Towards a Desirable Legal Framework for Attracting FDIs in Sri Lanka

Naomal Goonewardena and Ranali Fernando

I. Overview

A multitude of diverse factors determine the viability and attractiveness of a host country's investment climate. The ability of a country to attract and retain foreign direct investment is dependent upon its political stability, its macroeconomic policies, the quality of its infrastructure networks, skill levels of its labour force, its taxation policies and a host of other interconnected socio-political and economic considerations[1].

The legal framework of a country is one of these critical factors which would influence an investor's decision to invest in a foreign state. A survey conducted in 2007 of 602 Transnational Corporations ("TNC") interviewed investors as to what extent the existence of an international agreement, such as a Bilateral Investment Treaty ("BITs"), impacted their decision on which foreign market to invest in. Approximately one fourth of the TNCs participating in the survey responded that they relied upon BITs "to a very great extent", and another 48 per cent of TNCs used them "to a limited extent", 23 per cent did not use them "at all", with the remaining 9 per cent responding that they "don't know"[2]. This establishes that for a majority of foreign investors, the existence of an international investment agreement of some form plays a role in their decision of investing in foreign markets.

Whilst the conclusion of Bilateral Investment Treaties is a progressive step in ensuring the protection of investors' interests, it is necessary to appreciate that the legal framework of foreign investment law cannot be encoded in a singular instrument or considered in isolation from the rest of a country's legal system. The law applicable to foreign investments is located at the intersection of several branches of law relating to commercial and corporate law, taxation, public policy, financial regulation, property ownership etc.

---

[1] Investment Climate Advisory Services of the World Bank Group, *Investment Law Reform A Handbook for Development Practitioners* (2010) p.1

[2] United Nations Conference on Trade and Development (UNCTAD) *The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries, UNCTAD Series on International Investment Policies for Development* (2009). UNCTAD/DIAE/AI/2009/5 p. 51

One of the first things Governments wishing to attract FDI can do (and should do) is to establish an enabling policy framework for FDI. Of course, they need to recognize that the FDI policy framework is but one of the factors that attract FDI inflows. It is a necessary but not a sufficient condition to influence locational decision. Business facilitation measures –the efficiency and efficacy of the administrative system that impinges on the entry and operations of transnational corporations, as well as investment promotion (including incentives available to foreign investors) can also influence FDI inflows."[3]

In this context, any attempt to evaluate the adequacy of the legal framework for foreign investments cannot be confined to an examination of BITs which are the traditional sources of investment law, but also needs to consider the applicability of the guarantees and protections provided in such instruments in light of the overall workings of the legislative, administrative and judicial organs of the state. Despite the existence of treaty guarantees if the actions of state consistently interfere with the rights of an investor or are not in accordance with the requirements of the rule of law and due process, this would act as a deterrent for the inflow of FDIs.

This article will first examine the various protections and guarantees which are accorded to foreign investors in terms of BITs. This article will then specifically focus on the importance of providing foreign investors with guarantees against arbitrary nationalization, unlawful expropriation, or confiscation of their property which emerges as the primary risk associated with foreign investment. It will explore how expropriation and "taking" of property by the state does not always happen directly but can manifest in multiple forms and consider in what circumstances expropriation may be permissible.

It will then go on to analyze certain administrative actions and legislative enactments in Sri Lanka's recent experience which could be tantamount to unlawful expropriation and/or a violation of the Fair and Equitable Treatment standard which is of fundamental significance to foreign investors. Notwithstanding the existence of international treaty instruments which prohibit the unlawful expropriation of property and attempt to safeguard the interests of

[3] UNCTAD, World Investment Report 1999, Foreign Direct Investment and the Challenge of Development, 1999.

investors, this article underscores the need to minimize the risks involved with "indirect expropriation" of property through a greater emphasis on rule of law and due process in connection with actions of the state which could affect property rights of foreign investors, and highlights this as a necessary transformation which is required to improve investor perceptions and create an environment which is more conducive to foreign direct investments in Sri Lanka.

II. Investor protection mechanisms within the Sri Lankan legal framework

Constitutional Guarantee of BITs

Bilateral Investment Treaties may be considered the most common instrument which is used in contemporary foreign investment law and it is estimated that over 3000 BITs have been concluded globally[4]. Sri Lanka has currently entered into Bilateral Investment Agreements with 28 countries.[5]Sri Lanka has also entered into Double Taxation Avoidance Agreements with 38 countries.[6]

There is a constitutional protection of BITs and Investment Protection Agreements enshrined in Article 157 of the 1978 Constitution of Sri Lanka which provides that;

"…where Parliament by resolution passed by not less than two-thirds of the whole number of Members of Parliament (including those not present) voting in its favour approves as being essential for the development of the national economy any Treaty or Agreement between the Government of Sri Lanka and the Government of any foreign state for the promotion and protection of the investments in Sri Lanka of such foreign state, its nationals or of corporations, companies and other associations incorporated or constituted under its laws, such Treaty or Agreement shall have the force of law in Sri Lanka, and otherwise than in the interests of national security, no written law shall be enacted or made and no executive or administrative action shall be taken in contravention of the provisions of such Treaty or Agreement[7]"

Article 157 therefore accords foreign investors with a guarantee that no legislative, executive or administrative measures would be taken in contravention of any provisions of a BIT except in

[4]Rudolf Dolzer and Christoph Schreuer. *Principles of International Investment Law* (2nd edn. 2012) p. 13
[5]Board of Investment of Sri Lanka. http://www.investsrilanka.com (accessed 31 March 2016)
[6] *Ibid*
[7] Constitution of the Democratic Socialist Republic of Sri Lanka (1978) Article 157

the interests of national security. A detailed analysis of the standard provisions contained in BITs will be discussed in Section III below.

III. Protections offered to Investors in terms of BITs

BITs have grown to be ubiquitous and there is a remarkable degree of uniformity and homogeneity in their scope, structure, and content. This similarity in the substantive clauses contained in BITs tends to demonstrate that certain minimum standards of protection have emerged as almost universal norms which host states are expected to provide foreign investors.

BITs typically contain provisions relating to admission and entry of investments,a guarantee of fair and equitable treatment, a guarantee of most favored nation treatment, full protection and security, prohibitions on expropriation, guarantees of observance of host state assumed obligations, provisions relating to freedom to repatriate "fruits of investment" and recourse to arbitration in the case of disputes. These provisions are often expressed in very similar ways across BITs using relatively identical language[8].

The principal provisions of BITs, which would be the entitlement of any non-resident investor from a state with which Sri Lanka has entered into a BIT with, have been discussed briefly below.

(i) Fair and Equitable Treatment

The Fair and Equitable Treatment standard contained in BITs requires that host states should provide fair and equitable treatment and protection for foreign investments of the other contracting state and take measures to create a favourable environment for foreign investment.

FET standard is intended to protect investors against arbitrary and discriminatory measures taken by the host state. A measure by a host state would be considered to be a breach the FET standard

---

[8]Jeswald W. Salacuse, *The Emerging Global Regime for Investment*, 51 Harv. Int'l L.J. 427, 431 (2010) : Stephan Schill, *The Multilateralization of International Investment Law: The Emergence of a Multilateral System of Investment Protection on the Basis of Bilateral Treaties*, Society of International Economic Law, Working Paper No. 18/08, 7

when it has a crucially negative impact on the investors' property rights or lacks legitimacy or propriety. Discriminatory measures are also often considered as arbitrary, and the two concepts are closely intertwined.

In *Waste Management v. Mexico*[9], ICSID defined FET as follows:

"[T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process."[10]

The Tribunal in *Merrill & Ring* posited the view that FET forms part of customary international law. FET is generally described as "an overarching principle that embraces the other standards of treatment typically found in investment treaties"[11]. Section VI of this article will consider how certain administrative actions and legislative enactments in Sri Lanka during the past decade could be construed as being in violation of the principles of the FET standard.

(ii) National Treatment

The national treatment standard embodied in BITs seeks to ensure adegree of competitive equality between nationals and foreign investors. The purpose of the NT standard is "creating a level playing field"[12] between local and foreign investors. It establishes that the host state must extend to foreign investors treatment that is at least as favorable as the treatment it accords to its own local investors in similar circumstances.

[9] Waste Management Inc. v. United Mexican States, ICSID Case No. ARB (AF)/98/2 (Final Award, 30 April 2004)
[10] *Ibid*
[11] Merrill & Ring Forestry v Canada, Award 31 March 2010, para 187
[12] Rudolf Dolzer and Christoph Schreuer *Supra* Note 4 at p. 198

In *Occidental Exploration and Production Company v. The Republic of Ecuador*[13] Occidental Exploration and Production Company (OEPC), a U.S. company, entered into a participation contract with Petroecuador, a state-owned Ecuadorian corporation. OEPC applied for the reimbursement of the value-added tax (VAT) it had paid on the purchases required to fulfill its terms of the contract. The government refused to reimburse OEPC for the amount of VAT paid. OEPC argued that this was a violation of national treatment principle embodied in the BIT between the United States and the Republic of Ecuador, as all other exporters were entitled to VAT refunds. The arbitral tribunal concluded that the Republic of Ecuador, in denying reimbursement to OEPC, had violated the principleof national treatment.[14]

(iii) Guarantees against Expropriation

An important guarantee provided to Investors in terms of BITs is that investments of nationals and companies of the other contracting state shall not be subject to expropriation, confiscation or nationalization except for any purpose authorized by law and against adequate, effective and prompt payment of compensation. The scope of this guarantee will be examined in detail in Section IV below.

(iv) Repatriation

BITs generally provide that the contracting party shall guarantee to nationals and companies of the other contracting party the free transfer of their capital, returns from investment and any compensation obtained due to expropriation of their property.

(v) Investor–State arbitration

BITs also contain provisions for investor-state arbitration. Sri Lanka is a member of the International Centre for the Settlement of Investment Disputes (ICSID) Convention which was signed on 30 August 1967 and entered into force on 11 November 1967.

---

[13] London Court of Arbitration, Final Award in the Matter of a UNCITRAL Arbitration: Occidental Exploration and Production Company v. The Republic of Ecuador – Case No. UN 3467, July 1, 2004

[14] *Ibid*

ICSID arbitration provides a forum for settlement of investment disputes where the investor may bring a claim directly against a state, in contradistinction to traditional international law, where states were the main participants in international fora.

The provisions of BITs which have been discussed above provide an overview of standards of protection which investors would deem to be of fundamental importance. In the following sections this article will specifically examine the prohibition on expropriation of alien property which is embodied in BITs and consider certain examples of legislative enactments and administrative measures in Sri Lanka's recent past which have been contrary to this fundamental guarantee. Notwithstanding the legal protection encoded in a BIT or other contractual document, if a state has continuously acted in violation of these principles, this would diminish the confidence of a potential investor regarding the security of their investment.

IV. Unlawful expropriation as a predominant concern for foreign investors

The decision to make a foreign investment constitutes a long term commitment on the part of an investor who would be "locking in" substantial funds towards a project or enterprise during the initial stages based on the guarantees provided by the government of the host country in relation to the proposed business of the investor.

"[t]he central political risk which henceforth arises for the foreign investor lies in a change of position of the host government that would alter the balance of burdens, risks and benefits which the two sides laid down when they negotiated the deal and which formed the basis of the Investor's business plan and legitimate expectations embodied in the plan"[15]

The risk that a change in government or a change in governmental policy triggering actions by the executive, legislative or judicial organs of the state which results in a direct or indirect loss or transfer of the ownership rights in connection to their investment, is perceived as one of the main political risks by all foreign investors.

[15]Rudolf Dolzer and Christoph Schreuer *Supra* Note 4 at p. 22

The risk of expropriation may take many forms and in this context, it is necessary to distinguish between direct expropriation and indirect expropriation.

Direct expropriation occurs when the state takes over property owned by an investor located within the territory of the state resulting in a direct deprivation of wealth or property attributable to the State[16]. Nationalisation measures resulting in a wholesale takeover of certain industries or sectors may be cited as an instance of direct expropriation. In the present global context, direct expropriation is rarely witnessed.

Indirect expropriation is the most usual form of expropriation which takes place currently, although there is some debate regarding its precise scope and definition. Indirect expropriation is sometimes referred to as"disguised appropriation"[17] or being "tantamount to expropriation"[18]. It involves the interference with or diminution of title and related rights of the investment without an actual disentitlement or formal divestiture of title. Accordingly, the investor would be deprived from enjoyment of the full benefit of the rights attaching to the investment despite continuing to possess *de facto* title to the investment. For example, government actions which would restrict accessibility of an investor's funds or "fruits of the investment" or which would mandatorily require an investor to sell or transfer property at prices which are far below the market value would be considered to be instances of indirect expropriation.[19]

In the Iran-United States Claims Tribunal[20] which dealt with the appointment of Iranian managers to an American housing project, the Tribunal concluded that an act of expropriation had taken place notwithstanding the fact that there was no transfer of title:

"[I]t is recognised by international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be

[16]M.Sornarajah. The International Law on Foreign Investment (3rd edn Cambridge University Press, 2009) p. 367

[17] *Ibid*

[18]*Ibid*

[19]Rosenn, Keith S. 1998. "Consulting Assistance on Economic Reform (Project), Suggested principles for regulating foreign investment." CAER II Discussion paper, Issue 26.

[20]Starret Housing Corp. v. Iran, 4 Iran-United States Cl. Trib. Rep. 122, 154 (1983).

deemed to have been expropriated, even though the State does not purport to have expropriated them and the legal title to the property formally remains with the original owner".

V. Sovereign right of the state to regulate vs. unlawful indirect expropriation

It should be noted that not every action of the state which has adverse repercussions for investors can be treated as being act of indirect expropriation. There may be legitimate regulatory governmental measures which interfere with or diminish an investors' profits or property rights, which would not be considered as indirect expropriation.

In distinguishing between the rights of a state to impose regulations to accommodate changes in policy and acts which amount to unlawful indirect expropriation, tribunals have generally considered the following criteria i) the degree of interference with the property rights of the investor ii) the purpose and context in which the governmental measures were imposed and iii) the degree of interference of the governmental measure with the legitimate expectations of the investor[21].

In *Micula v the Government of Romania*[22] the Tribunal took the view that the FET Standard incorporated in a BIT would not prohibit a state from later amending its policies provided that the state's conduct was in line with the requirements of substantial propriety and procedural propriety. This involves an absence of arbitrary or discriminatory motivations on the one hand and observation of the rule of law and due process on the other hand.

In *Pope & Talbot*, the Tribunal found that although the introduction of export quotas resulted in a reduction of profits the company, sales abroad were not entirely prevented and the company was still able to make profits and concluded that "…mere interference is not expropriation; rather, a significant degree of deprivation of fundamental rights of ownership is required"[23] Similarly in *S.D. Myers*, a case involving banning the export of PCB waste to the United States.

[21] *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic* (ICSID Case No. ARB/02/1), Decision on Liability, 3 October 2006, para. 189; TecnicasMedioambientalesTecmed S.A. v. United Mexican States (ICSID Case No.ARB(AF)/00/2), Award, 29 May 2003, paras. 161-162; Azurix Corp. v. Argentine Republic (ICSID Case No. ARB/01/12), Award, 14 July 2006, para 361
[22] *Micula v. Romania* ICSID Case ARB/05/20 of 11 December 2013
[23] *Pope & Talbot, Inc v. Canada*, Interim Award (June 26, 2000), paras.96-98.

The Tribunal also distinguished regulation from expropriation on the yardstick of the degree of interference with property rights noting that regulatory measures did not sufficiently impact ownership rights to be deemed acts of unlawful appropriation.[24]

It is also generally accepted that right to expropriate property is an inherent sovereign right and entitlement of any state and there are circumstances where expropriation is both a necessary and justifiable action in view of public purpose[25].Generally, in order to be considered a legitimate exercise of a state's sovereign rights, any expropriatory actions would need to satisfy the following conditions;

(a). It must be to serve a public purpose;
(b). It should not be arbitrary or discriminatory;
(c). The procedure followed must conform to the requirements of due process;
(d). The expropriatory measure taken by the state should be accompanied by prompt, adequate and effective compensation. Adequate compensation is generally interpreted as being the equivalent of the fair market value of the expropriated property

A failure on the part of the state to satisfy these requirements would result in international liability being incurred by the state.

VI. Legislative enactments and administrative measures in Sri Lanka's recent experience which would be tantamount to "indirect taking" and/or a violation of the Fair and Equitable Treatment standard

In considering measures which need to be implemented towards establishing an investment climate that is conducive to investors it is evident that there is a need to look beyond the various BITs and other contractual mechanisms which are in place and consider how actions attributable to the state which amount to indirect expropriation and /or a violation of the FET standard need to be minimized in order to heighten investor confidence.

---

[24]*S.D Myers, Inc. v. Canada*, (November 13,2000) Partial Award, 232. International Legal Materials 408, para. 232.
[25]M.Sornarajah. *Supra* Note 16 at p.136

It is notable that from the 1950s through the 1970s, Brazil was a leading FDI recipient among developing countries, although it did not have any BITs in place[26]. This is a strong indicator that whilst BITs may be important towards guaranteeing investor protection, investors are also significantly influenced by the stability of the legal system and reliability and accountability of the state as a counterparty.

The following illustrations from Sri Lanka's recent history may be cited as instances which resulted in or may have potentially resulted in expropriation of foreign investments and/or a violation of the FET standard. It is important to recognize that while in some of these instances, there may have been no actual divestiture of property for foreign investors since the investors were local, the increase in the perceived risk attaching to existing or future investments, would have diminished the appeal of Sri Lanka as an investment destination and to that extent would be relevant to this analysis. The general notion amongst foreign investors arising from these situations would have been that if such an occurrence could have befallen a local investor they themselves would be equally or more susceptible to a similar fate.

Land (Restrictions on Alienation) Act No 38 of 2014

The Act imposed restrictions on the transfer of lands to foreigners, foreign companies and certain institutions with foreign shareholding[27]. Furthermore, the Act introduced a land lease tax of fifteen per cent which was payable upfront at the time of entering into the lease agreement by the non-resident.[28] The preamble of the Act expressed the position that these restrictions on transfer and leasing of land by non-residents was "deemed expedient and necessary to ensure the prudent use of land which is a limited resource, in a manner that preserves the national interest".

Perhaps the most controversial aspect of the Act was its retrospective operation with effect from 1 January 2013. The introduction of laws with retrospective application although permissible under the present Constitution (with the exception of penal laws), is highly contentious as it results in instability and volatility in the entire system. This Act would have undoubtedly

[26]UNCTAD *Supra* Note 1 p.17

[27]*Land (Restrictions on Alienation) Act No 38 of 2014* Section 2 (1)

[28] *Ibid* Section 6(1)

discouraged potential investors and raised serious concerns regarding the certainty of property ownership rights vested in foreign investors. Whilst it is accepted that there was an administrative announcement of the possible change in the November 2012 Budget, there was no certainty until the Act was passed with regard to the scope of its applicability and hence the concern.

The land lease tax which was imposed by this Act was particularly onerous since foreigners were not only paying the tax but they were also required to pay the tax upfront with the result that one could easily end up paying several multiples of one year's lease rental as tax at the inception of the project itself which would have made the project unviable.

The Revival of Underperforming Enterprises and Underutilised Assets Act No 43 of 2011

The Act sought to expropriate property of thirty seven identified underperforming enterprises or underutilized assets where the land belonging to the state was leased to an enterprise. A press release issued by the Central Bank of Sri Lanka shortly after the passing of the Act attempted to justify this piece of legislation stating that "the Revival of Underperforming Enterprises and Underutilized Assets Act does not, in any way, constitute the nationalization or the expropriation of private assets, but instead, is designed to ensure the productive use of assets that have hitherto been lying abandoned or have been seriously underutilized[29]".

However, it is noteworthy that several properties identified in the Act were located in Free-Trade Zones where agreements had been entered into between such enterprises and the Board of Investment (BOI). Whilst the Act had provisions for payment of compensation to the enterprises whose property were being expropriated, the compensation itself has not yet been paid to several of the enterprises and hence the actions of the state have fallen far short of what could be justified in respect of expropriations (as discussed in Section V above). The nature of this enactment even though limited in scope smacked of 'nationalisation' and the uncertainty relating to rights of ownership has cast a pall over the business environment even as of today.

[29] Press Release issued by the Communications Department of the Central Bank of Sri Lanka dated 17 November 2011

The Lanka Marine Services, Waters Edge and Sri Lanka Insurance Corporation cases

The recent series of cases of Lanka Marine Services[30], Waters Edge[31] and Sri Lanka Insurance Corporation[32] involved the intervention by the Supreme Court in setting aside transactions which were entered into by investors with the Government and state authorities in the course of exercising its fundamental rights jurisdiction. All these transactions had been approved at the level of the Cabinet of Ministers and there had been a multitude of other regulatory approvals which had been obtained as well. Notwithstanding all this the Supreme Court set aside these transactions on the basis of certain incidental approvals or processes not being followed and this cast a severe blow to investor confidence.

Any prudent investor would be entitled to assume that when Cabinet has approved a transaction that it would have satisfied itself that all government functionaries had followed due process and that government approvals have been duly obtained. The problem is further compounded by the fact that Cabinet Memorandum and Cabinet decisions are not public documents and hence an investor is entirely at the mercy of a government functionary with regard to what the Cabinet has approved in relation to a Project.

The facts of these cases have brought to light the failure of administrative bodies to observe the rule of law and procedural propriety when transacting with investors and as mentioned previously, although not all the investors involved in these cases were non-residents, the circumstances which transpired had an adverse impact on investor perceptions.

The impact of Fundamental Rights jurisdiction have not been limited to FDI but has extended to foreign portfolio investment as well where a reputed foreign fund's shares in a listed company were frozen in the *Golden Key* case and only released after a period of more than one year. In a normal civil case if assets have been sequestered wrongfully by a plaintiff there would be remedies for the defendant, but in a fundamental rights case such as the *Golden Key* case such remedies would be virtually non existent.

[30] Vasudeva Nanayakkara V K N Choksy and 30 others SC (FR) 209/2007, Supreme Court Minutes 21 July 2008
[31] Sugathapala Mendis and others V C B Kumaratunge and others SC (FR) No 352/2007 Supreme Court Minutes 8 October 2008
[32] Vasudeva Nanayakkara V K N Choksy and Others SC (FR) 158/2007, Supreme Court Minutes 4 June 2009

Hedging Cases

The hedging cases resulted in high profile litigation involving several foreign banks, Ceylon Petroleum Corporation (CPC) and the Government of Sri Lanka. In the ICSID arbitration of Deutsche Bank AG V. Democratic Socialist Republic of Sri Lanka[33] the defences which were taken up by the state included lack of capacity, lack of authority and supervening illegality. Each of these defences raises serious concerns amongst foreign investors since these are of general application to any foreign investment. The hedging transactions had been discussed and approved at Cabinet level prior to them being entered into and duly approved by the CPC Board. Furthermore, the actions of the Central Bank of Sri Lanka post default by the CPC raised serious concerns with regard to the role of the regulator itself.

Deutsche Bank AG instituted arbitration proceedings in terms of the Germany-Sri Lanka BIT. Deutsche Bank AG claimed that CPC was a willing counter-party which considered the Hedging Agreement to be a binding contract and duly made payments to the Bank up until November 2008, when the Supreme Court and the Central Bank intervened and ordered that no further payment should be made. The Bank claimed that the effect of this was "to substantially to deprive Deutsche Bank of the economic value of the Hedging Agreement, since it was deprived as a matter of fact and under Sri Lankan law, of payment under the Hedging Agreement"[34] and that this constituted a breach of Article 4 (2) of the Germany-Sri Lanka BIT which prohibited expropriation of investor's property. The Bank's position was that the intervention of the Supreme Court and the Central Bank amounted to indirect expropriation of their rights under the Hedging Agreement.

The Government of Sri Lanka took up the position that contractual rights were not capable of being expropriated and only rights *in rem* are capable of expropriation. It further submitted that the actions of the Central Bank and the Supreme Court were legitimate *bona fide* regulatory measures.

The analysis of the Tribunal on these issues was highly pertinent. It stated

[33] ICSID Case No. ARB/09/02 (31 October 2012)
[34] *Supra* Note 33 at Para 496

The present case is a not typical case of regulatory action: the entire value of Deutsche Bank's investment was expropriated for the benefit of Sri Lanka itself. Moreover, as we have determined in the section devoted to fair and equitable treatment, the actions by the Supreme Court and the Central Bank were not legitimate regulatory actions. They involved excess of powers and improper motive as well as serious breaches of due process, transparency and indeed a lack of good faith. It was the Central Bank which encouraged Deutsche Bank to enter hedging agreements with CPC in the first place and which continued to monitor the conclusion of such transactions. Claimant had a legitimate expectation that a validly concluded hedging agreement with CPC would be in force in Sri Lanka and that its contractual rights would not be later interfered by a regulator which was essentially an interested party to the transaction.[35]

The Tribunal found the Respondent to be in violation of Article 4 (2) of the Germany-Sri Lanka BIT. The Tribunal's observations on serious breaches of due process by administrative and regulatory bodies is one the predominant concerns of foreign investors and an aspect which needs to be addressed in order to increase the inflow of FDI into Sri Lanka.

It is noted that an Annulment Proceeding on this award is currently pending before ICSID[36].

Arbitrary taxation regime

Sri Lanka has been ranked 171 out of 189 countries on the "Paying Taxes" section in the global Doing Business survey by the IFC in 2014[37]. This is mainly due to the multiplicity of taxes and the administrative difficulties in paying taxes by SME's. This position however has been compounded by certain periodic arbitrary actions which have directly affected foreign investors. Some of them are outlined below.

The Budget for 2016 announced that the dividend withholding tax exemption which was applicable to foreign investors who had signed agreements with the Board of Investment of Sri Lanka (BOI) before 31 December 1994 would be withdrawn. This would be in breach of the provisions of the BOI Agreements entered into with such investors.

---

[35] *Supra* Note 33 at Para 593
[36] Pending as at 31 March 2016
[37] The World Bank. Paying Taxes 2014. http://www.doingbusiness.org/reports/thematicreports/~/media/GIAWB/Doing%20Business/Documents/Special-Reports/Paying-Taxes-2014.pdf accessed 31 March 2016

The Finance Act No 10 of 2015 which was passed in Parliament on 30 October 2015 imposed a Super Gains Tax calculated at the rate of 25% of the taxable income for the year of assessment 2013/2014 for companies and groups of companies whose profits exceeded Rs 2,000 Mn in 2013/14. This tax resulted in large tax liabilities for most companies for a past year and it was clearly indicative of the arbitrary actions that the Government could take by way of taxation inspite of there being a regular framework for payment of income tax. Furthermore the fact that the proceeds were necessary for the Government to fulfil its election promises adds to the general notion that this could be an indication of things to come whenever there are major elections in Sri Lanka.

The aforesaid Finance Act also imposed a Casino Industry Levy of Rs 1,000 Mn per casino and a Dedicated Sports Channel Levy of Rs 1,000 Mn both of which seem to have been directed levies at particular persons and seem to be both arbitrary and discriminatory.

The Economic Service Charge Act No 13 of 2006 imposed an economic service charge which resulted in several companies which had been given income tax holidays by the BOI in terms of BOI Agreements having to pay tax under another name. This was widely considered as being in violation of the spirit in which investors had been granted concessions by the BOI.

VII. Concluding Remarks

BITs cannot act as a substitute for weak domestic legal and administrative framework in the host country and this appears to be the case for Sri Lanka.

Based on the administrative actions of the Government and the litigation mentioned above the Government seems to have become an unreliable contractual counterparty for foreign investors and it is absolutely essential that such investors be given comfort with regard to the validity of their contracts with the Government.

The saga of the ‘Port City Project” demands that an immediate solution be found. The time may now be opportune for the Government to set up a Contracts Management Authority (CMA) by Statute and it should be manned with independent and professional persons with relevant expertise. The CMA could be responsible for all contracts of the Government of Sri Lanka and State Owned Enterprises (SOE) in excess of a particular monetary value. Before such a contract is signed there should be a certificate issued by the CMA which would be final and conclusive with regard to the capacity and authority of the governmental party and in relation to investments indicative that all approvals have been obtained for the Project other than those specifically mentioned in the certificate. The CMA could include officers from the Attorney General's Department who have been seconded on a full time basis and thus would in actual fact not amount to a duplication of resources. In an era where public servants are not taking decisions for fear of being found fault with, such an Authority could centralize the necessary expertise and facilitate more expeditious contracting.

In summary if the Government wished to attract more FDI it needs to be seen as a reliable counterparty by the investors at large. *Ad hoc* policy changes and arbitrary and discriminatory actions which have impacted investors have eroded the confidence of investors. The regaining of this confidence is more likely to have a greater impact on FDI than a higher ranking on IFC's Doing Business Index which the Government seems to be currently obsessed with.