court.

<sup>198</sup> Muchlinski (n 171 above) 523

<sup>199</sup> 226 F 3d 88 (2d Cir. 2000).

<sup>200</sup> 963 F Supp 880 (CD Cal 1997).

<sup>201</sup> 374 F. Supp. 2d 331; 2005 U.S. Dist. LEXIS 11368.

<sup>202</sup> 2002 US App LEXIS 19263 (9<sup>th</sup> Cir 2002), 41 ILM 1367 (2002)

of the crime or tort in question and has actual or constructive knowledge that its actions will assist the perpetrator in the commission of the crime or tort.

Hence, as a way of mitigating human rights risks in project finance, a good starting point could be adherence to the UN Norms, particularly those that have been discussed above. Additionally, firms may go a step further by taking steps towards self assessment and monitoring by addressing human rights concerns as part of their business management strategy, especially when they invest in potentially politically authoritarian or corrupt states or less developed countries like Malawi.

John Ruggie Report (2011)<sup>203</sup> also has guidelines on corporate responsibility to respect human rights. One of the fundamental guidelines provided in the report is that Business enterprises should respect human rights; meaning that they should avoid infringing on the human rights of others and should address adverse human rights impacts with which they are involved.<sup>204</sup> It goes further to state that the responsibility of business enterprises to respect human rights refers to internationally recognized human rights – understood, at a minimum, as those expressed in the International Bill of Human Rights and the principles concerning fundamental rights set out in the International Labour Organization’s Declaration on Fundamental Principles and Rights at Work.<sup>205</sup>

John Ruggie’s Report goes on to state that the responsibility to respect human rights requires that business enterprises should avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur; and that they should seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products or services by their business relationships, even if they have not contributed to those impacts.<sup>206</sup>

As a way of mitigating human rights risks, John Ruggie suggests that business enterprises should have a policy commitment to meet their responsibility to respect human rights; have a human

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<sup>203</sup> UN Doc A/HRC/17/31

<sup>204</sup> Ibid Principle 11

<sup>205</sup> Ibid Principle 12

<sup>206</sup> Ibid Principle 13

rights due-diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights; and have processes to enable the remediation of any adverse human rights impacts they cause or to which they contribute.<sup>207</sup>

Hence, following the framework proposed by John Ruggie in his Report on the issues of human rights and transnational corporations and other business enterprises could be a good way of mitigating human rights risks in project finance.

This follows the contemporary thinking that Multinational enterprises cannot be seen any longer as a sum of fragmented legal entities subject to the jurisdiction of the different states in which they operate but must be seen rather as unitary economic entities which although not endowed with full legal personality as a state or an international organization, must assume a share of responsibility in securing human rights in the conduct of their business abroad.<sup>208</sup>

#### **4.4. Mitigation of Investor Security Risks**

As stated in the preceding chapter, this is a collection of risks that a foreign investor, even in a project finance set up, could face as a result of failure by the host state to meet its obligations. Notable among them is what is termed as political risks which come in the form of nationalization of foreign owned entities, currency inconvertibility and transfer, civil unrests and wars, breach of undertakings by host governments and, different treatment of foreign investors.

There a number of ways through which these risks can be mitigated in project financing, but the general rule is that investors should ensure that all licenses, permits, contracts etc are clearly and unambiguously worded and if not granted for a specified period, they must have express and acceptable grounds for termination.

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<sup>207</sup> Ibid Principle 15

<sup>208</sup> E Gatto, *Multinational Enterprises and Human Rights and Obligations under EU law and International Law*. (2011) 61

#### 4.4.1. Use of Stabilization clauses

A stabilization clause is a term that provides that the contracting state will not change the terms of the investment agreement or contract by legislative action without the consent of the other party to the contract.<sup>209</sup>

Whenever there is a change of regime, there is a tendency in countries like Malawi for new host governments to unilaterally change, review or sometimes terminate the investment contracts that were entered into by the previous government. This is mainly as a result of the perceived corruption in the way such investment ventures came about and allegation of massive benefits that those in power get out of these deals. This is a big risk in project finance because any substantial changes could put the project on the line when a lot of equity has already gone into the project.

Thus, a stabilization clause attempts to keep the legal framework within which the contract has been negotiated and agreed to. This clause forms part of the terms of the contract. This type of clause addresses the future possibility of unilateral contract termination by the state or the imposition of unfavorable and non negotiated terms on the parties. Hence, it is said that the host government's ability to change, through legislative fiat, the terms of the parties' mutual understanding is curtailed through the operation of the stabilization clause inserted in the contract.<sup>210</sup>

While such clauses have been questioned as to their validity and enforceability,<sup>211</sup> it has been argued that such a clause puts the investor in a position of adjusting the contractual terms to reassume the same bargaining position he occupied prior to any legislative change taking place.<sup>212</sup>

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<sup>209</sup> I Goldner, "Arbitration and Public Policy: States and State Controlled Corporations in International Commercial Arbitration." (2000) 7 *Croat Arbit. Yearbook* 159 @ 162

<sup>210</sup> Sarkar, (n 14 above) 260

<sup>211</sup> See for example the case of *Libyan American Oil Company (LIAMCO) v Government of the Libyan Arab Republic* 20 I.L.M (1981) where the arbitrators held that the Libyan government's nationalization was a valid exercise of its sovereign rights despite the existence of a stabilization clause but that the parties were entitled to equitable compensation.

<sup>212</sup> Goldner, (n 209 above) 163

Stabilization clauses could be put in a number of ways. They could be put in the form of a ‘change clause’; a ‘revision clause’; a ‘unilateral change clause’; or a ‘termination for cause clause.’

A change clause permits the parties to renegotiate the terms of the contract to enable the parties to return to their bargained for positions before the changed circumstance took place.<sup>213</sup> A revision clause imposes a duty to renegotiate the salient terms of the contract provided that the duty to do so is well founded, for example where operating costs exceed more than 10% of the initial cost projections.<sup>214</sup> Unilateral change clause imposes a duty on the parties to agree to a change order where unforeseen changes in the contractual performance are necessitated by changed circumstances.<sup>215</sup> The termination for cause clause imposes a duty on the terminating party to establish cause before terminating.<sup>216</sup>

This alley of options insures against political risks in volatile countries such as Malawi.

Under the theory of sanctity of contract, the will of the parties must serve as a foundation of their agreement. Consequently, a stabilization clause, as an expression of the will of the parties, must be upheld. Indeed it was held in the case of *Texaco v Libya*<sup>217</sup> that the effect of the stabilization clause was to limit the state’s sovereignty in relation to its rights over natural resources for the limited time of the concession.

In Malawi, there is already public suspicion and discomfort on how the concessions on the Kayelekera Uranium Mine and the Nsanje World Inland Port were granted. At the time of writing this dissertation,<sup>218</sup> a new government had just been sworn in following the death of President Prof Bingu Wa Mutharika. Since the new regime was not in good books with the late President, this dissertation can only speculate on the future of these concessions. Suffice it to say that this risk could have been mitigated with the use of stabilization clauses.

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<sup>213</sup> Sarkar, (n 14 above) 261

<sup>214</sup> Ibid

<sup>215</sup> Ibid

<sup>216</sup> Ibid

<sup>217</sup> 17 ILM 1 (1978)

<sup>218</sup> April, 2012

#### 4.4.2. Use of Political Risk Insurance

The most common mode of securing against political risk is by taking up political risk insurance. There are a number of organizations which offer political risk insurance but at the multilateral level, there is an organization called the Multilateral Investment Guarantee Agency (MIGA). MIGA was established to –

encourage the flow of investment for productive purposes among member countries and in particular to developing member countries, thus supplementing the activities of the International Bank for Reconstruction and Development, the International Finance Corporations and other international development finance institutions.<sup>219</sup> It provides insurance including coinsurance and reinsurance against non – commercial risks.<sup>220</sup> Its risk coverage includes restriction on currency transfer outside the host country; expropriation and similar measures; breach of contract; war and civil disturbance.<sup>221</sup>

Regarding its advantages, it is said that MIGA –

offers a more comprehensive and complete system of cover which would have the benefit of aggregating investments from many countries and enjoy access to a wider range of reinsurers and coinsurers than national systems; a depoliticized approach to underwriting decisions; consideration of the soundness of the investment and its developmental impact; and a broader role in the creation of a good international investment climate by offering additional specialist advisory services.<sup>222</sup>

To be eligible for cover, investments must be new and originating from a member state but outside of the country in which the investment is made<sup>223</sup>; investment in any developing member country<sup>224</sup> and investors must be organized and have a principal place of business in a member country (other than the country in which the investment is made or be the majority owned by national of member countries.<sup>225</sup> Malawi is a member of the MIGA Convention<sup>226</sup> and it is listed as a developing country in Schedule A to the Convention meaning that projects in Malawi can qualify for MIGA cover.

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<sup>219</sup> Convention Establishing the Multilateral Investment Guarantee Agency (MIGA Convention) of 11 October, 1985 Art. 2

<sup>220</sup> Ibid Art. 2(a)

<sup>221</sup> Ibid Art. 11(a) (i) – (iv)

<sup>222</sup> IFI Shihata, *MIGA and Foreign Investment: Origins, Operations, Policies and Basic Documents of the Multilateral Investment Guarantee Agency*. (1988)

<sup>223</sup> Art 2(a) of MIGA Convention

<sup>224</sup> Art 14 of MIGA Convention

<sup>225</sup> Art 13 of MIGA Convention

<sup>226</sup> Malawi joined the MIGA Convention on 22 April, 1988

MIGA may insure up to \$200 million but has a country cover of \$620 million in place. Hence it stands as a good option for mitigating political risk in project finance in Malawi. However, notable setbacks with MIGA are that the host government has to approve the issuance of cover against the designated risk and that the investor will have to seek appropriate administrative remedies under the laws of the host state before making a claim.<sup>227</sup>

There are also other institutions which grant political risk insurance and where applicable, parties may resort to them as well as a way of mitigating political risk. Among them is the IFC (which provides protection for currency inconvertibility and transfer risk; the World Bank (IBRD) (which covers breach of undertakings by host government); the Asian Development Bank (which covers basically all political risks); the Overseas Private Investment Corporation (established to assist participation by US private companies in economic development in developing countries, emerging democracies and free market economies; Export Credit Guarantee Department of the United Kingdom (provides commercial and political risk insurance to UK exporters, investors and lenders); Japan Bank for International Corporation; and Export Development Corporation of Canada.

There are also private commercial insurance companies which provide political risk insurance such as Lloyds of London; Zurich – American; American International Underwriters and Chubb.

In the absence of political risk insurance, risk of currency inconvertibility could also be mitigated by structuring projects in a way that hard currency revenue streams are captured in off shore jurisdictions.<sup>228</sup>

#### *4.4.3. Going round the MFN and National Treatment Clause*

The case of *Maffezini v Kingdom Of Spain*, supra, exposed the risk that parties may import favourable conditions from other bilateral investment treaties through the use of the MFN and National treatment principles.

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<sup>227</sup> Art 17 of MIGA Convention

<sup>228</sup> Hoffman (n 17 above) 256



As a way of mitigating this risk, one option is to avoid an MFN clause altogether in a BIT or to provide for certain exceptions or limitations to the MFN provision and also to clarify the relationship between the investment treaty and other treaties.<sup>229</sup>

With regard to national treatment, it is said that such provisions could be subject to qualifications and exclusions arising out of the regulatory discretion of the host country under national law.<sup>230</sup>

It is said that for public policy reasons, certain exceptions have always been recognized in this regard and some BITs have even included such provisions.<sup>231</sup>

Another problem with “national treatment” is in relation to market access especially if the BIT national treatment provision covers the pre-establishment phase. This means that if a sector is open to national investors, it must also be open to foreign investors. Consequently, host countries may fail to restrict entry or impose conditions on foreign investors in certain industries. This can be limited by putting a positive or negative list of sectors covered or excluded.<sup>232</sup>

#### **4.5. Mitigation of risks in dispute settlement process**

In our discussion on dispute settlement in the preceding chapter, we mentioned the pros and cons of the various modes of settling disputes. From that discussion, it seems that arbitration is mostly the preferred means of resolving disputes in a project finance arrangement. Among the coercive reasons for arbitration is the aspect of privacy and confidentiality of its proceedings. It is said that privacy can provide flexibility to the arbitrators in receiving evidence and developing compromises and awarding damages<sup>233</sup> without attracting public attention that projects of this nature carry. Privacy also allows the selection of an arbitration panel with experience in project finance especially with risks inherent in developing countries.<sup>234</sup>

Another advantage of arbitration, in addition to being fast and efficient, is its capability to adapt to the complex structure of the financing involving multiple contracts and parties under one

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<sup>229</sup> International Institute for Sustainable Development (n 137 above) 13

<sup>230</sup> Muchlinski (n 171 above) 625 - 6

<sup>231</sup> See German Model BIT

<sup>232</sup> International Institute for Sustainable Development (n 137 above) 14

<sup>233</sup> Hoffman (n 17 above) 415

<sup>234</sup> Ibid

project.<sup>235</sup> Hence, arbitration affords a coordinated approach to the settlement of all disputes under the various contracts in the project.

Another argument in favour of arbitration over litigation is that while there is no multilateral/international regulation for the recognition and enforcement of foreign judgments, a multilateral system for recognition and enforcement of arbitral awards is available under the auspices of the New York Convention.<sup>236</sup> Although Malawi is not a party to the New York convention, it is said that parties in project finance can nevertheless agree that the arbitration award will be enforced in accordance with the Convention.<sup>237</sup>

With the above in mind, and with arbitration selected as the preferred means, this dissertation turns to how the various arbitration clauses ought to be couched in order to avoid risks associated with the dispute settlement process.

#### *4.5.1. Choice of Law*

It is important to provide for the law that would govern the contract. This is in two categories namely; substantive law and procedural law. In substantive law, the parties should agree on the type of law that should guide the contract (e.g. common law or New York law<sup>238</sup>). It is important to look at the local law of the project site before deciding which one is preferable among the parties because for instance, laws relating to remedies available to certain parties defer from jurisdiction to jurisdiction.

In procedural law, this is where the parties choose procedural rules that should govern the arbitration process. Parties may wish to adopt The United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules or indeed adopt their own ad hoc rules to govern the arbitration. This may also include agreeing on the language in which the arbitration will be conducted because failure to agree on a language could have disastrous effects on a project. For example, in the Nsanje Inland Port case of Malawi, the party that was given the concession is Portuguese company. In the event of a dispute, the parties may have to decide whether to discuss in English or Portuguese which might be a source of friction between the parties.

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<sup>235</sup> Ibid

<sup>236</sup> Full name: Convention on the Recognition and Enforcement of Foreign Arbitral Awards

<sup>237</sup> Hoffman (n 17 above) 412

<sup>238</sup> New York being an international business centre has developed its own laws to regulate business activities.

#### *4.5.2. Scope of arbitration*

It is important for the parties to agree on the scope of issues subject to arbitration. It is generally ideal to subject all disputes in a contract to arbitration but where the parties intend to exclude other issues, these issues must clearly be described. This avoids a situation where one contracting party wanting to escape arbitration by arguing that the dispute was not intended to be settled by arbitration.<sup>239</sup>

#### *4.5.3. Choice of forum and Panel*

There is a whole array of institutions that deal with arbitration for transnational projects. The choice of panel or forum is important depending on the availability of qualified arbitrators, the institution's experience with the type of dispute and the industry involved. Whichever institution is selected, it must be stated in the contract that it is the one that will arbitrate on disputes. Among the institutions that conduct arbitration are; the American Arbitration Association (AAA) based in New York City; the International Chamber of Commerce (ICC) based in Paris; the London Court of International Arbitration (LCIA) based in London, the Stockholm Chamber of Commerce for non – western entities looking for an alternative to the ICC or LCIA; and the International Centre for the Settlement of Investment Disputes (ICSID) located in Washington. Prominent among these is ICSID which normally handles arbitration arising from Bilateral Investment Treaties. UNCITRAL) does not administer arbitrations but only provides rules governing arbitrations. The advantages of using these arbitral bodies are manifold. They provide standard rules but still allow choice of language; they provide institutional and administrative support; they monitor conduct of arbitrators; they may enforce time limits; and they may also control fees of arbitrators.<sup>240</sup>

There is also an ad hoc approach. Parties can decide to do the arbitration themselves and select their own arbitrators. Caution should however be exercised before choosing the ad hoc approach because it is best suited for transactions in which all parties are experienced with international arbitration.<sup>241</sup> However, where a foreign government is involved in project finance, institutional

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<sup>239</sup> Hoffman (n 17 above) 416

<sup>240</sup> Riekie Wandrag's Lecture notes. LLM (International Trade and Investment Law), University of Pretoria. November 2011

<sup>241</sup> Hoffman (n 17 above) 412

arbitration is best because it will be difficult for the government to allege that the arbitration process was corrupt or biased.

Another point is that due to the involvement of foreign investors in project finance, it is recommended that the forum selected for arbitration of a dispute should be a signatory to the New York Convention. In general, the New York Convention mandates that signatory countries honor arbitration clauses in agreements subject to this convention; enforce arbitration of disputes covered by arbitration; and recognize and enforce arbitral awards made in other signatory countries without reviewing the arbitrator's decisions.<sup>242</sup> Of course, as alluded to above, non parties to the Convention like Malawi can agree that the arbitration award will be enforced in accordance with the convention.

#### *4.5.4. Res Judicata*

The principle of *res judicata* is to the effect that there must be an end to litigation. The other distinguishing feature of arbitration is that its decisions are normally final, binding, enforceable and not subject to appeal. The contract must specify this aspect and also the fact that arbitration has been selected as the only means of resolving disputes under the project financing arrangement. This mitigates the risk of having an aggrieved party commencing proceedings in the conventional court system in the name of exercise of right to access to judicial remedy which might take forever to be resolved due to the disadvantages inherent in that system. This does not however mean that parties should not seek interim reliefs like injunctions/interdicts in the courts pending the start or conclusion of the arbitration process.

#### *4.5.5. Continuing Performance*

Parties should also agree in the contracts whether performance under their various obligations in the contract would continue or not when a particular issue has been referred to arbitration. This provision is particularly important in project finance because of its reliance on time limits within which certain things have to be done. Any delay because of a dispute on a particular issue could trigger a fatal chain reaction on the project activities.

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<sup>242</sup> Ibid 410

In general, the foregoing are issues that any project finance participant should consider when couching provisions relating to dispute settlement.

## CHAPTER FIVE

### CONCLUSION

#### 5.1. Introduction

The aim of this dissertation has been to expose the various legal risks susceptible in a project finance arrangement and pointing out the ways through which these risks can be mitigated. After introducing the topic and the problem statement in the case of Malawi in the first chapter, this dissertation went on to discuss the concept of project finance in chapter two. An understanding of the concept is very important since project finance is a unique way of funding infrastructural developments. Unlike the traditional ways of lending where the borrower is encumbered to the extent of the debt that he has taken and starts repaying the loan almost immediately, a project finance loan is non recourse in that the debt only starts to be repaid upon completion of the particular development that was being undertaken using revenues generated from the development itself. The collateral for the loan is the project structure itself and does not have to be provided by the project sponsor. Hence, projects that should qualify for project financing should be only those that would be able to generate revenues upon completion. We have seen that this is what makes project finance so attractive especially to developing countries.

From the foregoing, the importance of project finance is apparent to countries such as Malawi who cannot afford large scale infrastructure projects on their own due to budgetary constraints. This mode of financing, if utilized in a proper manner and handled professionally, has the ability to transform this socially and economically underperforming country by providing the necessary infrastructure for sustainable economic growth and development. As part of good project financing, there is need for an understanding of the different key players in a project finance set up including their roles, and expectations. To this end, chapter two also discussed the various players in a project finance arrangement and how they interrelate to achieve the project finance objectives.

## **5.2. Summary of Findings**

Chapter three was a lengthy discussion of the various legal risks associated with project finance. As noted previously, there are various players in a project finance arrangement that need to work harmoniously to achieve the project finance objectives. Firstly, this requires legal ingenuity to put together the necessary documentation and contracts. This calls for an understanding of the formalities of the contract, proper execution of documents, proper crafting of contentious provisions and an understanding of the legal environment where the project finance structure is domiciled. As we have seen, failure to exercise due diligence in this regard is a legal risk.

Secondly, there are legal risks posed by the failure to follow environmental law requirements. Such risks lie in failure to observe local and international environmental standards that might lead to destruction of ecosystems and even injury to human beings. This can attract huge liabilities on the part of the project sponsor or developer through litigation and damage to reputation, which matters might in the end jeopardise the viability of the project. Litigation in the US under the Alien Tort Claims Act is a classic example. Furthermore, investors who do not follow environmental law requirements risk losing or failing to access funding from financial institutions which have set out principles that investors should follow, among them being, environmental standards.

Thirdly, chapter three also discussed the risks that come with failure to observe human rights. Consensus has now been reached that corporations or business entities, even though they are not subjects of international law properly so called, should respect human rights during their conduct of business. Indeed, we have seen that there is a lot of litigation going on in Europe and America against multinational corporations that have been seen to perpetrate human rights abuses in developing countries. Multinational corporations with business interests in Malawi could fall under the same trap if they pay a blind eye to legal risks that come with failure to observe human rights. The chapter attempted to put a comprehensive discourse on this aspect of business and human rights.

Fourthly, the same chapter looked at investor security risks. Most of the projects in our area of study are for large scale infrastructure projects and normally of public or national interest. i.e.

roads, dams, mines, ports, electricity generating plants, railway lines, etc. As such, there is always an element of government interest in these projects and in many cases, the temptation of making them public property. Hence, there is always the risk of nationalisation and a whole range of other political risks such as restrictions on taking revenues out of the jurisdiction of the project site. Sometimes the failure of the host government to meet its obligations also poses a legal risk. The chapter put up a comprehensive discussion on these issues.

Lastly, chapter three looked at the dispute settlement aspect in project finance and the risk associated with it. Disputes almost invariably arise in this area due to the multiplicity of players involved in the arrangement. Indeed, we saw how handling dispute in a particular manner poses a legal risk to the project financing arrangement.

In chapter four, the dissertation pointed out the various ways of mitigating the legal risks which were identified in chapter three. The approach was to discuss mitigating ways of the legal risks that were identified one at a time. Thus, in terms of risks posed by documentation, it has been suggested that parties should agree on the governing law and language of the various contracts; they should ensure proper execution of documents; make a thorough analysis of the remedies available to each party regard being had to the local laws of the project site; and that they should make sure that provisions in contracts are couched in a way that will bring out the true aspect of project financing; and further that the various contracts satisfy the different interests of the stakeholders in the arrangement.

As a way of mitigating environmental law risks, project developer should always bear in mind the link between environmental issues and the concept of economic growth and sustainable development. By that it means present and future generations should also be able to enjoy the fruits of these developments and ecosystems around these projects. Hence, three principles have been recommended to guide sound environmental stewardship namely; the precautionary principle; the preventive principle and the polluter pays principle. These principles are all products of the Rio Declaration. Other ways suggested are regulation by states through national laws and the involvement of non state actors like NGOs; and self regulation by firms themselves through the adoption of the ISO 14000 Series of Environmental Management Standards.



With regard to human rights risks, chapter three concluded that corporations in modern day human rights discourse also have the responsibility to respect human rights and that failure to do so is a legal risk. It was discussed in chapter four that this risk can be mitigated by firms adopting the UN Norms on Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights where at least a set of five obligations have been provided in relation to companies. There is also a framework proposed by John Ruggie, the Special Representative of the Secretary General on the Issue of human rights and transnational corporations where, in essence, he says that business enterprises should have a policy commitment to meet their responsibility to respect human rights.

In relation to other risks in project finance mainly faced by investors especially the political risk associated with nationalizations, unilateral changes of contractual clauses, currency inconvertibility and failure by the host state to meet its obligations, chapter four proposed the use of stabilization clauses which prohibit the host state to change the terms of the investment agreement or contract through legislative action without the consent of the other party to the contract. Another strategy proposed is the taking up of political risk insurance from institutions that provide that kind of cover notably MIGA. This is highly recommended in Malawi due to the extent of political involvement in projects of this nature.

When it comes to dispute settlement, this dissertation, having analyzed the pros and cons of the various modes of resolving disputes, came to the conclusion that arbitration is the preferred mode of settling disputes in project finance. Be that as it may, arbitration itself poses legal risks if parties do not agree on the intricacies of how it should be handled. To this end, chapter four recommended the way arbitration should be structured in project finance. It thus proposed that parties should agree on the choice of law; the scope of arbitration, that is, the issues that will be subject to arbitration and those that will be excluded; choice of forum and panel and the preferred forum for project finance; and clauses to do with finality and enforceability of proceedings as well as whether the parties subsisting obligations will continue before and during the arbitration process.

### **5.3. Conclusion**

From the foregoing, we have seen that project finance is a very good option for achieving infrastructural development in Malawi. Be that as it may, there are inherent legal risks in project finance that ought to be assessed and structured properly. Such risks come about due to failure to put up the right documentation and contracts; the failure to observe environmental standards; the failure to observe human rights; the failure to guard against political risks and other state measures; and lastly the failure to structure the dispute settlement process in a prudent manner.

We have also observed that there are ways by which the risks mentioned above can be mitigated. Indeed, adherence to the recommendations suggested in chapter four could go a long way in ensuring the success of project financed developments. Such successes could be a great attraction for more private investment in Malawi.

This dissertation is therefore commending the various ways of mitigating legal risks in project finance. Although project finance is a multidisciplinary initiative in that some of the intricacies involved in this financing arrangement are not legal in nature, the legal part nevertheless plays a crucial role towards the success of the project as parties derive their rights from legal prescriptions and would always want to enforce their rights through legal means. The importance of the analysis proffered by this dissertation need not therefore be overemphasized. Project finance has proven to be a good and attractive financing option for developing countries such as Malawi. At the same time, it has also given investors access to lucrative infrastructure markets that previously did not exist or were solely done by the governments. Hence, project finance affords a ‘win, win’ situation to both the investor as well as the government and at the same time extends the benefits to the people through the provision of services. There is therefore need to develop these projects in a prudent manner to ensure success which will be another attractive factor for other participants to follow suit. In that way, Malawi would easily achieve its goal of infrastructural development without having to financially invest much itself and hence achieve its ultimate goal of sustainable social and economic development.

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