The Investment Treaty Arbitration Review

Eighth Edition

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PREFACE

This year's edition of *The Investment Treaty Arbitration Review* boasts a number of new chapters. The result is greater coverage and a resource that is even more useful to practitioners.

As before, this new edition provides an up-to-date panorama of the field. This is no small feat given the constant flow of new awards, decisions and other developments in investment treaty arbitration.

Although many useful treatises on investment treaty arbitration have been written, the relentless rate of change in the field rapidly leaves them out of date.

In this environment of constant change, *The Investment Treaty Arbitration Review* fulfils an essential function. Updated every year, it provides a current perspective on a quickly evolving topic. Organised by topic rather than by jurisdiction, it allows readers to access rapidly not only the most recent developments on a given subject, but also the debate that led to those developments and the context behind them.

This eighth edition represents an important achievement in the field of investment treaty arbitration. I thank the contributors for their fine work in developing the content for this volume.

Barton Legum
Honlet Legum Arbitration
Paris
June 2023

Chapter 21

FAIR AND EQUITABLE TREATMENT

Kelvin Poon SC, Matthew Koh, David Isidore Tan, Dennis Saw, Jodi Siah, Natalee Ho and Timothy James Chong[1]

I INTRODUCTION

The fair and equitable treatment (FET) standard remains one of the key protections relied on by investors in investment disputes. Despite the differences in the wording of the FET provisions across treaties, especially bilateral investment treaties (BITs), there appears to be a general consensus on the core content of the FET standard: (1) protection afforded to the legitimate expectations of the investor; (2) protection against arbitrary or discriminatory treatment; and (3) protection against a host state's denial of justice to the investor.

This chapter reviews recent awards that have discussed and applied the FET standard, including another decision involving Russia's actions that led to the bankruptcy of Yukos Oil Company OJSC (Yukos Oil). This chapter also examines a case in which the alleged FET protection was contained in the preamble of the relevant BIT (wherein the tribunal found there was no FET obligation).

II RECENT CASES ON THE PRINCIPLES OF FET

i Muhammet Çap & Sehil

In *Muhammet Çap & Sehil Inşaat Endustri ve Ticaret Ltd. Sti v. Turkmenistan* (*Muhammet Çap & Sehil*),[2] the second claimant, Sehil, was a Turkish company engaged in the construction business. It was owned and controlled by the first claimant, Mr Çap. It was undisputed that different state organs and state-owned companies awarded 64 projects to Sehil through different tender processes between 2000 and 2009, and that 32 of those contracts (the disputed contracts) were the subject of disputes between the parties. While the claimants assert that the actions and omissions of Turkmenistan hampered or impeded the performance of the disputed contracts, Turkmenistan contended that the claimants violated those contracts by failing to perform their contractual obligations.

Regarding the claims for breach of the FET standard, the main issues were whether the 1992 Turkey–Turkmenistan BIT imposed an FET obligation in the first place and, if there was an FET obligation under the BIT, whether this obligation was breached.

1 Author is a job title at firm.

2 *Muhammet Çap & Sehil Inşaat Endustri ve Ticaret Ltd. Sti v. Turkmenistan*, ICSID Case No. ARB/12/6, Award, 4 May 2021.

The first issue arose because the only reference to the FET standard was in the preamble to the BIT, which acknowledged the state parties' agreement that 'fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources'.

The claimants argued that the BIT envisages the existence of an FET standard not only by way of the clause granting most-favoured nation (MFN) protection, but also through the reference to FET in the preamble. They argued that this was the case given the context of the aim of encouraging the inflow and retention of foreign investment, which was evident from the explanatory note to Turkey's draft law on ratification of the BIT.

Relying on the 1969 Vienna Convention on the Law of Treaties (VCLT), the claimants contended that the preamble of an international convention does not merely contain exhortative or hortatory statements, but that the preamble is part of the text of the treaty. The fact that the term 'fair and equitable treatment' is contained in the preamble means that, at a minimum, they form part of the object and purpose of the treaty. The claimants submitted that, since the VCLT mandates that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose of the treaty, the Tribunal must give effect to the ordinary meaning of the term 'fair and equitable treatment' contained in the Treaty. They contended that this was supported by the principle of effectiveness, an established principle of international law that posits that a treaty should be construed to display a proper – if not the maximum – degree of effectiveness.

Finally, the claimants relied on the fact that, at the time of conclusion of the BIT, the state parties to the BIT were not sophisticated negotiators, as also noted by the tribunal,[3] and that Turkmenistan, therefore, lacked enough experience to evaluate the importance of some substantive protection standards crucial for attracting investments, and the parties could not possibly have intended to exclude importation of an FET obligation.

The respondent rejected the claimants' submission that an FET obligation could be inferred from the preamble of the BIT, as preambles were 'hortatory statements and do not contain independent binding obligations'.[4] In this regard, preambles to treaties 'only provide context for interpreting the ordinary meaning of the terms of a treaty'[5] and cannot be viewed as capable of creating binding legal effects upon parties.

The respondent relied on the conclusion of the *İçkale v Turkmenistan*[6] tribunal that rejected the attempt to create a binding FET obligation from the preamble to the BIT, concluding that a preamble 'cannot be relied upon as a source of independent or free-standing legal rights or obligations'.[7] Further, the respondent submitted that the fact that 'FET is not included in the obligatory clauses of the BIT setting forth the substantive duties agreed to by the States, shows that the States were cognizant of the concept, but deliberately chose not to include it as a binding obligation'. Finally, the ordinary meaning of the words used in the

3 ibid, Decision on Respondent's Objection to Jurisdiction under Article VII(2), 13 February 2015, Paragraph 575.

4 ibid., Award, 4 May 2021 Paragraph 577.

5 ibid.

6 *İçkale İnşaat Limited Şirketi v. Turkmenistan*, ICSID Case No. ARB 10/24, Award, 8 March 2016.

7 ibid., Paragraph 337.

preamble, namely that FET of investment is 'desirable', could not reasonably be interpreted as imposing a binding obligation on the states to guarantee FET, as mandatory language is absent.

The tribunal held in favour of the respondent. It held that, in the absence of a specific provision in the BIT itself providing for FET, the preamble itself cannot create a free-standing obligation to accord FET. It agreed with the respondent's submissions that the fact an FET obligation was not expressly included in the BIT, and the preamble only referred to FET being desirable, was a clear indication that FET was not agreed.

In the tribunal's view, the claimants' argument regarding the FET obligation comprised conferring on the preamble a normative value from which a binding obligation could be derived. That interpretation ran contrary to the customary rules of interpretation as codified by the VCLT. The tribunal accorded with other tribunals that had held that a preamble 'cannot be relied upon as a source of independent or free-standing legal rights or obligations'.[8] The claimants' reliance on supplementary means of interpretation – in particular, Turkey's draft law on ratification of the BIT – cannot turn the hortatory and aspirational language of the preamble into a binding obligation.

As the tribunal found that there was no obligation to accord FET, it did not go on to consider the second main issue (i.e., whether an FET obligation was breached).

ii Yukos

Yukos Capital SARL v. The Russian Federation (*Yukos*)[9] is one of the arbitration proceedings involving Russia's well-known launching of tax evasion criminal proceedings that led to the bankruptcy of Yukos Oil. The claimant was Yukos Capital Ltd (formerly Yukos Capital SARL), a private company existing under the laws of the British Virgin Islands (Yukos Capital). The dispute concerned the Russian government's alleged expropriation of Yukos Capital's investments in its indirect parent company in Russia, Yukos Oil and the Russian government's allegedly unfair and discriminatory treatment of Yukos Capital.

Yukos Capital had advanced two loans to Yukos Oil on 2 December 2003 and 19 August 2004 (the loans). On 25 October 2003, Mr Mikhail Khodorkovsky, the CEO of Yukos Oil, was arrested on charges of fraud, embezzlement and tax evasion. The Russian government also commenced various proceedings against Yukos Oil in relation to its alleged tax liabilities, including the auction of Yuganskneftegaz (YNG), the largest of the three primary oil production companies owned by Yukos Oil. At the time of the auction on 19 December 2004, YNG accounted for around 60 per cent of the oil production of the Yukos group of companies. The auction was won within a few minutes by a company that was eventually found to have been funded by the then-Russia-owned oil company Rosneft OJSC (Rosneft). On 23 December 2004, President Putin acknowledged the practical nationalisation of YNG at a press conference on 23 December 2004.

Following the auction of YNG, Yukos Oil stopped making payments under a US$ 1 billion loan agreement that it had entered into with a consortium of western banks (the western banks) in September 2003 (the syndicate loan). On 13 December 2005, the western banks concluded an agreement with Rosneft in relation to the syndicate loan. The

8 ibid.
9 *Yukos Capital SARL v. The Russian Federation*, PCA Case No. 2013-31, Final Award, 23 July 2021.

effect of this agreement was that Rosneft would pay the outstanding debt under the syndicate loan; in return, the western banks would assign their rights as lenders to Rosneft and initiate enforcement and bankruptcy proceedings against Yukos Oil.

On 6 March 2006, the western banks filed an application requesting that Yukos Oil be declared bankrupt. On 29 March 2006, the Moscow Arbitrazh Court commenced bankruptcy proceedings against Yukos Oil based on the syndicate loan and formalised the replacement of the western banks with Rosneft as the applicant. Yukos Capital, as a creditor of Yukos Oil pursuant to the loans, filed applications with the Moscow Arbitrazh Court to include its claims in the register of creditors of Yukos Oil. The applications (and subsequent appeals) were all dismissed by the court. During the proceedings initiated by Yukos Capital, Russia's General Prosecutor's Office (GPO) also initiated a case against the company and its officers, conducting a search of the offices of Yukos Capital's Moscow attorneys, seizing documents in those offices and interrogating one of the attorneys at the firm.

Yukos Capital's claim in this case was that Russia, through its various actions against Yukos Capital and its parent Yukos Oil, expropriated Yukos Capital's investment (constituted by the loans) and failed to afford it FET, in breach of Articles 10 and 13 of the Energy Charter Treaty (ECT). Russia's defence was that its actions were legal and, therefore, did not amount to expropriation under the ECT and that Yukos Capital's investments were illegal under both international and domestic law and thus not entitled to protection.

The tribunal held that Russia had, in breach of Article 13 of the ECT, expropriated Yukos Capital's investment by taking its loans without due process or compensation.[10] As regards Yukos Capital's claim for breach of a guarantee of FET (which fell under Article 10 of the ECT), the tribunal opined as follows:

a There was a difference between an expropriation claim and a denial of justice claim (like a claim for breach of a guarantee of FET); the former is concerned with a substantive deprivation of property, while the latter is 'concerned with the process of decision-making by the State and its effect upon the investor'.[11]

b However, a constituent requirement of the ECT protection from expropriation under Article 13 is that any taking must be 'under due process of law' and 'not discriminatory', meaning that the tribunal must consider the process of decision-making by the state as part of its evaluation of whether there had been a breach of Article 13.[12] In particular, it held that where 'the impugned acts of the State include judicial acts, this means that it will be necessary for the conduct of the judiciary to be assessed according to the same standard and applying the same factors as would arise in a denial of justice claim'.[13]

c The tribunal, therefore, would have considered the question of whether Russia accorded Yukos Capital's investment 'due process or law' and whether any taking was or was not 'discriminatory' for the purpose of its assessment of the claim of expropriation under Article 13 of the ECT. In the circumstances of this case, it would only be if the tribunal were to reach the view that the claim did not otherwise constitute a breach of Article 13

10 ibid., Paragraph 898(1).

11 ibid., Paragraph 380.

12 ibid., Paragraphs 381 and 390(iv).

13 ibid., Paragraph 381.

of the ECT (as, for example, if the tribunal were to take the view that the act did not constitute a taking) that it would be obliged to go on to consider whether there was, in the alternative, a breach of Article 10 of the ECT.[14]

In coming to its decision that there had been a breach of Article 13 of the ECT, the tribunal held as follows:

a There was an absence of due process of law in Russia's treatment of Yukos Capital's claims in the bankruptcy of Yukos Oil, as Yukos Capital was 'never afforded a proper opportunity to have its claim considered and admitted'[15]; instead, Yukos Capital was 'subjected to a series of actions, both by the [Russian] courts and the prosecutorial authorities, which precisely foreclosed that opportunity'.[16] Among other things:
- the tribunal could find 'no indication of an independent judicial consideration' in the Moscow Arbitrazh Court's dismissal of Yukos Capital's proof of debt;[17]
- the criminal proceedings brought against Yukos Capital were based on a 'demonstrably incorrect' ground, and ordered 'without independent examination' on the part of the GPO;[18]
- the search and seizure of the files, and interrogation, of Yukos Capital's lawyers left Yukos Capital 'without effective legal representation';[19] and
- Yukos Capital's application to be entered in the register of creditors was terminated without a substantive determination of the validity of the loans or Yukos Capital's rights thereunder.[20]

b Russia's actions in excluding Yukos Capital from the creditors of Yukos Oil were discriminatory. The tribunal held that, having reviewed the record of decisions by the Russian courts, and considered the expert evidence adduced by both Yukos Capital and Russia, it could find 'no valid reason for the exclusion of [Yukos Capital's] claims in the bankruptcy', when the claims of other Yukos subsidiaries that had been or were subsequently acquired by Rosneft (including YNG) were admitted.[21]

c The tribunal also relied on additional evidence of a 'concerted campaign' against the Yukos Group, including Russia's actions toward third parties to the case, as corroborating its finding that Russia had expropriated Yukos Capital's investment of funds under the loans.[22] Although the tribunal acknowledged that it was concerned only with the claim of Yukos Capital, it nevertheless held that it was entitled to consider the evidence adduced before it in relation to the treatment of the Yukos Group as a whole 'to the extent that it may be relevant to the allegation that the treatment accorded to Yukos Capital was part of an orchestrated campaign on the part of [Russia] against the Group'.[23]

14 ibid., Paragraph 385.
15 ibid., Paragraph 452.
16 ibid.
17 ibid., Paragraph 442.
18 ibid., Paragraph 443.
19 ibid., Paragraph 444.
20 ibid., Paragraph 451.
21 ibid., Paragraph 459.
22 ibid., Paragraph 485.
23 ibid., Paragraph 464.

In view of its finding on Article 13 of the ECT, the tribunal found it unnecessary to determine Russia's liability under Article 10 of the ECT (i.e., for a breach of the FET guarantee).[24]

iii Big Sky Energy

In *Big Sky Energy Corporation v. Republic of Kazakhstan* (*Big Sky Energy*)[25] the claimant brought claims under the Treaty between the United States of America and the Republic of Kazakhstan Concerning the Encouragement and Reciprocal Protection of Investment. In 2003 and 2005, the claimant had entered into two sale and purchase agreements (SPAs), pursuant to which it allegedly purchased 100 per cent of the shares in an oil and gas company, Kozhan; however, the first SPA for a 90 per cent interest was invalidated on the basis that the sellers' spouses had not provided notarised consent to the sale, and the claimant's 10 per cent stake was executed against by the respondent in recovery of a judgment debt arising out of earlier court proceedings.

The claimant alleged, among other things, that the courts and authorities of the respondent state expropriated its interests in Kozhan, that it had been the victim of denial of justice and that the FET standard had been breached.

The tribunal first considered the claimant's denial of justice claim and dismissed it in full. The claimant raised 14 different grounds for alleging that there had been a denial of justice.[26] The tribunal considered each of those grounds and, on the facts, concluded that none of the grounds constituted a breach of international law. Even though the tribunal acknowledged that it had questions about the manner in which the respondent's courts had conducted themselves in some instances, the tribunal did not think that any of the questionable conduct rose to the level of a denial of justice and a breach of international law.[27]

The claimant proceeded to argue that the FET standard prohibited arbitrariness and required due process and predictability in a legal framework, and therefore even if the respondent's conduct did not rise to the level of a denial of justice, it could amount to a breach of the FET standard.[28]

The tribunal observed that the claimant's FET claim was premised on the same alleged acts and omissions of the respondent's courts, which the tribunal had already held did not constitute denial of justice.[29] It noted that, regardless of whether the claimant framed its claims as a denial of justice or a breach of FET, the claimant had to establish that the respondent's conduct was wrongful because it was arbitrary, lacking in procedural fairness and due process, not transparent or not in good faith;[30] however, the tribunal had already held, as part of the due process analysis, that the respondent's courts had not acted wrongfully under international law and the tribunal, therefore, had taken into account whether, among other

24 ibid., Paragraph 898(2).

25 *Big Sky Energy Corporation v Republic of Kazakhstan*, ICSID Case No. ARB/17/22, Award, 24 November 2021.

26 ibid., Paragraph 363.

27 ibid., Paragraphs 506, 516, 519, 524 and 541.

28 ibid., Paragraph 530.

29 ibid., Paragraph 529.

30 ibid., Paragraph 532.

things, the courts' decisions, actions and omissions were arbitrary, lacking in due process or lacking in good faith.[31] In addition, the tribunal concluded that the respondent could not be said, overall, to have lacked good faith or failed to exercise due diligence.[32]

The tribunal also dismissed the claimant's attempt to rely on the MFN clause in the BIT to apply a provision in the Kazakhstan Investment Law that entitled an investor to damages if the respondent's state body were to commit an act conflicting with the respondent's legislative acts or as a result of an illegal action. The tribunal noted that even if this standard were applicable, there were no actions on the respondent's part that were illegal or wrongful so as to breach this provision.[33]

In conclusion, the tribunal dismissed the claim for breach of FET, finding that it was simply not actionable as there was no wrongful conduct at the level of international law.[34]

iv MOL

MOL Hungarian Oil and Gas Company Plc v. Republic of Croatia (I) (*MOL*)[35] marks the second of two arbitrations initiated in the *MOL v. Croatia* saga.[36] In this case, MOL initiated proceedings under the Arbitration Rules of the International Centre for Settlement of Investment Disputes against Croatia. MOL is a Hungary-incorporated multinational oil and gas company. It is also the major private investor of Industrija Nafte dd (INA), Croatia's largest energy company. Croatia held a substantial portion of the remaining shareholding in INA. In 2009, the parties amended the shareholders' agreement, pursuant to which MOL was given control over INA and Croatia agreed to take over INA's gas storage facilities and the business of gas sales.

Among other allegations, MOL brought its claims under Article 10(1) of the ECT. It alleged that Croatia had breached its obligations of FET and non-impairment and failed to observe obligations entered into with an investor or investment of another party.[37] In this regard, MOL also made a claim in relation to the state's failure to sufficiently liberalise the Croatian gas market and to follow through with the agreed plan to relive INA of its loss-making gas supply business while protecting its own social objectives.

The state argued that there must be an express undertaking towards the investor to found the basis for an FET claim under the ECT; however, the majority of the tribunal was not persuaded. First, the state's argument elided the central fact that, in the cases relied on, the investor was asserting a duty on the part of the host state to maintain a regulatory or legislative framework. MOL's argument was the opposite: it was relying on change in the regulatory framework. Second, in the cases relied on by the state, the purpose of the investment was to enter a foreign market under the terms of a regulatory regime; however, in

31 ibid., Paragraph 533.

32 ibid., Paragraphs 534–535.

33 ibid., Paragraph 536.

34 ibid., Paragraph 537.

35 *MOL Hungarian Oil and Gas Company Plc v. Republic of Croatia (I)*, ICSID Case No. ARB/13/32, Award, 5 July 2022 (*MOL*).

36 The other arbitration being *Republic of Croatia v. MOL Hungarian Oil and Gas Company Plc*, PCA Case No. 2014-15, which was instituted under the Arbitration Rules of the United Nations Commission on International Trade Law.

37 *MOL*, Paragraph 570.

this case, the foreign investor (MOL) was being invited to take a share in a fully functioning domestic activity as a key part of a process to effectuate a change in the way that the activity would function.

The majority proceeded to analyse whether there was a breach of the FET guarantee.

First, in respect of the gas pricing and supply until 2013, it was clear to the majority that the state had failed to fulfil the understandings and commitments on the liberalisation of the Croatian gas market and the movement of regulated consumer gas tariffs towards market prices. It was also evident that INA's gas supply business was inherently loss-making, owing to the state's public service obligation (PSO) plus tariff regime. Further, it was not disputed that the state deliberately chose not to fulfil its side of the agreed solution, even while MOL kept to its own side of the bargain, including a substantial further injection of funds to rescue INA from potential collapse. Given the above, the majority found that the state's deliberate failures constituted a breach of the guarantee of FET under Article 10(1) of the ECT.[38]

Brigette Stern (the minority) took a different view. She was of the view that MOL's assumptions about an envisaged liberalisation could not translate to a special commitment on the state's part, which was necessary to establish a legitimate expectation. She noted that MOL's expectations were quite different from its memorial, in which it stated that: 'Notwithstanding Croatia's commitment to gas market liberalization, MOL considered that INA's gas business bore high regulatory risk, because the gas price increase that liberalization would entail was expected to be "politically sensitive"'.[39] Separately, in relation to the state's failure to buy both the gas supply company and the gas storage company, Stern was of the view that the envisaged sale was exclusively rooted in contract, for which the majority had already decided that it had no jurisdiction over. As such, she did not consider the gas pricing and supply until 2013 to constitute a violation of the ECT.

Second, regarding the gas pricing and supply from 2014, the issue was whether the revised tariff agreements constituted discrimination against MOL's investment and for the benefit of an entity owned by the state. The claimant argued that virtually all requests for increases in gas tariff pricing were turned down, until PSO was transferred to a Croatian state-owned enterprise, HEP.[40] Further, the associated requirement for INA to supply specified volumes of gas to HEP at a mandatory price caused INA to continue with a loss-making activity. The state attempted to justify its measures by explaining the need to substitute Prirodni Plin (PP) (i.e., the resulting gas storage and gas trading company, following the unbundling from INA) with HEP into the gas supply chain; however, it was evident to the tribunal that the 2014 gas pricing and supply measures were directed at INA and PP. Accordingly, it held that the gas pricing and supply measures constituted a breach of both the guarantee of FET and non-impairment.[41]

Finally, in relation to the 2014 gas storage regime, the state included a further requirement on Podzemmo skladiste plina d.o.o. (PSP) (a subsidiary of INA) to allocate 70 per cent of its storage capacity to HEP. This created radically altered circumstances for those competing businesses with the remaining 30 per cent. Eventually, PP was allocated only 10 per cent of what it had bid for and was left with quantities that exceeded a very substantial

38 ibid., Paragraph 630.

39 ibid., Paragraph 631.

40 ibid., Paragraph 633.

41 ibid., Paragraph 635.

margin of the storage it has been allocated.[42] Ultimately, it had to face a forced auction sale. HEP withheld its bid until the final day and was able to buy a substantial volume of gas well below market prices. The tribunal had no doubt that the circumstances revealed a breach of the twin guarantees of FET and of non-impairment under Article 10(1) of the ECT. It was of the view that when the different policy was implemented to transfer the PSO to HEP, radically restructure the storage regime and impose on INA, through PP, a fresh supply obligation to HEP at regulated prices, it became incumbent on the state to devise an arrangement by which PP could, on FET terms, dispose within a reasonable time of the gas it held in storage.[43]

Having found the above breaches, the tribunal considered the issue of damages. In respect of the gas pricing and supply measures, the majority adopted a blend of the cost-plus approach to that proportion of the gas supply to HEP. This resulted in an award of damages of US$167.84 million.[44] Regarding the gas storage measures, the tribunal accepted the analysis put forth by MOL's expert, which was computed on the basis of a current market price determined by the purchase costs of imported gas plus its transportation to the Croatian border. Taking into account the action sales, with some adjustments and interests, the figure amounted to US$18.2 million.[45]

v Gramercy

Regarding the case *Gramercy Funds Management LLC, and Gramercy Peru Holdings LLC v. The Republic of Peru* (*Gramercy*),[46] in the 1960s and 1970s, the Peruvian government issued land reform bonds as compensation to expropriated landowners. Under the bonds, the bondholders had the right to claim an annual payment comprising part of the principal and the interest accrued for a period of 20 and 30 years from the Peruvian government. In 1979, the bonds became freely transferable. The claimants had acquired the bonds from their original bondholders between 2006 and 2008.

The bonds were rendered worthless following hyperinflation and currency changes[47] and the promulgation of a number of decrees, as follows:

a In 1991, President Fujimori issued a decree that provided that the value of the expropriated land had to be repaid at market value.

b In 1996, President Fujimori's decree was reversed, and Law No. 26,597 was passed. The Law established that the bonds would be paid at face value (which was practically worthless). The constitutionality of Law No. 26,597 was challenged.

c In 2001, the constitutional challenge was successful. The Constitutional Court found, among other things, that Law No. 26,597 had breached the general principle of Peruvian law enshrined in Article 1236 of the Civil Code that seeks to preserve the value of a debt and protect it against inflation. Law No. 26,597 sought to exclude the bonds from the readjustment for inflation, which was contrary to Article 1236.

42 ibid., Paragraph 637.

43 ibid., Paragraph 639.

44 ibid., Paragraphs 650 and 652.

45 ibid., Paragraph 655.

46 *Gramercy Funds Management LLC, and Gramercy Peru Holdings LLC v. The Republic of Peru*, ICSID Case No. UNCT/18/2 (*Gramercy*), Final Award, 6 December 2022.

47 Between the 1960s and the 1990s, Peru's economy experienced hyperinflation, which led to two currency changes to counter inflation.

While the constitutional challenge was successful, the Constitutional Court did not provide any guidance on how the revaluation was to be made (i.e., whether by dollarisation, application of the consumer price index or some other financially appropriate methodology).

d Between 2001 and 2011, there were several attempts by Congress to provide the methodology on how the bonds were to be revalued, although those attempts did not come to fruition.

e On 16 July 2013, the Constitutional Court issued a resolution,[48] which established that the bonds should be revalued applying a dollarisation methodology and provided that Peru's Ministry of Finance (MEF) would regulate the procedure for the registry of bondholders, for the quantification and revaluation of the bonds and for the payment of the debt.

f In 2014, the MEF issued two decrees (the 2014 decrees) to comply with the Court's orders.

g In 2017, the MEF issued a new decree (Supreme Decree No. 34/2017), which derogated from the 2014 decrees.

The tribunal in *Gramercy* found that Peru had breached the FET standard provided for under Article 10.5 of the Peru–USA Trade Promotion Agreement (TPA), as the formulas used in the supreme decrees were arbitrary and irrational, and the bondholder process was arbitrary in design and a complete failure in execution.[49]

As a starting point, the tribunal found that the FET standard under Article 10.5 of the TPA was the FET standard as understood under customary international law (CIL) and was to be applied given the express reference to the CIL standard.[50] Under CIL, the FET obligation protected investors against arbitrary actions by the host state;[51] however, the tribunal stressed that the threshold for finding arbitrariness is high.[52] It further defined 'arbitrariness' as 'prejudice, preference, bias and lack of reason [being] substituted for the rule of law and proper procedure'.[53]

In finding that the formulas used in the supreme decrees to revalue the bonds were arbitrary and irrational, the tribunal analysed, among other things, the MEF's calculation of the parity exchange rate (PER)[54] and applicable interest rate. In relation to the PER, the tribunal noted that the Constitutional Court ordered that the revaluation of the bonds be carried out by applying the parity exchange rate between soles and US dollars, although the

48 Resolution No. 00022-1996-PI/TC July 2013.

49 While there was a dissent by Professor Stern, her dissent was limited to the tribunal's jurisdiction, wherein she observed that the tribunal lacked jurisdiction as the commencement of the arbitration was an abuse of process. See Stern's dissent in *Gramercy*, Dissenting Opinion of Brigitte Stern, 6 December 2022, Paragraphs 1–4.

50 *Gramercy*, Final Award, 6 December 2022, Paragraphs 814–815 and 823–825.

51 ibid., Paragraphs 822 and 833–835.

52 ibid., Paragraphs 822 and 836–838.

53 ibid., Paragraphs 830–832. The tribunal cited, with approval, Paragraphs 262-263 of *Joseph Charles Lemire v. Ukraine (II)*, ICSID Case No. ARB/06/18, Decision on Jurisdiction and Liability, 14 January 2010.

54 The parity exchange rate refers to the rate of exchange between two currencies that makes their purchasing power substantially equal. For example, if a basket of goods and services in Peru costs 10 soles, and the same costs US$5 in the United States, the parity exchange rate between both currencies is two. ibid., Paragraphs 850–852.

Constitutional Court did not provide further guidance on the calculation and application of the PER.[55] The MEF had successively provided three starkly different methodologies to calculate the PER in Supreme Decrees Nos. 17/2014, 19/2014 and 242/2017.

In calculating the PER between the Peruvian sol and the US dollar, the first step is to determine an appropriate base period. The selected base period should be relatively uneventful years during which the two countries experienced fairly low and stable inflation, no major economic or political changes, and sustainable balances on their external accounts.[56] In Supreme Decree No. 17/2014, the base period the MEF selected was 1950 to 1982;[57] however, Supreme Decree No. 19/2014, which was published four days after the issuance of Supreme Decree No. 17/2014, derogated from the formula in Supreme Decree No. 17/2014, and created two new, separate formulas.

There were two significant issues with the formulas in Supreme Decree No. 19/2014. First, the two new formulas had a different base period of 1950 to 2013. There was no explanation for this change, although the claimants' expert had criticised the change, as the additional period between 1983 and 2013 included a period of hyperinflation into the calculation, which was antithetical to the principles for selecting an accurate base period. Second, the formulas contained significant mathematical errors, which had not been rectified for more than three years.[58]

The mathematical errors were not corrected, even when Peru issued Supreme Decree No. 34/2017, which sought to 'correct' the mistakes by additional explanations and not modify the formulas. Instead of clarifying the PER, these additional explanations created more ambiguities that allowed for six different interpretations and dramatically different estimates of the PER.[59]

Subsequently, the MEF published Supreme Decree No. 242/2017, which derogated from the three preceding Supreme Decrees and their formulas. The tribunal found that there were two elements[60] in the formula that were arbitrary:

a An unreasonable base period was used, which resulted in an unreasonably high PER, which, in turn, resulted in an unreasonably low valuation of the bonds in US dollars. The MEF had decided to reduce the base period from 63 years in Supreme Decree No. 19/2014 to one month (January 1969) in Supreme Decree No. 242/2017. In January 1969, Peru had a fixed exchange rate policy, high inflation and political and economic instability. In that month, Peru had also made the decision to peg the Peruvian sol to the US dollar, and the exchange rate was not floated until 1990. This meant that the Peruvian sol–US dollar exchange rate in January 1969 did not change in step with relative inflation in Peru and the United States. The tribunal, therefore, found that the selection of January 1969 as the base period was motivated by the MEF's desire to artificially increase the PER for the conversion of the bonds into US dollars, thereby reducing Peru's outstanding debt by approximately US$40.7million.

a This unreasonably high PER was only used when converting the bonds from Peruvian soles to US dollars. To convert back to Peruvian soles (the currency in which bondholders

55 *Gramercy*, Final Award, 6 December 2022, Paragraph 849.

56 ibid., Paragraph 852.

57 ibid., Paragraph 853.

58 ibid., Paragraphs 855–858.

59 ibid., Paragraphs 857–858.

60 ibid., Paragraphs 861–893.

are paid), the formula then adopted the much lower market exchange rate. The tribunal found that the inconsistent application of the PER had further reduced the amount due to the bondholder. The arbitrariness of this measure was amplified by the fact that there was no explanation for the inconsistency.

In calculating the interest owed to the bondholders, the tribunal held that the MEF's determination of the dates that interest under the bonds started to accrue was arbitrary. The Constitutional Court had stated that interest should start accruing on the date of revaluation into US dollars, which coincided with the date of the issuance, and cease when Peru actually paid the bondholders. Under Supreme Decree No. 242/2017, the MEF decided, without any explanation, that interest ceases to accrue on the date when the MEF calculates the revaluation, thereby depriving bondholders of the interest accruing between the date of revaluation and the date of actual payment by Peru.

In relation to the bondholder process, the tribunal found that certain elements of the procedure for payment established by the MEF were arbitrary, and the treatment of speculative investors was arbitrary. Regarding the payment procedure, the MEF had decided to limit the bondholder's entitlement to a cash payment to just 20 per cent of the total debt, with the remaining debt to be settled by either delivery of land or shares to the bondholders. The tribunal held that the MEF's unreasonable limitation of the cash payment and the MEF's right to impose on bondholders the form of payment were arbitrary.[61]

Regarding the treatment of speculative investors, the MEF had introduced a system with seven categories of bondholders in Supreme Decree No. 242/2017. The lowest priority category referred to legal entities that had purchased the instruments for speculative purposes. Oddly, the MEF did not state the requirements for a purchase of a bond to be considered 'speculative'. Given the lack of any explanation, the tribunal found that this category of bondholders was specifically aimed at the claimants, the only known investors who could arguably fall within the category. The effect of this categorisation was to deter the claimants from opting into the bondholder process and defer payment to the claimants until all other bondholders had been fully paid.[62]

As the tribunal had found that Peru had breached the FET standard, the tribunal held that it was strictly unnecessary to deal with the claimants' other claim; however, *in dicta*, the tribunal found that there was no denial of justice or expropriation.[63]

61 ibid., Paragraphs 939–943.

62 ibid., Paragraphs 944–951.

63 ibid., Paragraphs 991–992.