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EDITORS’ NOTE

Welcome to Issue No. 2 of The Journal of Damages in International Arbitration. As this issue was going to the publisher, the blockbuster awards in the various Yukos cases were released. Those awards will give the arbitral community much to think about in the coming months and years, and we expect the Journal will address that in coming issues.

We open this issue with an article by Howard Rosen outlining the need for experts to be objective and impartial in their work. While most would agree in principle, it sometimes seems that when put into practice, reality is a bit more challenging. Howard offers some suggestions that may help tribunals to ensure that impartiality is maintained.

In our second article, Peter Badala and Jim Zack describe the various methods of calculating damages in the context of construction delays. While this may seem at first blush to be a rather narrow niche of the damages world, many of the concepts are equally applicable to other long-term contracts, including government procurement programs and infrastructure concessions.

Next, we have an article by Patrick Dumberry and Sébastien Cusson focusing on moral damages. Some recent ICSID awards have touched on this issue. The authors argue that, rather than being an extraordinary remedy reserved for exceptional circumstances, moral damages should be viewed as part of the full reparation owed the claimant.

In our fourth article, we move to the question of interest and cost of capital. Mick Smith and Romans Vikis take us through an analysis of the interrelationship of the cost of capital concepts embedded in discount rate analysis to the interest rate applied to the award. They set out principles to enable full reparation for harm suffered, without allowing either party to benefit from asymmetric rates built into their calculations (or the tribunal’s analysis).

We broaden the focus in the fifth article, where Jonathan Lesser takes an in-depth look at the recent damage award in Guaracachi v. Bolivia. Dr. Lesser takes us through the discounted cash flow analysis in the case, to show us why the tribunal
rejected both experts’ analyses and struck a middle ground. He addresses the economic value of the investment, as well as some of the underlying regulatory economics.

Lastly, we have included some shorter case notes on recent damages awards. We open with the review of the award in one of the smaller Yukos matters – Quasar de Valores v. Russia. This award by an SCC tribunal, while small in comparison to the later Yukos cases, is consistent in its assessment of damages. In addition, we include reviews of the SCC’s Stati v. Kazakhstan and ICSID’s Micula v. Romania awards.

We have a number of articles in process for the 2015 issues, including a follow-up article on moral damages, damage calculations for several specific situations – energy trading arbitration, trade secrets and damages to income producing assets, to name a few – and some broader issues of reasonable certainty and the handling of taxes. Of course, we will include the transcript of Juris’ 3rd Annual Conference on Damages, which this year is under the able direction of Loukas Mistelis from Queen Mary University in London.

Beyond that, we want to know what interests you, and what you have to say. We again call your attention to the Call for Papers at the rear of this issue, which solicits material for subsequent issues of the Journal. If you would like to submit an idea for a paper, or simply discuss your ideas, please contact us at the addresses below.

Finally, our ongoing thanks to the staff at Juris Publications and to the many contributors to this second issue, as well as to the faculty for Juris’ annual damages conference, which is scheduled to take place shortly after publication.

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HOW USEFUL ARE PARTY-APPOINTED EXPERTS IN INTERNATIONAL ARBITRATION?

Howard Rosen

This article is based on material presented at the 22nd ICCA congress, “Legitimacy: Myths, Realities, Challenges”, Miami, 6-9 April 2014.¹

The role of the expert witness in domestic and international arbitration is a subject that has been often written about, debated, scrutinized, and reviewed. Experts, being in the role of “neutrals” with the obligation to assist arbitrator(s) in reaching decisions on issues that require special expertise, have come under suspicion as being advocates in disguise for the party retaining them. Further, published decisions from arbitrators have failed to adequately identify those experts, or attributes of expert reports, that they find helpful and / or unhelpful and thus there is no formal feedback mechanism for the arbitration community to identify those experts, or qualities found in expert reports, which are perceived to be inappropriate.

Notwithstanding the well-known role of the expert, and their duty to the trier of fact, experts find themselves pulled in different directions by the various factors that influence their behaviour. The chart below summarizes these various forces:

The criticism frequently levelled at experts is based on the manifestation of factors that can be seen at the bottom and to the right in the chart above. It is generally assumed that party-appointed experts will behave in a manner that ingratiates them to their clients and retaining counsel in order to “plant the seed” for future engagements and financial rewards. In these circumstances, it is assumed that the party-appointed expert will act as an advocate to further the position of their client, and not to assist the Tribunal in understanding the expert issues. This further manifests itself most blatantly when we see expert reports that are a thin disguise for their client’s pleadings.

As a potential counterweight to the perceived adverse forces presented above, experts are also bound by certain rules governing their conduct and work product, which ultimately should have a bearing on the credibility and objectivity of their work. These can be split into three broad categories: jurisdictional rules; rules and practice in arbitration; and professional body rules.
Experts in U.S. courts must meet the applicability threshold established under Rule 702 of the *Federal Rules of Evidence*:

- The expert’s scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
- The testimony is based on sufficient facts or data;
- The testimony is the product of reliable principles and methods; and,
- The expert has reliably applied the principles and methods of the facts of the case.

The *Federal Rules of Evidence* is silent on the duties of independence and impartiality, however, as outlined in the non-exclusive list below, Rule 702 is supplemented by the criteria established by the judgment on Daubert v. Merrell³ (the “Daubert Criteria”):⁴⁵

- Has the technique/theory been tested, or can it be tested;
- Has the technique/theory been subject to peer review and publication;
- What is the potential rate of error;
- Whether there exists standards controlling its operation; and,

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⁵ Daubert v. Merrell Dow Pharmaceuticals, (1993) U.S.
Has the technique/theory attracted widespread acceptance within the relevant scientific community.

Similar thresholds apply in other jurisdictions such as Canada, the U.K. and Australia, where the expert's duty is defined under various court rules and prior decisions. Unlike the Canadian and U.S. courts, English case law has a low reliability review of expert evidence in court and relies upon detailed review at the adjudication stage by the trier of fact. The expert's general duties in Australian courts echo that of the U.K. Civil Procedure Rules. The overriding duty to the court and the necessity of independence and objectivity is explicitly stated in the U.K., Canada, and Australia, but absent from the federal rules governing experts in the U.S. This absence of a specific rule governing independence and objectivity in and of itself is not evidence that quantum experts from the U.S. are any less prone to adopt these important attributes. Professional guidelines set out by the various professional bodies of which quantum experts are generally members, further serves to guide the behaviour of experts. Further, specific cases or case law may also serve to reinforce and modify behaviour and guide expert conduct.

However, in the case of arbitration, such jurisdictional rules may not apply. As in some jurisdictions, the practice of “qualifying” an expert does not exist in arbitration. There is no overt examination

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of an expert’s experience and credentials for the purposes of determining whether the expert being proffered possesses the necessary expertise to assist the court with issues that are beyond their own expertise. No voir dire is employed to determine the competency of an expert witness, and what their opinion should be limited to. The IBA Rules on the Taking of Evidence in International Arbitration (“IBA Rules”) and U.K. Civil Procedure Rules seek to mitigate the potential for partisanship and bias inherent in a system of party-appointed experts, but it is possible, however, that they do not go far enough towards achieving their goal. For that reason, I suggest below three measures that might help to preserve the best features of party-appointed experts while blunting those experts’ incentives to take unreasonable, contradictory or partisan positions.

I. INSTRUCTIONS RECEIVED BY THE EXPERT

The first recommendation is focused at the outset of the expert retainer, and deals with the instructions received by the expert. I believe that expert reports will be more useful to the parties and arbitral tribunals if the instructions once received from the parties, are reviewed with the tribunal. It is my experience (and that of my colleagues) that the vast majority of the differences between party-appointed experts arise in consequence either of their having received different instructions or their having employed different assumptions. When party-appointed experts reach strong opposing conclusions, it may be difficult for a Tribunal to know how much weight to place on either expert’s evidence or to identify the instructions or assumptions that polarise the experts’ opinions.

The new IBA Rules take a useful step towards transparency by requiring party-appointed experts to describe their instructions. A further step in that direction would be for parties to submit their proposed instructions to the Tribunal prior to their delivery to the expert. The Tribunal could then review those instructions and agree (or order) changes so that the instructions were clear and fitted the purposes of the Tribunal.

In my view, such requirement would be strengthened if experts were obliged to document the assumptions that they have made in drawing their conclusions. The clear documentation of assumptions – highlighting those that are a matter of instruction –
will assist Tribunals’ understanding of the underpinnings of each expert’s evidence. It could also allow a Tribunal to order both experts to prepare their conclusions on the basis of one or more sets of instructions and assumptions, which I shall refer to as “common-basis conclusions”. Such an order seems likely either to close the gap between two experts or, at a minimum, sharply to define the source of any further assumption(s) leading to divergent views.

In principle, an order to reach common-basis conclusions might be more powerful than existing procedures aimed at narrowing differences between experts, such as meetings of experts or witness conferencing. In my experience, those procedures do not result in a substantive narrowing of the gap if the experts’ approaches embody incompatible instructions or assumptions or if one of the parties seeks to emphasise sources of disagreement. An order to present one or more sets of common-basis conclusions solves these problems and could be used by a Tribunal either before or after a hearing to aid its understanding of the impact of different assumptions or instructions.

II. REQUIREMENT OF ARBITRATORS TO COMMENT ON THE MERITS OF EXPERTS’ WORK

The second recommendation is aimed squarely at the arbitrators. Arbitrators should be required to explicitly report in their awards their views on the roles the experts played in the arbitration, and if their reports, and conduct at the hearing, was helpful to the arbitrators.

It might be thought that party-appointed experts face pressure to adopt assumptions, points of view or approaches that are favourable to the party that instructed them. In my experience, that is generally untrue. The actual incentives faced by experts are more subtle.

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9 That is not to say that counsel-directed assumptions are always illegitimate. Occasionally, an expert may reach a “fork in the road” in the course of analysis, each path being open to a reasonable expert. In such cases, the expert must either seek instruction from counsel as to which assumption should be preferred, or present his or her conclusions on the basis of both assumptions. If the expert chooses to take instruction, however, the fact should be clearly documented.
Chief among the incentives faced by experts is that their testimony in a current case may have a bearing on their future opportunities to testify. At first glance, therefore, it might be thought that experts would wish to be known for their pliancy and helpfulness to the instructing party. In practice, that is unlikely to be the case, because a pliant expert might well find that Tribunals assign a lower weight to his or her testimony. That, in turn, would potentially diminish any future stream of expert instructions. A good expert therefore has an incentive to know where to draw the line between being helpful and being partisan and to resist unreasonable pressure to cross it.

In national courts, where expert evidence and judges’ opinions of it are often made public, the incentive to remain independent is strong: a partisan expert may quickly be “found out”. International arbitrations, however, provide much weaker incentives, particularly when the parties have agreed to strong privacy controls: in many arbitrations, the proceedings, expert evidence, awards and Tribunals’ reasoning remain confidential. In those circumstances, a Tribunal’s disregard for or criticism of an expert’s testimony may be known only to a small circle of insiders. Under a veil of confidentiality, a partisan expert might prosper for a considerable period. The diffuse nature of international arbitration may also mean that word travels only slowly between seats of arbitration or between arbitrators.

The best antidotes to expert partisanship, therefore, are transparency, feedback and peer review. The more that arbitrators comment on the merits of experts’ work and the more than those comments are published, the greater will be the incentives for experts to remain independent of the parties appointing them. Those incentives will counteract, and probably outweigh, an expert’s desire to please, leading to an increase in actual as well as perceived independence.

III. JOINT EXPERT REPORTS

The third recommendation is to require a joint expert report in all cases where party appointed experts provide opinions. Attached as Appendix 1 is a sample joint expert report that I have been using for several years, which I feel allows the Tribunal an excellent summary document of the important issues that have an
effect on the expert's opinion as to the quantum of damage. It isolates the technical points of the experts, where they agree completely, have some agreement, or disagree completely. It would also identify the approximate effect on the quantum of damages of each position. Using this summary report, the Tribunal can then decide which issues are best brought up in witness conferencing (if provided for), and determine based on the quality of the evidence, which expert position they prefer.

This paper has outlined the various factors that influence the behaviour of experts and posited that the best way to increase the perceived independence of party-appointed experts is to increase transparency and disclosure, so as to align the interests of experts with those of the Tribunal. A requirement for experts to document their assumptions, highlighting those upon which they have received instruction, will serve to highlight the sources of difference between experts. A requirement for experts' instructions to be agreed with the Tribunal, or for common instructions to be imposed on experts, may also limit the potential for experts to address or emphasise different issues in their reports. An order for experts to issue common-basis conclusions may assist Tribunals' understanding of the impact of different assumptions and help narrow the differences between experts. If Tribunals were also encouraged to comment on expert testimony and to publish those comments, experts would receive feedback on their work and be subject to outside scrutiny. That feedback and scrutiny will alter experts' incentives and go some way to resolving party-appointed experts' perceived lack of independence.

Although I accept that there is currently no requirement for transparency in many arbitrations, I am aware of comments by legal professionals arguing that publication of awards would advance the law upon which arbitration relies. The interests of Tribunals, experts and counsel on this point might therefore be aligned, even if parties often prefer confidentiality.
DELAY DAMAGES IN CONSTRUCTION ARBITRATION

Peter V. Badala
James G. Zack, Jr., CCM, CFCC, FAACEI, FRICS, PMP

Abstract - When contractors encounter owner caused (excusable/compensable) delay they are typically entitled under the contract to recover both the time resulting from the delay as well as delay damages. Idled equipment/labor and material escalation costs are fairly easily calculated in such situations. Typically, contractors also seek to recover their delay costs (extended field office overhead or general conditions costs) also. Calculating this cost is more complex than dealing with delayed direct costs. There are, at least, eight methods of calculating extended field office overhead costs. None of the calculations arrive at the same daily delay cost. This paper discusses all eight methods – offering commentary on the strong and weak points of each. The paper also offers a recommendation on how project owners can resolve this dilemma in advance of delays, thus making the issue less contentious should a contractor encounter an owner-caused delay.

I. INTRODUCTION

Virtually all construction contracts provide for changes to the Time of Performance of the work of the contract. Each contract
provides for a number of types of delay which may or may not qualify for a time extension. Some of these delay types provide for time only whereas others mandate both a time extension as well as compensation to the contractor for delay damages. When compensable delay arises, contractors look to the owner to compensate them for their delay damages. There are, generally, two types of delay damages – direct and indirect. Direct delay damages include such costs as idled and extended labor and equipment costs, extended storage costs, extended bond costs, material inflation costs, etc. Indirect delay costs include loss of efficiency, extended or unabsorbed home office overhead costs and extended field office overhead costs. Provided that the contractor has maintained reasonably good cost records during the performance of the work, proving the direct delay costs should not be a monumental task. Demonstrating their extended home office overhead, likewise, is not all that difficult once the duration of the delay has been calculated as home office overhead recovery is generally done on a formulaic basis; the Eichleay Formula in the U.S. and the Emden or Hudson’s Formula in Canada and the U.K., for example. Proving loss of efficiency is more difficult and is beyond the scope of this paper.

This paper focuses on recovery of a contractor’s extended field office overhead. Proving extended field office overhead costs used to be a relatively straightforward calculation. The contractor would sum up the total field office overhead costs expended on the project, divide by the number of days spent on the project and multiply times the number of days of compensable delay documented through forensic schedule analysis. It was simple and straightforward. It was, however, not always simple to recover such delay costs. Between 1942 and 1968 contractors on U.S. government contracts could not recover delay costs for government caused delay to the work arising from changed work. This rule was known as the Rice Doctrine which arose from a U.S. Supreme Court case, United States v. Rice.\(^4\) During this period a contractor could only recover time but no delay damages.\(^5\)

\(^4\) 317 U.S. 61 (1942).
In 1968 this inequity was remedied by a rewording of the Changes clause mandated by the Federal Acquisition Regulations ("FAR").\(^6\) By insertion of only a few words the Federal agencies’ drafting committees removed the ambiguous language the Supreme Court based their ruling on and effectively reversed the Rice Doctrine.\(^7\) Contractors could now recover delay costs for government caused delay. However, starting in the 1990’s the Armed Services Board of Contract Appeals, the U.S. Court of Appeals for the Federal Circuit and the U.S. Supreme Court began to shift back to the concept of limiting a contractor’s right to collect delay damages for government caused delay.\(^8\) Courts now hold contractors to a higher standard of proof of damages related to delay. Recent court decisions in the U.S. have required contractors prove delay damages with actual costs.\(^9\) With this as a backdrop, this paper discusses eight potential methods of calculating extended field office overhead costs.

II. TYPES OF DELAY

Most contracts deal specifically with three basic types of delay – each type of delay yielding a different recovery. The basic types of delay are the following.

- **Inexcusable Delay** – Inexcusable delay is delay caused by the contractor or any of their subcontractors, suppliers or materialmen, at any tier. Examples of this type of delay are failure to provide sufficient labor or late delivery of equipment or materials. As this is self-imposed delay the contractor is typically entitled to recover no time and no delay costs. Under most contracts, the contractor is exposed

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\(^6\) FAR § 52.243-4(d) (1968).


to potential liquidated damages or may be directed to accelerate their work, at their own expense, to recover the lost time.

- **Excusable Delay** – Excusable delay is typically third party caused or a force majeure delay. In essence, this is the type of delay which was not foreseeable, not under the control of, nor caused by either the owner or the contractor or any party for whom they are responsible, at any tier. Examples of this type of delay include abnormally severe weather, earthquakes, tsunamis, labor actions or acts of terrorism. Under most contracts, as neither the contractor nor the owner caused the delay, the contractor is entitled to recover the time but no delay costs, while the owner is required to grant an extension of time and forego late completion damages for this period of time.

- **Compensable Delay** – Compensable delay is generally described as owner caused delay but also includes delay caused by events or circumstances for which the owner has assumed liability under the terms of the contract. Examples of owner caused delay include suspensions of work; delays caused by owner issued changes to the work or delayed return of contractor submittals. Examples of owner assumed liabilities leading to delay include differing site conditions or late delivery of owner furnished equipment or materials. In such situations, as the owner is responsible for the delay most contracts provide for recovery of the time resulting from the delay and for delay damages from the owner.

It is beyond the scope of this paper to discuss how compensable delay is determined. But, suffice it to say that once compensable delay is proven the contractor is typically owed delay damages; provided that the contract does not contain an enforceable No Damages for Delay\(^\text{10}\) or Limitation on Delay

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Damages\textsuperscript{11} clause and the Consequential Damages clause does not preclude recovery of various forms of delay damages.

**III. WHAT ARE DELAY COSTS?**

The simplest description of the term delay damages is those costs that increase as a sole result of a delaying event on a project. Such increased cost may be direct or indirect costs. Put into the context of basic contract law these are damages that are the direct result of a breach of contract; that were within the contemplation of the parties at the time the contract was bid and executed; and can be documented or proven within reasonable certainty.\textsuperscript{12} In the case of delay damages, the breach of contract giving rise to damages is an owner caused delay.

There are no strict accounting rules on how delay damages are calculated. A general list of damages resulting from a project delay includes the following –

**Labor Costs**

- Additional labor hours
- Overtime and premium pay
- Loss of efficiency or loss of productivity
- Increased wage rates

**Equipment Costs**

- Increased rental or ownership costs
- Inefficient use
- Added equipment
- More expensive equipment

\textsuperscript{11} Bruner, Philip L. and Patrick J. O’Connor, Jr., *Risks of Construction Time: Delay, Suspension, Acceleration and Disruption*, Bruner and O’Connor on Construction Law, October, 2010.

Material Costs

Additional material
More expensive material
Material cost increases
Increased material storage

Subcontractor Costs

Extended labor, equipment and material costs
Extended jobsite overhead costs
Extended home office overhead costs

Jobsite Overhead Costs

Added supervision and project management
Extended supervision and project management
Increased and extended jobsite resources (office trailers, site utilities, etc.)

Home Office Overhead Costs

Additional home office overhead costs
Extended/unabsorbed home office overhead costs

Certainly the list can be longer and much more detailed but this is a basic outline of the costs likely to be impacted in the event of a project delay.

IV. WHAT IS FIELD OFFICE OVERHEAD?

In the construction industry “overhead” is defined as “That portion of the contractor’s cost which cannot properly and accurately be allocated to a specific operation on any project.”\(^{13}\) This general term is modified by the addition of the words “field office” to distinguish overhead on a single project or set of projects incurred by a field office from “home office” overhead which are costs incurred in the contractor’s home office for the benefit of all projects.

Like the term “delay damages” there is no standard method of accounting for field office overhead costs applicable industry wide. Likewise, there are no government regulations in the U.S. mandating how such costs should be gathered and accounted for. The one rule applicable to the issue of field office overhead costs is Cost Accounting Standard 401 – Consistency in Estimating, Accumulating and Reporting Costs.\textsuperscript{14} In simple terms, this standard requires that a contractor estimate, accumulate and report on all costs on all projects in the same manner and at all times. Basically, a contractor cannot calculate field office overhead costs one way on a privately funded project and a different way on a government contract.

Although not exhaustive, following is a list of costs typically found in a contractor’s field office overhead account.

<table>
<thead>
<tr>
<th>Field Office Facilities</th>
<th>Field Supervision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office trailer(s)</td>
<td>Project manager</td>
</tr>
<tr>
<td>Office furniture</td>
<td>Assistant project manager(s)</td>
</tr>
<tr>
<td>Office equipment (e.g. telephone system, fax, copying and computers)</td>
<td>Project engineer(s)</td>
</tr>
<tr>
<td>Communications (e.g., telephone, fax, Internet and radio costs)</td>
<td>Project scheduler(s)</td>
</tr>
<tr>
<td>Office utilities (including electrical, gas, water [potable and dust control])</td>
<td>Superintendent(s)</td>
</tr>
<tr>
<td>Office supplies</td>
<td>General foremen</td>
</tr>
<tr>
<td>Janitorial and trash services</td>
<td>Field office clerical</td>
</tr>
<tr>
<td>Jobsite photography and videography</td>
<td>Document control personnel</td>
</tr>
<tr>
<td>Printing and blueprinting</td>
<td>Cost engineer(s) and/or timekeeper(s)</td>
</tr>
</tbody>
</table>

**Field Office Equipment**

- Storage trailers on site
- Portable toilets
- Safety equipment (e.g., signage, K-rail, fencing, firefighting equipment)
- Site cleanup and supplies (e.g., trash dumpsters, street cleaning, truck washing, site watering)
- Jobsite equipment (e.g., forklifts, yard cranes and other equipment used exclusively at the field office for loading/unloading materials, etc.)
- Water storage and trucks
- Dewatering facilities and equipment
- Winterizing, snow removal, heaters, etc.
- Air conditioning
- Vehicles for project management team use (e.g., pickups, vans, cars, flatbeds, etc.)
- Fuel, oil, maintenance for equipment
- Equipment and field office repairs
- Project signage
- Generators
- Survey equipment

**Field Office Labor**

- Safety teams (e.g., safety engineer(s), flaggers, cone K-rail and fence maintenance
- Security personnel
- Site and street cleanup personnel
- Survey and staking crews
- Equipment maintenance personnel
- Storage yard/laydown area personnel
- Payroll and social taxes
- Fringe benefits
- Worker’s compensation insurance
- Subsistence costs for travelers

**Miscellaneous Field Office Costs**

- First aid, fall protection, hard hats, safety
- Travel
- Entertainment
- Mobilization
- Demobilization and final clean up
- Scaffolding
- Project insurance
- Permits and licenses
- Project legal costs
- Small tools and consumables

There may be other costs included in project field office overhead accounts but all of the above costs fit the general definition as they are costs incurred at the jobsite in support of just one project and cannot be allocated to any specific pay item on the project’s Schedule of Values.
V. HOW IS EXTENDED FIELD OFFICE OVERHEAD CALCULATED?

There are three general or basic methods of calculating extended field office overhead costs. They are

- Actual cost method
- Total cost method
- Jury verdict (or “fair and reasonable approximation” of the damages)\(^1\)

A fourth method, which owners can mandate if they include it into the contract documents before bidding is generally referred to as the

- Stipulated contract method

A. Actual Cost Methods

The first thing one has to do when calculating extended field office overhead costs in support of a delay claim is to review the field office cost account for the project to (1) classify each cost account as time related or non-time related and (2) remove the non-time related cost accounts. Why? Because by definition, non-time related costs are not impacted by a project delay as these costs are not temporal in nature. They are one time costs or fixed costs which do not change when the project is delayed. As they are not impacted by a delay these costs should not be included in a delay damage calculation. Some examples of non-time related costs are set forth below.

- Mobilization and demobilization costs – The contractor is required to move onto the project site once at the beginning of the project and demobilize once at the end of the project. These are one time costs not typically impacted by a project delay. However, if the project is suspended for a lengthy period of time and the contractor is directed to demobilize from the site and later remobilize once the suspension issue is resolved, these costs would probably be recoverable.

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\(^1\) Azure v. United States, 129 F.3d 136 (Fed. Cir. 1997).
• Site Utility Costs – The cost to install electrical, telephone, water, gas, etc. on the site at the beginning of the project is likewise a non-time related cost. However, the monthly costs of using the utilities is a time related cost which will continue monthly until the project is complete. These accounts will have to be disaggregated to sort out the purchase and/or installation cost from the operating costs.

• Office furniture, copiers, scanners, fax machines and computer costs – If these items are purchased for the project then they too are non-time related costs and should be removed from a delay calculation. However, the operating costs (such as paper, toner, printer ink cartridges, etc.) are time related since the longer the field office is in operation the more of these materials the project will consume.

Once the non-time related costs are removed the calculation of extended field office overhead costs can begin in earnest. Experience with preparing or analyzing delay damage claims has taught the authors that there are at least eight different methods of calculating extended field office overhead costs. Each method is described below followed by a discussion of the apparent strengths and issues related to each method.

• *Average Field Office Overhead Cost For The Project* – This is one of the more common techniques used when calculating field office overhead costs. The contractor using this technique adds up all field office overhead costs expended on the entire project. They should then remove the non-time related portions of the field office overhead cost account as discussed above. The contractor then divides the remaining time related costs by the duration of the project to arrive at a daily field office cost. The contractor then multiplies this daily rate by the number of days of compensable delay determined from their forensic schedule analysis to determine the extended field office overhead costs owed as a result of the owner caused delay.

*Strength of Method* – This is a simple and straight forward cost engineering or cost accounting exercise which does not typically require spending a lot of money on outside
legal counsel or forensic accountants. Ordinarily, this can be done by the onsite project staff.

**Issues** – There are two general issues related to this method. First, this is an end of the job calculation requiring the owner and the contractor to wait until the project is completed because the total cost of the field office overhead and the total duration of the project are not known until the project is completed. For owners and contractors striving to settle delay claims as they arise on the project, this technique doesn’t work. The second issue is that this method calculates an “average daily field office overhead rate”, pricing each day on the project the same as every other day. But, this is not accurate in the strict cost accounting sense. Field office overhead costs are typically like a bell shaped curve – low at the outset of the work, climbing fairly rapidly and leveling off at the high rate for a lengthy period of time, later dropping off with a long but low tail off while the project is being closed out. But by dividing the total field office cost expended by every day spent on the project an average cost is created with each day costing the same as all others. If a delay occurs on the project during one of the periods which are below the average cost line, the contractor may be overcompensated when the average field office daily rate is applied. Conversely, if the delay occurs when the field office cost is above the average cost line, the contractor may be undercompensated.
• **Average Field Office Overhead Cost For The Period Of The Delay** – This method is employed when owners and contractors are attempting to resolve delay issues as they arise on the project. This method is *not* an end of the project method. Instead, this method is a *contemporaneous* field office overhead rate calculation that determines the field office overhead rate *only* during the period of the delay. The method starts with the forensic schedule analysis. This analysis identifies the total amount of compensable delay owed and, more specifically, identifies the start and completion dates of the delay. Once these dates are known the cost engineer or cost accountant will determine what period(s) the delay fell in. For example, if the delay started on January 13, 2011 and ended on March 22, 2011 the periods for calculating the field office overhead would be January, February and March 2011. The contractor then sums up the total amount of field office overhead cost incurred in this three month period and divides by the total number of days during this period. Assuming each accounting period starts on the first of the
month and ends on the last day of the month, this period equals 89 calendar days. The contractor divides the field office cost for this three month period by 89 days to derive a daily rate. The contractor then multiplies the daily rate by 68 days (the number of days of delay identified earlier by the forensic schedule analysis) to determine the delay damage owed.

**Strength of Method** – The strengths of the method are twofold. First, this method can be used at any time during the project thus allowing the contractor and the owner to resolve delay claims as they arise. Second, this method avoids the issue of over or under compensation common to the average project cost method discussed above.

**Issues** – The issues related to this method lie in the difference between the actual delay period (in this case the 68 days between January 13 and March 22, 2011) and the time extension period (68 days added to the end of the project). That is, the project is delayed 68 days in the early part of 2011. But the extended period of time will take place for 68 days at the end of the project which may be September of 2013. If the cost during the delay period was very high but the field office overhead cost at the end of the project is very low, some argue that the contractor is being over compensated. (See Example 2 below.) Conversely, if the delay period occurred when the field office cost was very low and the extended period takes place when the field office cost is very high, contractors will surely argue that they are being under compensated. (See Example 3 below.)
Example 2 – Contractor Overcompensated?

Example 3 – Contractor Undercompensated?
B. Total Cost Methods

- **Total Cost Method** – In a situation where a contractor has not segregated their field office overhead costs sufficiently, they may be able to employ the total cost method. In the case of extended field office overhead, the total costs method is calculated as the difference between the field office overhead cost contained in the contractor’s bid and the total amount of field office overhead costs incurred on the project.

  *Strength of Method* – The simplicity of making this calculation has to be the strength of this method. No external legal counsel or accounting assistance is required and the math of the method can typically be applied in a matter of a few minutes.

  *Issues* – The issues related to this method lay in the difficulty the contractor faces in order to get an owner, an arbitration panel or a court to accept the results of this method. Typically, for a contractor to get an arbitration panel or court to accept such an approach, the contractor must demonstrate the following.

    1. There is no other way to document the damages;
    2. The as-bid field office overhead cost was reasonable at the time of bidding;
    3. The contractor mitigated damages to the maximum extent practical;
    4. And, the contractor was not responsible for any of the delaying events on the project.

This is a difficult challenge to meet on almost any project.

- **Modified Total Cost Method** – The modified total cost method is calculated in the same manner as the total cost method. However, the contractor then deducts certain self-imposed damages from the calculated difference between the as-bid and the actual field office overhead cost. It is up to the contractor attempting to use this method (1) identify contractor caused issues which impacted the field office
overhead costs and (2) calculate the value of the impact to the field office overhead cost

Strength of Method – Again, the relative simplicity of the method and the low cost of using the method are the apparent strengths of the method.

Issues – The contractor using this method not only has to meet the four proofs identified above but, in addition, must

1. Prove that the self-imposed events the contractor has admitted to are the only self-imposed impacts on the project;
2. Calculate the damages to be deducted from the total cost calculation and prove that these damages are a fair and reasonable cost to be deducted.

C. Jury Verdict Methods

A jury verdict requires that the arbitration panel or court arrive at a reasonable “equitable adjustment” after receiving sufficient evidence to reach such a decision. This method may be used where

1. There is clear proof of injury;
2. There is no more reliable method for computing damages;
3. And, the evidence presented is sufficient for the court or arbitration panel to make a fair and reasonable approximation of the damages.16

A contractor seeking a jury verdict award for delay damages, as the claimant, is required to present a calculation of the damages to the court or the panel in order from them to reach a decision as to how much is owed. One method for calculating field office overhead and seeking a jury verdict decision is set forth below.

• **Comparative Field Office Overhead Cost Method** – In situations where the contractor cannot prove the delay damages (extended field office overhead) by an actual damage method, it may be possible to present a comparison of the field office overhead cost incurred on this project with the field office overhead cost incurred on another, very similar project. The contractor, as claimant, bears the burden of proving that the projects are, in fact, similar in scope, cost, duration, location and time. If the contractor can demonstrate this then they may be able to compare the difference in cost incurred on each and use the calculated cost difference as the measure of damages.

**Strength of Method** – Once the similarity of projects is demonstrated, the calculation of the delay damages is simple.

**Issues** – It appears that proving the similarity of the projects is the biggest problem facing a contractor seeking to use this method. There are so many variables with every construction project (other than, perhaps, tract housing) that to argue that any two projects are virtually identical will be difficult at best.

**D. Stipulated Contract Methods**

There are various methods to calculate field office overhead that may be included in the contract documents prior to bidding. By including a specific method in the contract documents the owner has mandated the method to be used to calculate extended field office overhead costs in the event of an owner caused delay.

• **As-Bid Field Office Overhead Rate** – The California Department of Transportation (“Caltrans”) has employed a unique mechanism on some of their larger projects (the San Francisco – Oakland Bay Bridge replacement project, for example). They use a Time Related Overhead (“TRO”) bid item and specification to implement the approach.\(^\text{17}\)

One of the line items in the Caltrans bid form requires the

contractor to fill in their daily time related cost and multiply this daily rate times the number of working days in the Time of Performance clause.\(^{18}\) The cost is stipulated to include both the field office overhead costs as well as the home office overhead cost.\(^{19}\) The contractor is paid monthly as the project progresses based upon the number of work days consumed each month. If delays arise during the performance of the work, the TRO number is used to price the delay once agreement is reached on delay causation and liability. The TRO number is only subject to unit price adjustment if delay exceeds 149% of the original number of work days stipulated in the contract.

**Strength of Method** – This specification avoids the need for an audit concerning delay costs and makes settlement of delay claims easier both during and at the end of the project. Further, Caltrans has tied this requirement to their Escrow Bid Documents requirement such that the work sheets used to calculate and bid the daily delay costs are preserved in a secure neutral location for examination in the event the owner has a need to review the calculation in order to settle a delay claim.

**Issues** – The only perceived issue with this method is that there is nothing to prevent a contractor from unbalancing their bid and making their daily delay cost artificially high, counting on the owner to cause a lot of delay on the project. If this happens, the TRO specification would prevent the owner from modifying the daily rate until the total delay exceeds 149% of the original number of days stipulated in the contract documents.

- **Specified Mark Up Rates Stipulated In The Contract Documents** – Owners may include a fixed markup rate in the contract documents which specifically covers field office

\(^{18}\) California Department of Transportation contracts are all work day contracts. Should an owner want to employ this method but stay with a calendar day contract they need only change the wording of the specification to calendar days.

\(^{19}\) An owner can choose to use the same procedure or modify it to include only the field office overhead cost.
overhead rates. Should an owner decide to do this, they will have to specify clearly in the contract documents that this fixed rate includes extended field office overhead costs and/or unabsorbed or extended home office overhead costs. In the U.S. the General Services Administration, the Veteran's Administration and the U.S. Postal Service have all adopted contractually fixed overhead rates which have, to date, withstood court challenges. To see the Veteran's Administration overhead limitation clause see FAR § 8-7.650-21, Contract Changes. The General Services Administration overhead limitation clause may be found at FAR § 552.243-71, Equitable Adjustments. Numerous State highway agencies and professional associations in the U.S. also specify change order markups that include field office overhead costs. The table below summarizes 8 State agencies, 2 regional transportation agencies and 3 professional associations.

<table>
<thead>
<tr>
<th>Organization</th>
<th>Labor</th>
<th>Materials</th>
<th>Equipment</th>
<th>Subcontract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>20%</td>
<td>15%</td>
<td>0%</td>
<td>1 – 3%</td>
</tr>
<tr>
<td>Georgia</td>
<td>15%</td>
<td>10%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Kentucky</td>
<td>25%</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>35%, 6%24</td>
<td>15%</td>
<td>0%</td>
<td>1 – 10%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>30%</td>
<td>15%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>20%</td>
<td>15%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Virginia</td>
<td>45%, 25%25</td>
<td>15%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

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20 Santa Fe Engineers v. United States, 801 F.2d 379 (C.A.F.C. 1986); West Land Builders, VABCA 1664, 83-1 B.C.A. 16325.


24 North Carolina provides a fixed 35% of labor cost for overhead, benefits and profit. Insurance and taxes are paid at actual cost plus an additional 6% markup for administration.
<table>
<thead>
<tr>
<th>Organization</th>
<th>Labor</th>
<th>Materials</th>
<th>Equipment</th>
<th>Subcontract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maryland Transit Authority</td>
<td>35%</td>
<td>10%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Washington Metro Transit Authority</td>
<td>10%</td>
<td>5%</td>
<td>5%</td>
<td>--</td>
</tr>
<tr>
<td>AASHTO(^{26})</td>
<td>35%</td>
<td>15%</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>EJCDC(^{27})</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
<td>5%</td>
</tr>
<tr>
<td>CMAA(^{28})</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>5%</td>
</tr>
</tbody>
</table>

**Strength of Method** – The apparent strength of this method is its simplicity. Once the cost elements of a change order have been agreed to between the owner and the contractor the fixed markup rates from the contract are applied appropriately. No negotiations, no audits are required.

**Issues** – The method requires the owner to determine what changed costs they are willing to mark up and then they must determine what the markup percentages are “reasonable”. Additionally, the owner must craft the contract very carefully, with the assistance of experienced legal counsel, to the effect that these markup rates include field office overhead costs of any type. In order to make certain this contract requirement is enforceable, the owner may need to include a No Damages for Delay or a Limitation on Delay Damages clause in order to make the method legally enforceable.

- *Activity Specific Field Office Overhead Allocation Process (ASAP Method)* – Each of the methods presented above calculate extended field office overhead at the project level and then allocate it to a daily, weekly or monthly cost. A theoretical alternative to these methods has been identified at the Activity Specific Field Office Overhead

\(^{25}\) Virginia allows 45% of labor cost for labor overhead, benefits and profit. A tax and insurance allowance of 25% is paid separately.

\(^{26}\) AASHTO – American Association of State Highway and Transportation Officials.

\(^{27}\) EJCDC – Engineers Joint Contract Documents Committee.

\(^{28}\) CMAA – Construction Management Association of America.
Allocation Process Method. This method differs in approach, in that the time related overhead is allocated to each on site activity in accordance with the activity’s

- Labor hours
- Labor costs
- Direct costs, or
- Whatever cost driver the owner and contractor agree upon.

If compensable delay arises, an analysis of which activities were delayed and for how long is performed. Field office cost is then allocated to each impacted activity in accordance with the following formula.

\[
\text{Time Related Field Office Overhead for Activity } I = \frac{\text{Time Related Field Office Overhead} \times \text{Cost Driver for Activity } I}{\text{Cost Driver Value of Project}}
\]

**Strength of Method** – One obvious benefit of this method is that it can be applied both prospectively and retroactively. That is, should the owner want to use this method to settle change orders and delays as they arise, they can write a specification requiring that the contractor has to calculate this cost for each on site activity on the basis of whatever cost driver the owner wants to use, within 30 days after award of the contract and prior to receiving a Notice to Proceed. Once this submittal is made, reviewed and approved, it would be used for all future compensable delays.

**Issues** – First, implementing this method may be difficult. While the contractor should be able to perform such a calculation and submit it, the owner during review will have to agree that each activity’s proposed labor hours (if that is the cost driver the owner specifies for use) are reasonable. This will be difficult for most owners to do.

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29 Ibbs, William and Long D. Nguyen, *Analysis of Delay Damages for Site Overhead*, *Cost Engineering*, Vol. 50, No. 3, March, 2008. The method is considered “theoretical” by the authors. In a recent exchange of e-mail between the authors of this article and Dr. Ibbs and Mr. Nguyen it was learned that no project to date has employed this method.
Second, while this method may work for delays to base scope work, it adds an additional dimension of difficulty when negotiating changes which add work not contained in the original scope of work.

VI. CREDIT FOR OVERHEAD PAID ON OTHER CHANGE ORDERS

Some contracts have clauses which reduce the extended field office overhead costs by the amount of field office overhead paid on other change orders ongoing during the period of compensable delay. The intent of such clauses is to prevent double payment of extended field office overhead costs during the same period of time.

VII. COSTS TO BE ADDED TO EXTENDED FIELD OFFICE OVERHEAD COSTS

Assuming agreement on an extension of time can be reached and a method for calculating the cost of the extended field office overhead resulting from the compensable delay, delay damages are still subject to two additional markups. The first markup is profit. “… [A] contractor would be entitled to profit as an element of its quantum recovery if delays are compensable.”\(^{30}\) The second markup applies if the owner has required Performance and Payment Bonds on the project. If so, the sum of the delay damages plus profit is subject to bond cost markup as this is now an added cost to the project and the bond cost is based on total actual project costs.

VIII. CONTRACTOR’S OBLIGATION TO MITIGATE DELAY

Before concluding this paper, one caveat is in order. A contractor facing an owner caused delay has an affirmative obligation to mitigate the owner’s damages to the extent practical.

“It is a general principal of law that the aggrieved party must make a reasonable effort not to unduly increase the damages it suffers. To the extent it can be proved that the aggrieved party did not mitigate, awarded damages may be reduced. It is not, however, necessary

\(^{30}\) Owen L. Schwam Construction Co., Inc., ASBCA No. 22407, 79-2 BCA 13919.
for the injured party to actually mitigate the damages; it need only make a reasonable effort not to unduly increase the damages. Failure to minimize one's losses does not bar the remedy but affects only the amount of damages recoverable.” (Citations removed.)  

A contractor facing an owner caused delay is obligated to mitigate damages. They should look at mitigating damages and document their decisions and actions appropriately. In determining what damage mitigation is reasonable, courts generally consider the following.

1. Whether the delay was of a reasonably known length to allow for planning for mitigation activities;
2. Whether the contractor has other ongoing projects that could use the resources impacted by the delay effectively;
3. What costs would be incurred by the contractor in redeploying these resources;
4. Would it be possible to partially or totally demobilize the project for the period of the delay;
5. How would subcontractors and suppliers be affected by the delay;
6. How can the impact of the delay on the subcontractors and suppliers best be managed;
7. Can the remaining non-delayed work be resequenced to allow progress to be made on other portions of the project; and,
8. What is the cost of demobilizing, remobilizing and/or resequencing the work?

**IX. Conclusion**

Almost all projects encounter compensable delay at some point during the performance of the work. Few contracts set forth any specific method for calculating the cost of a day of delay in the contract documents. As has been discussed, there are at

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least eight different methods of calculating extended field office overhead, a typical element of delay damages. It is recommended that the owner, their design professionals and their legal counsel consider this issue during the design period, select a method and carefully craft and include the method in the contract documents prior to bid.
WRONG DIRECTION: “EXCEPTIONAL CIRCUMSTANCES” AND MORAL DAMAGES IN INTERNATIONAL INVESTMENT ARBITRATION

Patrick Dumberry*
Sébastien Cusson**

I. INTRODUCTION

Moral damage is an elusive concept. It can be defined, in its broadest sense, as the opposite of a material damage resulting in an economic loss. The Lusitania tribunal defined the concept as an “injury inflicted resulting in mental suffering, injury to his feelings, humiliation, shame, degradation, loss of social position or injury to his credit or reputation.”\(^1\) The Commentary to the International Law Commission (ILC) Articles on State responsibility provides the following illustration of the type of moral damage to an individual that can be compensated: “Non-material damage is generally understood to encompass loss of loved ones, pain and suffering as well as the affront to sensibilities associated with an intrusion on the person, home or private life.”\(^2\) One author, Wittich, has recently proposed a more detailed definition:

First, it includes personal injury that does not produce loss of income or generate financial expenses. Secondly, it comprises the various forms of emotional harm, such

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** L.L.L / J.D. (University of Ottawa), MSc in Law and Finance candidate (University of Oxford), Law Student at McCarthy Tetrault LLP, Montreal, Canada.


as indignity, humiliation, shame, defamation, injury to reputation and feelings, but also harm resulting from the loss of loved ones and, on a more general basis, from the loss of enjoyment of life. A third category would embrace what could be called non-material damage of a 'pathological' character, such as mental stress, anguish, anxiety, pain, suffering, stress, nervous strain, fright, fear, threat or shock. Finally, non-material damage would also cover minor consequences of a wrongful act, e.g. the affront associated with the mere fact of a breach or, as it is sometimes called, 'legal injury'.

Based on recent developments, a fifth category must be added to Wittich's definition, namely, a loss of credit or reputation suffered by a legal entity. It is now recognized in case law that moral damages are not limited to natural persons and may be awarded to a legal person (i.e. a corporation) for loss of its reputation.

Moral damages are difficult to assess and to quantify objectively as they are not financial in nature. Yet, as explained in 1923 by the Lusitania tribunal, even if moral damages are "difficult to measure or estimate by money standards" it nevertheless remains that they are "very real" and must therefore be compensated. Thus, under Article 31 of the I.L.C.'s Articles on State Responsibility (the I.L.C. Articles), a State must make full reparation for any "injury" caused to another State by an internationally wrongful act. The concept of "injury" includes material and moral damages caused by a wrongful act. As noted

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5 Desert Line Projects LLC v. The Republic of Yemen, ICSID Case No. ARB/05/17, Award, ¶286 (Feb. 6, 2008) [hereinafter Desert Line].


7 Opinion in the Lusitania Cases, at 32.

by the ILC: “material and *moral damage* resulting from an internationally wrongful act will normally be financially assessable and hence covered by the remedy of compensation.” Moral damages have been awarded by several tribunals in many areas of international law. Some writers have qualified the concept as a general principle of law.

The availability of compensation for moral damages is a fairly recent issue in international investment law. Investors have in the past rarely claimed compensation for such damages for the simple reason that bilateral investment treaties for the promotion and protection of investments (BITs) focus on the protection of economic interests. Breaches of these treaties therefore rarely involve damages that are not financial in nature. Yet, it is recognized that tribunals have jurisdiction to award moral damages under these treaties since they generally do not expressly exclude that remedy.

In 2008 and 2009 alone, no less than *five* arbitration awards discussed the issue. In one such case, *Desert Line v. Yemen*, the tribunal awarded an amount of US$ 1 million in compensation to

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10 Such tribunals include the International Tribunal for the Law of the Sea (ITLOS), the United Nations Compensation Commission (UNCC), the Ethiopia-Eritrea Claims Commission, the Inter-American Court of Human Rights, the European Court of Human Rights, as well as several other human rights bodies and mixed claims commissions, the Administrative Tribunal of the International Labour Organisation (ILOAT) and the United Nations Administrative Tribunal (UNAT). These cases are examined in: Lars Markert & Elisa Freiburg, *Moral Damages in International Investment Disputes – On the Search for a Legal Basis and Guiding Principles*, 14 The Journal of World Investment & Trade 1 (2013).

11 Markert & Freiburg, *supra* note 10, at 27.


14 *Desert Line*. 
the claimant. The tribunal held that Yemen should provide compensation to a corporation for its officers’ psychological suffering (in this case, the "stress and anxiety of being harassed, threatened and detained”15) directly resulting from physical actions, i.e. physical duress and other related measures of coercion, interference or intimidation conducted by army/police forces.16 The tribunal’s award marks the very first time compensation was awarded for moral damages in the context of an investment treaty. Since the Desert Line award 15 decisions have addressed claims for moral damages and a number of cases involving the issue are presently pending. In the recent Al-Kharafi v. Libya award the tribunal awarded the unprecedented amount of some US$ 30 million in compensation for moral damages suffered by the claimants as a result of loss of reputation.17 The legacy of this award is likely to remain however limited in view of its very succinct discussion of the relevant issues and the very large amount of money awarded.

At the time of writing this contribution (May 2014), the ‘mapping’ of awards that have dealt with moral damage claims can be summarised as follows18:

- No tribunal has expressly refused, as a matter of principle, to award compensation to an investor for moral damages;
- One tribunal simply decided not to address the allegation raised by the claimant;19
- Two other tribunals also refused to examine claims on the ground that they lacked jurisdiction over the disputes;20

15 Id. at ¶179, 286.
16 Id. at ¶290.
17 Mohamed Abdulmohsen Al-Kharafi & Sons Co. v. Libya and others, Award (Mar. 22, 2013) [hereinafter Al-Kharafi v. Libya].
18 To the list should be added the case of Oxus Gold v Uzbekistan, UNCITRAL, Award (Jan. 1, 2012) (the award is not publically available).
19 Helnan International Hotels AS v. Egypt, ICSID Case No ARB/05/19, Award (June 7, 2008).
20 Generation Ukraine, Inc. v. Ukraine, ICSID Case No ARB/00/9, Award, ¶17.6 (Sept. 16, 2003); Zhinvali Development Ltd. v. Georgia, ICSID Case No. ARB/00/1, Award, ¶¶278–280, 282 (Jan. 24, 2003).
In two cases (Europe Cement\textsuperscript{21} and Cementownia\textsuperscript{22}), the tribunals declined jurisdiction over the disputes, but nonetheless briefly addressed the unprecedented issue of the proper remedy for moral damages suffered \textit{by a State} in international investment law;\textsuperscript{23} In another case, the tribunal declined jurisdiction over a counterclaim submitted by a State alleging moral damages;\textsuperscript{24} A counterclaim alleging moral damages was also filed by the respondent State in another case, but the tribunal did not address the issue;\textsuperscript{25}

Another tribunal dismissed the claim because of its late filing;\textsuperscript{26}

In seven cases, tribunals have dismissed moral damages claims based on lack of evidence;\textsuperscript{27}

\textsuperscript{21} Europe Cement Investment & Trade S.A. v. Turkey, ICSID Case No. ARB(AF)/07/2, Award (Aug. 13, 2009).

\textsuperscript{22} Cementownia “Nowa Huta” S.A. v. Turkey, ICSID Case No. ARB(AF)/06/2, Award (Sept. 17, 2009).

\textsuperscript{23} This issue is discussed in: Patrick Dumberry, ‘Satisfaction as a Form of Reparation for Moral Damages suffered by Investors and Respondent States in Investor-State Arbitration Disputes’ 3(1) J. INT’L DISPUTE SETTLEMENT 205 (2012) [hereinafter Satisfaction as a Form of Reparation].

\textsuperscript{24} Limited Liability Company AMTO v Ukraine, Arbitration Institute of the Stockholm Chamber of Commerce (Case No 080/2005), Award, ¶¶35, 116 (Mar. 26, 2008).

\textsuperscript{25} Occidental Exploration and Production Company v. The Republic of Ecuador, UNCITRAL, Case No. UN3467, Final Award (July 1, 2004).

\textsuperscript{26} Bernardus Henricus Funnekotter, et.al. v. Zimbabwe, ICSID Case No. ARB/05/06, Award, ¶139-140 (Apr. 22, 2009).

\textsuperscript{27} Iurii Bogdanov, Agurdino-Invest Ltd. and Agurdino-Chimia JSC v. Moldova, SCC, Award, section 5.2 (Sept. 22, 2005) [hereinafter Bogdanov v. Moldova]; Meerapfel Sohne AG c. La République Centrafricaine, ICSID Case No. ARB/07/10, Award, ¶414, 431-435 (May 12, 2011); Société Ouest-Africaine des Bétons Industriels (SOABI) v. Sénégàl, ICSID Case No. ARB/82/1, Award, ¶ 6.22, 10.02 (Aug. 1, 1984) [hereinafter SOABI v. Sénégal]; Técnicas Medioambientales Tecmed S.A. v. Mexico, ICSID Case No. ARB(AF)/00/2, Award, ¶ 198 (May 29, 2003) [hereinafter Tecmed v. Mexico]; The Rompetrol Group N.V. v. Romania, ICSID Case No. ARB/06/3, Award, ¶ 289-293 (May 6,2013); Victor Pey Casado and President Allende Foundation v. Chile, ICSID Case No. ARB/98/2, Award, ¶ 27, 266, 689, 704 (May 8, 2008). To that list should be added Biwater Gauff (Tanzania) Ltd. v. Tanzania, ICSID Case No. ARB/05/22, Award, ¶ 808 (July 24, 2008) where the majority of the tribunal dismissed the investor’s claim because Tanzania’s violation of the BIT caused
In five other cases, the tribunal considered that the alleged moral damage did not meet the “exceptional circumstances” threshold required to award moral damages;\(^{28}\)

In one case (Siag\(^{29}\)), the tribunal rejected a claim for “enhanced damages” concluding that both moral and punitive damages require proof of “exceptional circumstances”;

The *Benvenuti v. Congo* tribunal concluded that the claim submitted by the claimant was unsupported by any evidence, but nevertheless awarded a small amount of money based on *ex aequo et bono* grounds;\(^{30}\)

no actual damage. In his ‘Concurring and Dissenting Opinion’ (¶¶ 32, 33), Gary Born concluded that the host State’s actions had caused a moral damage to the investor. The majority of the tribunal disagreed with Mr Born and stated that it would have been ‘inappropriate’ to award any such moral damages in the circumstances of the case and in light of the investor’s conduct.” The majority also noted that the claimant made no such claim.


\(^{29}\) Waguih Elie George Siag and Clorinda Vecchi v. The Arab Republic of Egypt, ICSID Case No. ARB/05/15, Award, ¶545 (June 1, 2009)

\(^{30}\) *S.A.R.L. Benvenuti & Bonfant v. People’s Republic of the Congo*, ICSID Case No. ARB/77/2, Award (Aug. 8, 1980); English translations of French original in: 8 YB COM. ARB. 144, at 150 (1983). The Italian investor claimed some CFA 250 million for ‘moral damages’ as a result of its expropriation in the People’s Republic of Congo (Congo-Brazzaville). Despite the lack of evidence of any moral damage, the tribunal nevertheless awarded the investor some CFA 5 million (i.e. EUR 8,000) in compensation based on equitable grounds as a result of ‘measures to which Claimant ha[d] been subject’ which had ‘certainly disturbed [its] activities’ (a reference to the occupation of the investor’s premises by the Congolese military, and the institution of criminal proceedings against Mr Bonfant, an officer of the company). It should be noted that the parties had agreed that the tribunal had the power to decide the dispute *ex aequo et bono* and that the amount of damage was determined solely on this basis.
• In only two cases (Desert Line Project31, Al-Kharafi32), tribunals have awarded compensation for moral damages suffered by investors.

While the availability of moral damages is not per se a controversial issue, many underlying questions regarding their compensation remain uncertain.33 The present article focuses on one new controversial development. Following the Desert Line award (2008), several tribunals have interpreted the decision as imposing a higher threshold of gravity, which limits moral damages only to situations involving “exceptional circumstances.” For instance, the Lemire v. Ukraine tribunal (2011) held that compensation for moral damages should be allowed only when a State conduct is considered grave (such as when it involves physical threat, illegal detention or other analogous situations) and results in a person’s substantial deterioration of health, stress, anxiety and other types of mental suffering.34 As mentioned by one writer, the Lemire award “elevated the requirement of exceptional circumstances to the status of a ‘general rule,’ and appears to have imposed something of a general presumption against the award of damages for non-pecuniary harm.”35 The Arif v. Moldova tribunal (2013) subsequently adhered to this high threshold of seriousness and identified the key question as being to “determine whether in the case at hand the conduct of Respondent and the suffering of Claimant have been so grave and substantial, as to amount to such exceptional circumstances that necessitate a pecuniary compensation for moral damages.”36 All other tribunals have since then adopted the same mantra.

31 Desert Line.
32 Al-Kharafi v. Libya.
33 Some of the issues are discussed in: Blake, supra note 12 at 393 ff.; Dumberry, Compensation for Moral Damages, supra note 4 at 266 ff; Stephen Jagusch & Thomas Sebastian, Moral Damages in Investment Arbitration: Punitive Damages in Compensatory Clothing?, 29 (1) ARBITRATION INTERNATIONAL 45, at 53 ff; Markert & Freiburg, supra note 10 at 26 ff.
34 Joseph Charles Lemire v Ukraine, ICSID (Case ARB/06/18), Decision on Jurisdiction and Liability, ¶ 333(Jan. 21, 2010) [hereinafter Lemire v. Ukraine].
35 Blake, supra note 12 at 393.
36 Arif v. Moldova, at ¶ 602.
The present article is structured in two parts. Chapter I reviews all recent awards that have focused on this new precondition of “exceptional circumstances.” In Chapter II, we submit that these awards mark a significant departure from established principles of international law concerning reparations and misconceives the compensatory nature of moral damages. We will also explain that these investor-State tribunals have been influenced by the context of older international law cases involving moral damages claims which systematically dealt with very grave violations of international law. Finally, we will provide a number of examples of the types of situations where tribunals should award compensation for moral damages suffered even though the State conduct involved may not qualify as a “grave” or an egregious violation of international law.

II. RECENT AWARDS DEALING WITH THE EXCEPTIONAL CIRCUMSTANCES CRITERIA

The present chapter will first recall the findings of the Desert Line award on the exceptional circumstances criteria (Section A) and then examine all other awards that have subsequently dealt with the issue (Sections B, C and D).

A. Desert Line v. Yemen

The Desert Line award was the first to offer a comprehensive analysis of the issue of moral damages in international investment law. The case involved a company from Oman building roads in Yemen. The tribunal concluded that the overall conduct of Yemen towards the investor fell “well short of the minimum standard of international law” and had breached the obligation to provide fair and equitable treatment under the BIT. The tribunal awarded the claimant US$ 24 million in compensation. The investor also claimed compensation for moral damages in the amount of US$ 104 million alleging continuing “harassment, threat and theft” by armed groups against the company’s personnel as well as the subsequent arrest and detention by the army of three

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37 For a review of earlier cases, see: Dumberry, Compensation for Moral Damages, supra note 4.

38 Desert Line, at ¶ 179.
executives.\textsuperscript{39} The tribunal summarised the claimant’s contention as follows: “[t]he Claimant’s executives suffered the stress and anxiety of being harassed, threatened and detained by the Respondent as well as by armed tribes; the Claimant has suffered a significant injury to its credit and reputation and lost its prestige; the Claimant’s executives have been intimidated by the Respondent in relation to the contracts.”\textsuperscript{40}

The tribunal first noted that the Respondent had “not questioned the possibility for the Claimant to obtain moral damages in the context of ICSID procedure.”\textsuperscript{41} The tribunal acknowledged that BITs’ “primarily aim” at “protecting property and economic values”, but added that “they do not exclude, as such, that a party may, in \textit{exceptional circumstances}, ask for compensation for moral damages.”\textsuperscript{42} According to the tribunal, “it is generally accepted in most legal systems that moral damages may also be recovered besides pure economic damages.”\textsuperscript{43} The tribunal noted that “it knows that it is difficult, if not impossible, to substantiate a prejudice of the kind ascertained in the present award.”\textsuperscript{44} In its decision, the tribunal quoted the aforementioned \textit{Lusitania} case to show that non-material damages may be “very real, and the mere fact that they are difficult to measure or estimate by money standards makes them none the less real and affords no reason why the injured person should not be compensated.”\textsuperscript{45} The tribunal also stated that it was “generally recognised that [a] legal person (as opposed to a natural one) may be awarded moral damages, including loss of reputation, in specific circumstances only”.\textsuperscript{46} The tribunal concluded that Yemen’s actions had caused moral damages in violation of the BIT:

\textsuperscript{39} \textit{Id.} at ¶ 19, 20, 26, 38.
\textsuperscript{40} \textit{Id.} at ¶ 286.
\textsuperscript{41} \textit{Id.} at ¶ 289.
\textsuperscript{42} \textit{Id.} (emphasis added).
\textsuperscript{43} \textit{Id.}
\textsuperscript{44} \textit{Id.}
\textsuperscript{45} \textit{Id.}
\textsuperscript{46} \textit{Id.}
The Arbitral Tribunal finds that the violation of the BIT by the Respondent, in particular the physical duress exerted on the executives of the Claimant, was malicious and therefore constitutive of a fault-based liability. Therefore the Respondent shall be liable to reparation for the injury suffered by the Claimant, whether it be bodily, moral or material in nature. The Arbitral Tribunal agree with the Claimant that its prejudice was substantial since it affected the physical health of the Claimant’s executives and the Claimant’s credit and reputation.47

The tribunal held that Yemen was liable to make reparation for “moral damages, including loss of reputation” for US$ 1 million (without interest).48 It added that this amount for moral damages was “indeed more than symbolic yet modest in proportion to the vastness of the project”.49

While the Desert Line award is interesting on many accounts,50 the tribunal’s passing reference to the “exceptional circumstances” is intriguing. The use of this expression has been interpreted by many scholars as a reference to the rarity and uniqueness of moral damage claims in the context of investor-State arbitration given the particular nature of investment treaties.51 In an earlier publication on the topic, one of the present authors argued at the time (in 2010) that the tribunal’s reference to “exceptional circumstances” should not be interpreted as supporting the existence of a higher threshold of gravity requirement.52 As it turns out, all tribunals have since then taken the opposite position. The following sections examine these awards.

47 Id. at ¶ 290.
48 Id. at ¶ 291, 297.
49 Id. at ¶ 290.
50 These issues are discussed in Dumberry, Compensation for Moral Damages, supra note 4, at p. 266 ff.
52 Dumberry, Compensation for Moral Damages, supra note 4, at 269.
B. Lemire v. Ukraine

The Lemire tribunal was the first one to firmly and unequivocally interpret the expression “exceptional circumstances” as supporting the existence of a higher threshold of gravity for moral damages claims. This case involved a US national who had invested in Ukraine's radio broadcasting industry. The claimant, Mr. Lemire, accused Ukraine's broadcasting authorities of having unfairly rejected several of his applications for new radio frequencies. In its first award on jurisdiction and liability, the tribunal held that Ukraine had breached the fair and equitable treatment provision contained in the United States–Ukraine BIT and Mr. Lemire was entitled to compensation, but postponed the quantification of the damage to the next phase of the arbitration. Mr. Lemire sought US$ 3 million in compensation for moral damages resulting from alleged harassment measures adopted by the authorities and the stress he said to have suffered. In its first award of 2010, the tribunal described the allegations as follows:

Claimant’s basic line of reasoning is that, behind the individual facts of this case, an overall aim appears: the Ukrainian authorities’ desire to get rid of an annoying American investor, by systematically denying any application for further frequencies, thwarting plans to create new channels, and harassing him with irregular inspections and difficulties for the renewal of his licence.

The tribunal first noted that “in most legal systems” damages for moral injury can be recovered. It also approved the conclusion reached by the Desert Line tribunal that investors can claim compensation for moral damages under BITs. The tribunal described the allegations at length and concluded that they

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53 Lemire v. Ukraine.
54 Id. at ¶ 449.
55 Id. at ¶ 476.
56 These allegations are summarized by the Tribunal as follows: “Claimant in essence is submitting that the National Council incurred in systemic bias against Gala Radio. Not only did the National Council reject the 200 applications made by the radio station for new frequencies, jeopardizing Gala’s plans to expand its activities, but it also maliciously subjected Gala to a series of inspections, with the hidden agenda to close it down, and then in bad faith
were "very grave indeed." The tribunal held that the question of whether these facts constituted “exceptional circumstances” meriting awarding compensation for moral damages would have to be decided in a subsequent award on damages.

In its 2011 final award, the tribunal awarded the investor US$ 8.7 million in compensation for his financial losses. Most importantly, for the purposes of the present article, the tribunal explained what were these “exceptional circumstances” under which compensation for moral damages could be awarded:

The conclusion which can be drawn from the above case law is that, as a general rule, moral damages are not available to a party injured by the wrongful acts of a State, but that moral damages can be awarded in exceptional cases, provided that:

- the State’s actions imply physical threat, illegal detention or other analogous situations in which the ill-treatment contravenes the norms according to which civilized nations are expected to act;
- the State’s actions cause a deterioration of health, stress, anxiety, other mental suffering such as humiliation, shame and degradation, or loss of reputation, credit and social position; and
- both cause and effect are grave or substantial.

The tribunal applied this test to the facts of the case and rejected the claim submitted by Mr. Lemire for moral damages. The tribunal noted that the "excessive or disproportionate efforts which an applicant may have incurred when requesting administrative licenses, by their nature, are most unlikely to give rise to moral damages, since the injury does not meet any of the three standards required for the existence of moral damages." For the tribunal, delayed the renewal of the licence, until a new regulation had come into force, which increased the renewal fee by 10" (Id. at ¶ 479).

57 Id. at ¶ 480.
58 Id. at ¶ 486.
59 Id. at ¶ 333.
60 Id. at ¶ 336.
Mr. Lemire did not suffer “extraordinary stress or anxiety” as a result of these efforts to obtain new radio frequencies. Mr. Lemire also claimed compensation for the disrespect and humiliation caused by the authorities’ constant rejections of his applications. The tribunal acknowledged that these recurring rejections may have caused him “a loss of reputation”, but added that “this is not enough: the main question is to determine whether the injury inflicted is substantial.” For the tribunal, “the gravity required under the standard is not present” since the injury he suffered ‘cannot be compared to that caused by armed threats, by the witnessing of deaths or by other similar situations in which tribunals in the past have awarded moral damages.” The tribunal therefore rejected the moral damages claim for lack of evidence.

In an obiter dictum, the tribunal added that in any event “the acknowledgement in the First Decision [of 2010] that Ukraine has indeed breached the BIT, and the present award of substantial compensation, are elements of redress which may significantly repair Mr. Lemire’s loss of reputation.” In its concluding remarks, the tribunal also made a very similar comment to the effect that it had “sympathy and understanding for the stress and anxiety which [Mr. Lemire] must have felt at certain times during his long fight in the defence of his rights”, but added that “the moral aspects of his injuries have already been compensated by the awarding of a significant amount of economic compensation, and that the extraordinary tests required for the recognition of separate and additional moral damages have not been met in this case.” These two comments suggest that the declaration of wrongfulness (contained in the first award) and the amount of compensation awarded for pecuniary losses (in the second award) were in themselves enough to compensate any sort of moral damages suffered by the investor. These comments raise

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61 Id. at ¶ 337.
62 Id. at ¶ 338.
63 Id. at ¶ 339.
64 Id.
65 Id. at ¶ 344.
66 It is important to note that those comments were truly in the form of an obiter. Thus, the Tribunal had already concluded that the investor had suffered
the question whether or not a tribunal established under a BIT could remediate moral damages suffered by a foreign investor with the remedy of satisfaction (in the form of a declaration of wrongfulness) instead of monetary compensation. One of the present authors has argued elsewhere that satisfaction is not the proper method of remediation for moral damages affecting an individual or a corporation.67

In sum, the Lemire tribunal was the first one to put forward the high threshold of severity test therefore limiting the award of compensation for moral damages only to “exceptional circumstances” where the “cause” is grave and the “effect” is substantial. The soundness of this reasoning will be discussed below (in Chapter II).

C. Arif v. Moldova

The dispute in the Arif v. Moldova case arose out of a contract between Mr. Arif’s wholly-owned company and the State of Moldova for the exclusive exploitation of duty free stores.68 The tribunal held that Moldova failed to provide fair and equitable treatment to the investor, but rejected the investor’s moral damages claim. The tribunal summarized that claim as follows:

Claimant also seeks moral damages in the amount of €5,000,000 for the pain, stress, shock, anguish, humiliation and shame suffered as a result of Moldova’s acts and omissions in relation to his investments, and the fact that he had to leave the country for his own safety, depriving him of the opportunity to personally manage his own business and to pursue new business opportunities.69

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67 Dumberry, Satisfaction as a Form of Reparation, supra note 23.
68 Arif v. Moldova, at ¶ 584 ff.
69 Id. at ¶ 562. Based on the three-part test put forward by the Lemire Tribunal, Moldova argued that the claim for moral damages was baseless and that the Claimant could not “satisfy the extraordinary tests required for the recognition of separate and additional moral damages” (¶ 565). Thus, the gravity of the harm suffered by Mr. Arif “could not be likened to the hurt caused by armed threats, or by witnessing the deaths of others, or the other
The tribunal acknowledged right at the outset that there was “no doubt that moral damages may be awarded in international law (...) although they are an exceptional remedy.”

The tribunal criticized some aspects of the Lemire award and concluded that it should not be accepted as the general test to determine whether to award compensation for moral damages:

The Tribunal notes that the formulation of the principles of the award of moral damages in Lemire was based on a limited discussion of three cases, with no broader consideration of underlying principles or policies. The statement might serve as a summary of the issues in these cases, but it should not be taken as a cumulative list of criteria that must be demonstrated for an award of moral damages. The first element, in particular, might reflect the particular circumstances of the Desert Line Projects LLC v Republic of Yemen case but the facts of a single case do not define the availability of moral damages as a remedy.

In the Tribunal’s view, the older Lusitania case, the basis of the second factor in Lemire, correctly states the criteria the Tribunal should take into account. This leaves the Tribunal with an element of discretion, but within the general framework that moral damages are an exceptional remedy.

In the following paragraph, the tribunal reiterated that “the element of exceptionality must be acknowledged and respected” and made the following important comment:

A breach of a contract or any wrongful act can lead to a sentiment of frustration and affront with the victim. A pecuniary premium for compensation for such sentiment, in addition to the compensation of economic damages, would have an enormous impact on the system of contractual and tortious relations. It would

types of suffering endured by claimants in earlier cases where moral damages were awarded” (¶ 588).

70 Id. at ¶ 584.
71 Id. at ¶ 590, 591.
72 Id. at ¶ 592.
systematically create financial advantages for the victim which go beyond the traditional concept of compensation. The fundamental balance of the allocation of risks would be distorted. It would have similar effects if permitted in investment arbitration. The Tribunal is therefore aligning itself to the majority of arbitral decisions and holds that compensation for moral damages can only be awarded in *exceptional cases, when both the conduct of the violator and the prejudice of the victim are grave and substantial.*73

In sum, while the tribunal recognized that compensation could be awarded in situations where State conduct does not involve any “physical threat and illegal detention” (or other analogous situations), it nevertheless emphasized on the requirement that such conduct must be *grave.* The tribunal also indicated that it is simply not enough for a State action to result in a person’s deterioration of health, stress, anxiety and other mental suffering; the prejudice suffered by the victim needs to be *substantial.* The Arif tribunal therefore ultimately fully endorsed the Lemire award three-stage test of “exceptional circumstances”.

The tribunal then applied this test to the facts of the case by emphasizing on the importance of some specific features of the Moldovan economy and governance when deciding on the availability of moral damages.74 It explained that Mr. Arif invested in 1998 in the emerging market economy of Moldova “during a period when the country transited from a Soviet to a market economy, a difficult and contradictory path indeed, characterized by instability and the unpredictability of economic and political institutions”.75 For the tribunal, Moldova therefore “offered exceptional business opportunities, but at the same time high risks.”76 In a controversial statement, the tribunal further explained how Moldova’s weak institutions and poor governance could have an impact on the availability of compensation for moral damages:

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73 *Id.* (emphasis added).
74 *Id.* at ¶ 603.
75 *Id.* at ¶ 604.
76 *Id.*
These circumstances do not lower the standard of investment protection provided by a BIT or excuse breaches of that standard. They have, however, an inevitable bearing on what characterizes “exceptional circumstances” as a threshold for the pecuniary compensation for moral damages. The perception of an egregious behavior is different in different business traditions. On the one hand, the loss of reputation as a consequence of governmental and police interference is much less dramatic in countries where the rule of law and protection against administrative discretion are low and any business is exposed to this risk, irrespective of its conduct, and, on the other hand, the individual's expectations are different and less easily to be shocked.77

This statement is open to criticism. It may be true a “bad” reputation is less damaging for a business person in the context of his/her investment in a country not respecting the rule of law. It is indeed probably more damaging for someone doing business in Finland to suffer from a loss of business reputation then if the same person was doing business in say, Somalia.78 Yet, it is not clear how Moldova’s weak institutions and poor governance can have any “inevitable bearing” on the availability of compensation for moral damages in other circumstances. Thus, to what extent does it matter that Moldova’s State institutions are weak in the context involving physical threat and illegal detention? Would Moldova’s poor governance render such a breach less grave and less exceptional? How can these specific circumstances make a person’s mental suffering less substantial? In another intriguing passage the tribunal notes that “the perception of an egregious behavior is different in different business traditions”. While the comment may, to some extent, be relevant in the specific instance of alleged loss of reputation, one can hardly see how it can be valid in other circumstances giving rise to moral damages claims. In our view, it is quite irrelevant how certain behaviors may be perceived from the perspective of Moldova. What matters is whether or not State conduct is considered as an egregious behavior based on the minimum standard of treatment under customary international

77 Id. at ¶ 604.

78 Somalia is the most corrupt country in the World according to Transparency International, Corruption Perceptions Index 2013 Brochure, (HTTP://CPI.TRANSPARENCY.ORG/CPI2013/RESULTS/)
law. The relevant perspective is that of an international tribunal applying international law, not that of different business traditions. In sum, while the tribunal is prudent enough to state at the outset that such specific circumstances should not “lower the standard of investment protection”, the impression one gets is that it may just do that.

In any event, the tribunal concluded that “neither Mr. Arif, nor any of his relatives or employees [had] been exposed to physical violence, armed threats, deprivation of liberty or a forceful taking of property.”\(^7^9\) Also, while the search and investigations conducted by the authorities “may have been unpleasant and painful”, the tribunal added that “they were conducted in accordance with Moldovan procedural law, upon an order and under the supervision of a judge after a request from a prosecutor and carefully minuted.”\(^8^0\) Moreover, the Moldovan company owned and controlled by Mr. Arif ended up only having to pay minor penalties for tax irregularities.\(^8^1\) Finally, although the tribunal acknowledged that “the conduct of the Moldovan authorities provoked stress and anxiety” to Mr. Arif, it held that such actions “did not reach a level of gravity and intensity which would allow it to conclude that there were exceptional circumstances which would entail the need for a pecuniary compensation for moral damages.”\(^8^2\)

D. Other Tribunals’ Findings

Before the *Lemire* tribunal first interpreted the expression “exceptional circumstances” as supporting the existence of a higher threshold for gravity for moral damages claims, two earlier awards rendered in 2009 have briefly examined the issue.

\(^7^9\) *Arif v. Moldova*, at ¶ 607. See also at ¶ 611: “There is no evidence of any threat or intimidation against Mr. Arif, no sign of danger for his personal security and liberty or the security of his employees, no hint as to a plot and apparently no sign of a real risk for him to be present in Chisinau [the capital of Moldova].”

\(^8^0\) *Id.* at ¶ 610.

\(^8^1\) *Id.* at ¶ 611.

\(^8^2\) *Id.* at ¶ 615.
The *Siag v. Egypt* case arose from Egypt seizing Mr. Siag's property and his subsequent arrest. The tribunal found that Egypt had committed an illegal expropriation and had failed to provide the investment full protection and a fair and equitable treatment. The investor did not request moral damages specifically, but referred to “enhanced damages.” The tribunal concluded that the claimant had asked for punitive damages and rejected the claim on the ground that the BIT did not allow such remedy. In *obiter*, the tribunal stated that “the recovery of punitive or moral damages is reserved for extreme cases of egregious behavior.” 83 This controversial statement supports the reasoning subsequently adopted by the *Lemire* tribunal regarding the requirement of exceptional circumstances for awarding compensation for moral damages. In any event, the tribunal was wrong in comparing moral damages to punitive damages.84 Punitive damages are commonly referred to as the “payment of damages in addition to actual (compensatory) damages when the defendant acted with recklessness, malice, deceit, or other reprehensible conduct (e.g., violence, oppression, fraud).” 85 Since “punitive damages are intended to punish the defendant and thereby to deter blameworthy conduct,” 86 the concept is not recognized under international law.87 As explained by the ILC Commentaries on State Responsibility, “the function of compensation is to address the actual losses incurred as a result of the internationally wrongful act ... It is not concerned to punish the responsible State, nor does compensation have an expressive or exemplary character.” 88

83 *Waguih Elie v. Egypt*, at ¶545 (emphasis added).

84 Dumberry, Compensation for Moral Damages, *supra* note 4, at 274 ff.


86 *id.*


The Europe Cement case involved a Polish company which started arbitration proceedings against Turkey under the Energy Charter Treaty. The tribunal declined jurisdiction over the dispute based on the claimant’s inability to prove its ownership of shares in two Turkish corporations which had allegedly suffered a damage.89 Interestingly, Turkey sought inter alia monetary compensation for the moral damages it allegedly suffered to its "reputation and international standing"90 as a result of the "jurisdictionally baseless claim asserted in bad faith and for an improper purpose"91 which caused it “intangible but no less real loss.”92 In its 2009 award, the tribunal decided not to award any compensation since “it [did] not consider that exceptional circumstances such as physical duress are present in this case to justify moral damages.”93 A similar reference is also found in the Cementownia v. Turkey case involving similar facts.94 These statements suggest that compensation for moral damages can only be awarded in exceptional circumstances.

Since the Lemire decision of 2011, all tribunals have adhered to the “exceptional circumstances” requirement.95

A good example is the case of Tza Yap Shum v. Peru arising from measures taken by the Peruvian authorities following a

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89 Europe Cement v. Turkey, at ¶163.
90 Id. at ¶ 177.
91 Id.
92 Id. at ¶ 128.
93 Id. at ¶ 181.
94 Cementownia v. Turkey, at ¶ 169: In this case, the Tribunal declined jurisdiction over the dispute. The Tribunal granted Turkey’s request for a “declaration” that the Claimant filed a fraudulent claim, but refused to award compensation for alleged moral damages to its reputation or prestige. The Tribunal distinguished the present claim from the Desert Line award where the arbitral tribunal decided, on the basis of the obligations contained in the BIT between Yemen and Oman, in particular the obligation of security, that exceptional circumstances, such as physical duress suffered by the investor, justified the compensation.

95 It should be added that a number of recent awards dealing with moral damages claims do not discuss the exceptional circumstances requirement: Al-Kharafi v. Libya, Award; Inmaris v. Ukraine, Award, ¶428; Rompetrol Group v. Romania, Award, ¶ 289 ff.
financial audit which allegedly expropriated the investment of a Chinese national, Mr. Tza. The tribunal concluded that the measures constituted an arbitrary seizure and an indirect expropriation and awarded him some US$ 786,000 in compensation. The tribunal rejected, however, the claimant’s request of compensation for loss of reputation. The tribunal specifically referred to the three-step test put forward by the Lemire award and indicated that the exceptional circumstances requirement was the general principle governing the award of moral damages. The tribunal concluded that in the instant case both the first and third elements of the Lemire test were not present. Thus, the measures taken by the authorities did not involve any physical threat nor caused any serious injury to his mental health.

In the Lahoud v. Congo case, the claimants (two Lebanese nationals) requested US$ 3 million in compensation for loss of reputation resulting from their company’s expulsion from the country as well as their personal humiliation and trauma due to violent actions allegedly taking place during the expropriation of the company. The Claimants specifically referred to the Arif award arguing that both the State conduct and its effect on them were grave and substantial. Interestingly, they also argued that Congo’s weak institutions and poor governance could not be an excuse for such serious violation of the law. The tribunal recognized the exceptional character of moral damages claims and concluded that no such circumstances were present in the

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97 Id. at ¶ 281.
98 Id. at ¶ 282.
99 Id.
100 Antoine Abou Lahoud v. Democratic Republic of the Congo, Award, ¶ 547 ff., 620-624.
101 Id. at ¶ 548.
102 Id.
103 Id. at ¶ 621: «Dans l’analyse du Tribunal, il ressort de la jurisprudence internationale que si le dommage moral peut faire l’objet d’une indemnisation, la réparation de ce type de préjudice reste exceptionnelle ». See also at ¶ 624 where the tribunal refers to: « Les circonstances exceptionnelles exigées par la jurisprudence internationale pour l’indemnisation du dommage moral ». 
instant case insofar as no act of violence or loss of reputation were proven.\textsuperscript{104}

As shown by this survey of recent cases, the “exceptional” character requirement now seems to be applied by all tribunals as a \textit{sine qua non} condition for awarding compensation for moral damages. The next Chapter will critically assess this interpretation.

\section*{III. The High Threshold of Gravity Requirement Misconceives the Compensatory Nature of Moral Damages}

As just demonstrated in the previous chapter, there is now a consensus amongst tribunals to the effect that compensation for moral damages should only be awarded in “exceptional circumstances” where grave and severe violations of international law occur. This trend is all the more surprising considering that this interpretation has been rejected (to the best of our knowledge) by \textit{all writers} who have recently examined the question of moral damages in the specific context of investor-State arbitration. In fact, there seems to be a consensus amongst scholars that the approach adopted by these tribunals regarding the “exceptional circumstances” requirement represents “a significant departure from established principles of international law concerning reparations.”\textsuperscript{105}

Let us briefly pause and recall what the basic principles of international law regarding reparation are. Article 31 of the I.L.C. Articles provides that a State must make \textit{full reparation} for any “injury” caused to another State by an internationally wrongful

\textsuperscript{104} \textit{Id.} at ¶ 622: « Au vu des éléments mis à sa disposition et dans l’exercice de son pouvoir discrétionnaire d’appréciation des faits, le Tribunal estime que l’affaire qui lui est soumise ne présente pas le caractère exceptionnel requis par la jurisprudence ».

act. The Permanent Court of International Justice famously explained what “full reparation” means in its 1928 Chorzów Factory case: “reparation must, so far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.” What about the concept of “injury”? Article 31 of the ILC Articles indicates that injury refers to “any damage, whether material or moral, caused by the internationally wrongful act of a State.” A State must therefore provide full reparation for all damages, including moral damages. The work of the ILC on State Responsibility makes it clear that compensation is the appropriate remedy for moral damages affecting an individual or a company.

To the extent that under international law a State must provide full reparation for all damages, it is conceptually difficult to understand why one certain type of damages should be treated differently. This is because compensation for moral damages share the same function as for material damages: to eliminate all consequences of the breach. There are simply no reasons why moral damages should not be subject to the same rules as other compensatory damages. Logically, no higher threshold of gravity or seriousness should therefore be required for finding a breach of international law in the context of moral damages claims. Thus, why should compensation be available only in “exceptional circumstances” for moral damages when such compensation is available in “normal” circumstances for material

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106 ILC Articles on State Responsibility, supra note 8, at Article 31.

107 Factory at Chorzów (Germany v Poland), 1928 PCIJ (ser A) No 17, at 47.

108 ILC Articles on State Responsibility, supra note 8, at Article 31(2) (emphasis added).

109 ILC Commentaries, supra note 2, at 10 ¶ 3. The question of whether or not a tribunal established under a BIT could (or, indeed, should) remediate moral damages suffered by a foreign investor with the remedy of satisfaction in the form of a declaration of wrongfulness is addressed in: Dumberry, Satisfaction as a Form of Reparation, supra note 23.

110 Coriell & Marchili, supra note 13, at 214.
damages? These basic arguments have been supported by scholars who have examined the question in recent years.\textsuperscript{111}

The question arises as to why investment tribunals have nevertheless adopted the “exceptional circumstances” requirement test. One reason could be that arbitrators are generally reluctant to award any compensation for moral damages. The test would therefore serve to deliberately reduce the possibility of success of any moral damages claim. Yet, there is no evidence of any such general pattern. In fact, tribunals have openly recognized in their awards the availability of compensation for moral damages under BITs. In our view, there is a much more simple reason explaining why tribunals have adopted this test. Arbitrators are understandably unfamiliar with the unprecedented issue of moral damages claims in the specific context of investment arbitration.\textsuperscript{112} They naturally seek guidance from general public international law. One obvious and invaluable source of information is, of course, the work of the I.L.C. on State responsibility where the issue of moral damages has been discussed. Another source is the writing of scholars examining older international law cases dealing with moral damages.\textsuperscript{113} The striking feature of the overwhelming majority of such cases is that they involve very grave and serious violations of international law. In our view, investor-State tribunals have been influenced by the context of these older cases. This question is examined in Section A. In the next section, we will provide a number of examples of the type of situations where tribunals should, in our view, award compensation for moral damages even though the conduct involved may not qualify as “grave enough” to pass the “exceptional circumstances” requirement test put forward by the Lemire and Arif tribunals (Section B).

\textsuperscript{111} Blake, supra note 12, at 394-395; Coriell & Marchili, supra note 13, at 214, 217; Dumberry, Compensation for Moral Damages, supra note 4, at 270; Ehle & Dawidowicz, supra note 105, at 307; Jagusch & Sebastian, supra note 33, at 55, 61-62; Lawry-White, supra note 51, at 236.

\textsuperscript{112} Blake, supra note 12, at 379.

\textsuperscript{113} The classic books examining these cases include: CHRISTINE GRAY, JUDICIAL REMEDIES IN INTERNATIONAL LAW 33 ff (1990); MARJORIE M. WHITEMAN, DAMAGES IN INTERNATIONAL LAW 350-357, 483-491, 578-591, 777-786 (Vol. I, 1937). See also: Stephan Wittich, “Non-Material Damage and Monetary Reparation in International Law”, supra note 3, at 321-368.
A. Tribunals Have Been Influenced by the Context of Older Cases Involving Egregious State Conduct

Investor-State tribunals have certainly been influenced by a long line of older cases dealing with moral damages claims which typically involved very grave and serious violations of international law. In these classic cases, tribunals have awarded compensation for death, deprivation of liberty, unlawful arrest, detention, deportation, etc. Investor-State tribunals have explicitly referred to some of these cases in their awards.\footnote{114} Such a strong influence is clear when the Lemire tribunal states that it “sympathizes with Mr. Lemire’s predicament, but feels that the injury suffered cannot be compared to that caused by armed threats, by the witnessing of deaths or by other similar situations in which tribunals in the past have awarded moral damages.”\footnote{115} The “other situations” mentioned by the tribunal is certainly a reference to a number of classic cases specifically cited by the I.L.C. in its Commentary on Article 36 of its Articles.\footnote{116}

One famous often-cited case is Lusitania adjudicated by the U.S.-Germany Mixed Claims Commission in 1923. This case involved the sinking of the British liner Lusitania by a German submarine during the First World War killing 1,198 people, including 128 U.S. nationals.\footnote{117} In the following paragraphs, we will briefly highlight a number of other older cases involving moral damages suffered by individuals.\footnote{118}

\footnote{114} Desert Line, at ¶ 289 and Lemire v. Ukraine at ¶ 329, both referring to the Lusitania case. See also: Arif v. Moldova, at ¶586 referring to the Fabiani case at ¶586 and the Lusitania case ¶ 591.
\footnote{115} Lemire v. Ukraine, at ¶ 339 (emphasis added).
\footnote{116} ILC Commentary, supra note 2, at 101, ¶ 16 footnote 540: “International tribunals have frequently granted pecuniary compensation for moral injury to private parties. For example, the Chevreau case (see footnote 133 above) (English translation in AJIL, vol. 27, No. 1 (January 1933), p. 153); the Gage case, UNRIAA, vol. IX (Sales No. 59.V.5), p. 226 (1903); the Di Caro case, ibid., vol. X (Sales No. 60.V.4), p. 597 (1903); and the Heirs of Jean Maninat case, ibid., p. 55 (1903).”
\footnote{117} Lusitania, at 32.
\footnote{118} The other question of moral damages suffered by States is examined in: Dumberry, Satisfaction as a Form of Reparation, supra note 23.
The Chevreau case involved the arrest and detention in Persia in 1918 of Mr. Chevreau, a French national, by the British authorities and his subsequent deportation to India and Egypt.\(^{119}\) In his 1931 award, the Sole Arbitrator concluded that his prolonged detention and deportation were not justified under international law and that these acts had caused him a moral damage.\(^{120}\) Yet, the Sole Arbitrator also noted that the detention did not involve any harsh internment conditions.\(^{121}\) The Sole Arbitrator concluded that Great Britain should compensate France on behalf of its nationals (in fact his heirs) the sum of 2100£.\(^{122}\)

The Di Caro case was decided in 1903 by Umpire Ralston of the Italian-Venezuela Mixed Claims Commission.\(^{123}\) It involved Venezuelan soldiers killing Mr. Cammarano, an Italian national shopkeeper in Venezuela in 1902. In his determination of the proper compensation to be awarded to the widow of the deceased for moral damage resulting from violent death, the Umpire took account not only of the financial deprivation, but also of the shock she had suffered as a result of the particularly violent death of Mr. Cammarano and her consequent deprivation of affection,


\(^{120}\) *Id.*, p. 1138. The Tribunal held that « Il ne paraît pas douteux que la détention de M. Chevreau et sa déportation, dans la mesure où l’Arbitre a reconnu que ces actes donnent lieu à une réclamation en droit international, ont causé à M. Chevreau un dommage surtout moral mais aussi un dommage matériel ; entre autres choses, lesdits actes l’ont mis dans l’impossibilité de continuer ou de reprendre son activité comme professeur de langues en Perse. »

\(^{121}\) *Id.*, p. 1140, adding that « Les conditions plus ou moins rigoureuses de la détention ont été prises en considération dans la fixation de l’indemnité pour la détention et la déportation. »

\(^{122}\) The Arbitrator indicated that of that total amount some 100£ were for a lost violin.

\(^{123}\) *Di Caro, UNRIAA*, vol. X, at 597 (1903).
The violent actions were described as follows by the Umpire:

Two government soldiers went to the store (...) of Giovanni Cammarano in Duaca, when he was absent, and, after demanding various articles with which they were supplied, attempted to assault the claimant, Beatrice Di Caro and her daughter-in-law. The two sons of Giovanni Cammarano struggled with the soldiers and one son, getting possession of the gun of a soldier, shot and killed him. The remaining soldier escaped. The sons thereupon fled. A detachment of soldiers in charge of an officer shortly after went to the house and, finding Giovanni Cammarano, who had meanwhile returned, demanded the whereabouts of his sons. This he was unable or unwilling to give. They seized him and, conducting him about a square and a half, cut him with a machete and shot and killed him in the street. Thereafter the soldiers sacked the store and again, on January 27, 1903, the store having been somewhat replenished, it was plundered by the government forces.

The *Heirs of Jean Maninat* case was decided in 1905 by the Franco-Venezuelan Mixed Claims Commission. It involves injuries suffered by a French national living in Venezuela as a result of an assault by members of the Venezuelan army. The Umpire concluded that Mr. Maninat’s subsequent death was caused by the wounds inflicted upon him by the soldiers. He concluded that Venezuela had breach its international law obligation to protect foreign nationals on its territory.

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124 Id. at 598.
125 Id. at 598.
126 *Heirs of Jean Maninat, UNRIAA*, vol. X, at 55.
127 This is the reasoning of the Umpire (at 79): “Although alien born, Juan Maninat had a right under the laws of Venezuela to the same protection as is granted to its nationals. (...) When he entered the presence of the Venezuelan general it was the duty of that general to throw around him the protection of the Government and to make his person while there safe — absolutely safe. When he was wounded under the eye and within the power of this general a gross outrage had been permitted, the office of the commanding general had been perverted or set at naught, and the respondent Government having intrusted this general to hold that office and stand in its stead in that
Umpire awarded to France a sum of 100,000 francs for compensation for Mr. Maninat’s sister. The amount was particularly based on her moral suffering resulting from the death of her brother.\textsuperscript{128}

The \textit{Gage} case was decided by the U.S.-Venezuela Mixed Claims Commission.\textsuperscript{129} Mr. Gage was arrested and detained in Venezuela after a train journey where he “behaved in a way as if he were intoxicated and indulged in actions that were liable to disturb the public peace.”\textsuperscript{130} Mr. Gage claimed damages for illegal arrest and detention, which ground was rejected by Umpire Barge. He also claimed compensation for “personal indignities” for death threat he had received from the chief of prison while he was detained. For this head of damage, the Umpire indicated that “the ill-treatment by the officials for which the government is liable, and on which the claim is founded, exists in insults and in menaces that were not carried out” and concluded that “a sum of $100 seems a just reward.”\textsuperscript{131}

One more recent case is the \textit{Dispute concerning responsibility for the deaths of Letelier and Moffitt} between the United States and Chile.\textsuperscript{132} Mr. Orlando Letelier, a Chilean national living in exile in Washington, was an opponent of the Pinochet regime which took power in Chile in a \textit{coup d’Etat} in 1973. He was assassinated in that city in 1976 by Chilean secret police agents in a car bomb along with his assistant, Mrs. Ronni Moffitt (a U.S. national). The United States sought compensation from Chile on

\textsuperscript{128} \textit{UNRIAA}, vol. X, at 81-82.

\textsuperscript{129} \textit{Gage, UNRIAA}, vol. IX, at 226 (1903).

\textsuperscript{130} \textit{Id.} at 228.

\textsuperscript{131} \textit{Id.} at 229.

behalf of both the Letelier and Moffitt families because it considered Chile to be responsible under international law for the deaths of Mr. Letelier and Mrs. Moffitt and the personal injuries to Mr. Moffitt.\footnote{Mrs. Moffitt’s husband, Mr. Michael Moffitt (also a U.S. national), was injured in the car bomb, but survived.} In 1990, after a regime change in Chile, the United States and Chile entered into a \textit{compromis} under which they set up an \textit{ad hoc} Commission, which awarded a total of more than US$1 million in compensation for moral damages to the individuals and their heirs.

Finally, reference should be made to the \textit{Diallo} case decided by the ICJ in 2012.\footnote{Ahmadou Sadio Diallo (Republic of Guinea v. Democratic Republic of the Congo), 2012 I.C.J. Reports 324 (Compensation, Judgment) at 10–12.} This case involved a claim brought by Guinea for the arbitrary arrest of Mr. Diallo (a Guinean national), his detention for 72 days without due process and his eventual expulsion from the Democratic Republic of Congo (DRC) where he had lived for over 30 years. These events took place at a time where Mr. Diallo was pursuing recovery of debt owed to his business by the DRC and State (partially) owned oil companies. The Court concluded that the DRC breached various provisions of the International Covenant on Civil and Political Rights and the African Charter on Human and Peoples’ Rights. Guinea’s claim included US$ 250 000 in moral damages, including injury to Mr. Diallo’s reputation. The ICJ cited the \textit{Lusitania} case by finding that non-material injury may include “mental suffering, injury to [a claimant’s] feelings, humiliation, shame, degradation, loss of social position or injury to his credit or to his reputation”.\footnote{\textit{Id.} at 10 ¶18.} The Court awarded Guinea some US$ 85,000 despite the lack of evidence that Mr. Diallo had actually suffered any such moral damages. The Court stated that such “non-material injury can be established even without specific evidence” and that, in the instant case, the fact Mr. Diallo had “suffered non-material injury is an inevitable consequence of the wrongful acts of the DRC already ascertained by the Court.”\footnote{\textit{Id.} at ¶21.} In other words, the Court simply \textit{inferred} the existence of psychological suffering and loss of reputation based on the gravity and seriousness of the wrongful act. The court also considered the link between the

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133 Mrs. Moffitt’s husband, Mr. Michael Moffitt (also a U.S. national), was injured in the car bomb, but survived.
135 \textit{Id.} at 10 ¶18.
136 \textit{Id.} at ¶21.
\end{flushright}
events and the recovery of the debt to be an aggravating factor as it demonstrates the motivation behind the State’s actions. The approach adopted by the ICJ is consistent with that of international human rights tribunals.\footnote{Blake, supra note 12, at 384.}

What these classic (and two modern) cases all have in common is clearly the gravity and egregiousness of the State conduct involved. The specific context of these cases must have influenced the reasoning of recent investment tribunals. Yet, in our view, tribunals should not confuse the principles guiding compensation for moral damages and the circumstances under which they have typically been awarded in the past.\footnote{Blake, supra note 12, at 395; Cabresa, Moral Damages in Investment Arbitration and Public International Law, paper presented at the Third Annual Investment Treaty Arbitration Conference: A Debate and Discussion, Interpretation in Investment Arbitration, 13 (2009); Coriell & Marchili, supra note 13, at 219-220.} In other words, while it is true that compensation for moral damages has been awarded in the past in some truly “exceptional circumstances”, often involving “egregious” acts, that does not mean that the threshold for awarding compensation has consequently become higher. Thus, from the seriousness of the breach typically involved, it should not necessarily follow that a higher level of gravity has suddenly become a \textit{precondition} for awarding compensation.\footnote{Dumberry, Compensation for Moral Damages, supra note 4, at 270.} In that sense, it is quite \textit{irrelevant} for the \textit{Lemire} tribunal to ask the question whether or not the injury suffered by the claimant “compares” to those egregious situations which arose in older cases. Such comparison is not the benchmark against which State conduct must be assessed. The right question to be asked is simply whether or not the claimant has proven the existence of any non-material injury directly resulting from the commission of a wrongful act by the host State.

Finally, it should be noted that there is a controversy amongst writers as to whether or not investor-State tribunals that have recently started requiring “exceptional circumstances” to award compensation for moral damages have also been influenced by
human rights case law. While no investor-State award has explicitly referred to any such human rights cases, it remains that they are mentioned by the I.L.C. in its Commentary to Article 36 when dealing with moral damages. The question is relevant here because international human rights courts have often awarded compensation for moral damages in the context of particularly grave or exceptional violations of individual rights. There are many reasons which may explain why this is the case, including the fact that these tribunals “focus primarily on condemning rather than compensating for human rights violations.” In any event, even if it is the case that arbitration tribunals have somehow been ‘influenced’ by the work of human rights tribunals, it remains that this would be based on a misreading of human rights case law. Thus, according to Blake the “question of gravity does not operate as a pre-condition for the award of moral damages” in the human rights context. For him, “the fact that the human rights cases awarding moral damages have tended to address situations of grave or systematic state abuse does not mean that the courts have imported a ‘gravity’ or ‘egregiousness’ test as a qualification for moral damages.”

B. Types of Wrongful Acts Short of Grave Violations that May Cause Moral Damages

As stated above, recent awards that have required “exceptional circumstances” to allow compensation for moral damages have misinterpreted the basic principles of reparation under international law. In our view, a tribunal should be allowed

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140 Some authors argue that this is the case: Coriell & Marchili, supra note 13, at 223; Sabahi, Moral Damages in International Investment Law, supra note 13, at 260. Others have adopted the opposite position: Blake, supra note 12, at 395.

141 ILC Commentary, supra note 2, at 102 ¶ 19.

142 Blake, supra note 12, at 382 ff, 396-7; Coriell & Marchili, supra note 13, at 215 ff.

143 See, the different reasons examined in: Blake, supra note 12, at 395 ff.

144 Coriell & Marchili, supra note 13, at 218.

145 Blake, supra note 12, at 395.

146 Id. at 387.

147 Id.
to award compensation in situations where the State conduct does not involve any “physical threat and illegal detention” (or other analogous situations). This is indeed the position adopted by the Lemire tribunal. Yet, and contrary to the view held by that tribunal, we believe that there should be no requirement that the State conduct be grave for compensation to follow. In other words, an investor simply needs to demonstrate that the commission of a wrongful act by the host State has caused him/her a moral damage.

What matters is indeed the effect that such act has had on the investor. It needs to be shown that State action has resulted in the deterioration of a person’s health, to stress, anxiety or any other mental suffering. The question arises as to whether or not compensation should be allowed only when the prejudice suffered by the victim is substantial. For instance, the Lemire tribunal set the threshold at “extraordinary stress or anxiety” and indicated that injury inflicted must be “substantial.” Similarly, in one recent case the tribunal dismissed the investor’s moral damages claim based on lack of evidence of any “emotional” harm suffered that was “sufficiently serious” to require compensation. In our view, the Arif tribunal is certainly right to affirm that no compensation should be awarded when an investor suffer a mere sentiment of frustration and affront as a result the commission of a wrongful act (such as a breach of a contract) by the host State. A “real” moral damage must be proven. Yet, we believe that there is no logical reason for requiring that only “extraordinary stress or anxiety” be compensated. The “extraordinary” nature of the stress or anxiety suffered by a person will be relevant in the context of a tribunal’s actual quantification of the amount of compensation (a question further discussed in the conclusion section).

The difficult question is, of course, to identify the types of international wrongful acts short of grave violations that could hypothetically result in compensable moral damages. The

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148 Lemire v. Ukraine, at ¶ 337.

149 Id. at ¶338. See also: Arif v. Moldova, at ¶ 592.

150 Inmaris Perestroika Sailing Maritime Services GmbH and Others v. Ukraine, at ¶ 428.

151 Arif v. Moldova, at ¶ 592.
present section briefly examines three such wrongs: denial of justice (i), due process (ii) and arbitrary conduct (iii).

1. Denial of Justice

There is a consensus amongst scholars that the obligation not to deny justice is one of the elements of the fair and equitable treatment (FET) standard, and that it is part of the minimum standard of treatment under custom. Under international law, a State is responsible for the actions of its courts. A denial of justice occurs in the context of the maladministration of the host State’s judicial system toward an investor. One important point to highlight is that only “gross or manifest instances of injustice” will be considered a denial of justice. Thus, “a simple error, misinterpretation or misapplication of domestic law is not per se a denial of justice”. There is indeed a certain threshold for denial of justice to occur. This position has been endorsed by investor-State tribunals.

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154 I.L.C Articles on State Responsibility, supra note 8, at article 4(1).


156 Newcombe & Paradell, supra note 153, at 238; Diehl, supra note 152, at 467; Paulsson, supra note 155 at 60 (speaking of ‘egregious’ actions by the State and of ‘fundamental violations’ of international law).

157 UNCTAD, supra note 152, at 80. See also: Diehl, supra note 152 at 462, 503; Kläger, supra note 152, at 227; Newcombe & Paradell, supra note 153, at 238; Paulsson, supra note 155, at 73 ff, 87 ff.

158 Diehl, supra note 152 at 456, 503.

159 Chevron Corporation (USA) and Texaco Petroleum Company (USA) v. Ecuador, UNCITRAL, PCA Case No. 34877, Partial Award on Merits, ¶ 244 (30
In his classic book on the topic, Paulsson lists a number of instances where tribunals have found a denial of justice, including “refusal of access to court to defend legal rights, refusal to decide, (...) unreasonable delay, politically dictated judgments, corruption, intimidation, fundamental breaches of due process, and decisions so outrageous as to be inexplicable otherwise than as expressions of arbitrariness or gross incompetence.”160 One can easily envisage such wrongful acts causing significant anxiety and other mental suffering to a person without, however, necessarily qualifying as a “grave” violation of international law. This is indeed the conclusion reached by Paulsson for whom “claims of mental suffering, injury to feelings, humiliation, shame, or injury to credit and reputation are predictable in the context of denial of justice, where the personal integrity of the victim may have been profoundly affected.”161 According to the NAFTA Mondev tribunal, for a judicial decision to constitute a denial of justice, it must be “clearly improper and discreditable” in the sense that it would “shock or surprise: any impartial observer and raise “justified concerns as to the judicial propriety of the outcome” of the case.162 Here again,

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160 PAULSSON, supra note 154, at 204-205.

161 Id. at 121.

162 Mondev International Ltd. v. United States, ICSID No. ARB(AF)/99/2, Award, ¶127 (Oct. 2, 2002): “The test is not whether a particular result is surprising, but whether the shock or surprise occasioned to an impartial tribunal leads, on reflection, to justified concerns as to the judicial propriety of the outcome, bearing in mind on the one hand that international tribunals are not courts of appeal, and on the other hand that Chapter 11 of NAFTA (like other treaties for the protection of investments) is intended to provide a real measure of protection. In the end the question is whether, at an international level and having regard to generally accepted standards of the administration of justice, a tribunal can conclude in the light of all the available facts that the impugned decision was clearly improper and discreditable, with the result that the investment has been subjected to unfair and inequitable treatment.” The test set out in Mondev has been subsequently endorsed by the Waste Management and Loewen tribunals. The Loewen tribunal thus referred to “manifest injustice” such as a lack of due process that leads to an outcome
although such a denial of justice would certainly fall below the high
threshold of grave violation of the law, it may nevertheless cause a
significant moral damage to the victim.

There are in fact some historical precedents supporting
awarding compensation for moral damages in the context of denial
of justice. In the Fabiani case, the sole Arbitrator (the President of
the Swiss Confederation) awarded compensation for Mr. Fabiani’s
moral losses as a result of repeated denial of justice by the
Venezuelan authorities. The dispute arises following an arbitral
award in favor of Mr. Fabiani rendered in France against two ex-
business partners domiciled in Venezuela. When Mr. Fabiani
attempted to enforce the award in Venezuela he was faced by
arbitrary actions, denial of justice and fraudulent resolutions by the
executive power of Venezuela to keep him from recovering his
debt. Notably, the government fraudulently assigned railroad
contracts and awarded maritime contracts to third parties in order
to insulate the assets of Fabiani’s debtor. The arbitrator considered
Venezuela’s hostile attitude towards Mr. Fabiani as an aggravating
factor and concluded that the authorities had committed repeated
denials of justice against him. Mr. Fabiani’s inability to recover the
amount of compensation of this award led to his bankruptcy. The
Arbitrator awarded him 1,800,000 francs to compensate both
material and moral loss arising from his bankruptcy.

2. Due Process

The concept of “denial of justice” is closely interconnected
with that of “due process”. The requirement of due process is

which “offends a sense of judicial propriety” (Loewen Group, Inc. and Raymond
L. Loewen v. United States, ICSID No. ARB(AF)/98/3, Award, ¶ 132 (June 26,
2003)). For the Waste Management tribunal, a denial of justice occurs when a
decision by a domestic court is “clearly improper and discreditable” in the
sense that it would “shock or surprise” any impartial observer and would raise
“justified concerns as to the judicial propriety of the outcome” of the case
(Waste Management, Inc. v. Mexico (“Number 2”), ICSID No. ARB(AF)/00/3,
Award, ¶95 (Apr. 30, 2004)).

163 Fabiani Case, French-Venezuelan Mixed Claims Commission, 1905,
considered by many as an element of the FET standard.\textsuperscript{164} Under domestic law, the concept of the "rule of law" is generally considered to encompass a "procedural" dimension which is governed by the principle of "due process", which "requires that one to whom the coercive power of the state is to be applied receive notice of the intended application and an opportunity to contest that application before an impartial tribunal".\textsuperscript{165} While the term denial of justice is sometimes used in a much broader way,\textsuperscript{166} most scholars limit its scope to the maladministration of the host State's judicial system.\textsuperscript{167} On the contrary, the concept of due process is not limited to the judicial system; it applies to all forms of governmental decision-making, including measures taken by the government (both the executive and legislative branches) and the administration.\textsuperscript{168}

One of the present authors has examined elsewhere how NAFTA tribunals have interpreted and applied the obligation to provide due process to investors in the context of claims of breach of the FET standard under Article 1105\textsuperscript{169} NAFTA tribunals have held that the due process obligation is breached whenever an investor is not informed and not invited to a hearing discussing a permit application and whenever it is not given any opportunity to appear and to present evidence before this administrative body.\textsuperscript{170}

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\textsuperscript{164} Barnali Choudhury, 'Evolution or Devolution? Defining Fair and Equitable Treatment in International Investment Law', \textit{6(2) J. WORLD INVEST. & TRADE 316} (2005); Diehl, \textit{supra} note 152, at 432, 437.


\textsuperscript{168} Diehl, \textit{supra} note 152, at 431 ff.

\textsuperscript{169} Dumberry, \textit{Denial of Justice, supra} note 159; Dumberry, \textit{Fair and Equitable Treatment, supra} note 159, at 2225 ff.

\textsuperscript{170} Metalclad Corporation v. Mexico, ICSID No. ARB(AF)/97/1, Award, ¶ 91 (Aug. 30, 2000); International Thunderbird Gaming Corporation v. Mexico, UNCITRAL, Award, ¶ 198 (Jan. 26, 2006).
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breach of the FET standard also occurs when an investor is denied a permit based on reasons that are unrelated to specific existing requirements for issuing that permit and when an administrative order is not “adequately detailed and reasoned”, such as, for instance, in cases where an order does not review the evidence presented by a party at a hearing or where the order does not discuss the legal grounds on which that administrative body has based its decision. Another feature of an administrative process that have been considered by tribunals as breaching the due process requirement is when an administrative body asserts “non-existent policy reasons” to force an investor to comply with “very burdensome demands for documents” having for consequence that the investor is incurring ‘unnecessary expense and disruption’. Yet, tribunals have also concluded that a State does not breach its due process obligation when mere administrative “irregularities” are committed, unless such irregularities are “grave enough to shock a sense of judicial propriety.”

In our view, while such State conduct is not grave enough to pass the high threshold of gravity test put forward by recent investment tribunals, it may nevertheless cause serious moral damages to its victim.

3. Arbitrary Conduct

Arbitrary conduct is another type of wrongful act short of a grave violation of international law that can cause significant moral damages to a person. The classic definition of arbitrary conduct was enunciated by the ICJ in its 1989 ELSI case: “It is a wilful disregard of due process of law, an act which shocks, or at least

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171 *Metalclad v. Mexico*, Award, ¶ 93.

172 *Thunderbird v. Mexico*, Award, ¶ 198.

173 *Pope and Talbot Inc. v. Canada*, UNCITRAL, Award in Respect of Damages, ¶ 68 (31 May 2002). Another instance mentioned by the Tribunal in its earlier award (*Pope and Talbot Inc. v. Canada*, UNCITRAL, Award on the Merits of Phase II, ¶ 181 (10 April 2001) is when an administrative body refuses to provide the investor with ‘promised information’ and denies its ‘reasonable requests for pertinent information’ on administrative matters.

174 *Thunderbird v. Mexico*, Award, ¶ 200.
surprises, a sense of juridical propriety.”\textsuperscript{175} Case law suggests that there is arbitrariness when no rational relationship exists between a measure adopted by the government and the alleged purpose or goal of that measure.\textsuperscript{176} In this analysis, whether the measure is unwise, insufficient or inconsistent with domestic law is not pertinent.\textsuperscript{177} Writers have also used rationality\textsuperscript{178} or legitimacy\textsuperscript{179} as a yardstick to determine arbitrariness. They have defined arbitrary measures as those made “on the basis of irrelevant considerations”\textsuperscript{180} or those that are unjustified and unexplained by objective reasons.\textsuperscript{181} Heiskanen has proposed what is perhaps the most comprehensive test.\textsuperscript{182} Another definition of arbitrariness in


\textsuperscript{176} UNCTAD, supra note 152, at 78. See Alex Genin, Eastern Credit Limited, Inc. and A.S. Balttoil v. Estonia, ICSID No. ARB/99/2, Award, ¶ 370 (June 25, 2001); Siemens A.G. v. Argentina, ICSID No. ARB/02/8, Award, ¶ 319 (Jan. 17, 2007).

\textsuperscript{177} Enron Corporation and Ponderosa Assets, L.P. v. Argentina, ICSID No. ARB/01/3, Award, ¶ 281 (May 22, 2007).


\textsuperscript{182} Veijo Heiskanen, ‘Arbitrary and Unreasonable Measures’, in STANDARDS OF INVESTMENT PROTECTION, 104, 111 (Reinisch eds., 2008):“The decision-maker assesses the international legality of the governmental measure in question by focusing on the relationship between the measure and its underlying policy justification. Has any rationale or justification been put forward in support of the measure in the first place? In the affirmative, is such a rationale or justification related to a legitimate governmental policy? If the answer to the first question is in the negative, and if there is no conceivable rationale that could justify it, the measure can be classified as ‘arbitrary’. This ‘definition’ of arbitrary is also largely in line with the standard definition of arbitrary in legal dictionaries - an arbitrary measure can indeed be defined as a measure taken without any justification, actual or conceivable. If the answer to the first question is yes - if a rationale or justification has in fact been put forward for the measure - then the relevant question is whether there is a reasonable
the context of international investment law is found in a recent UNCTAD report.\textsuperscript{183} 

One of the present authors has examined elsewhere how NAFTA tribunals have interpreted and applied the prohibition against arbitrary conduct in the context of claims of breach of the FET standard under Article 1105.\textsuperscript{184} The threshold of severity applied by NAFTA tribunals in order to establish a finding of arbitrariness has been consistently high. For instance, the Glamis tribunal held that a breach of Article 1105 "requires something greater than mere arbitrariness, something that is surprising, shocking, or exhibits a manifest lack of reasoning\textsuperscript{185} NAFTA tribunals do not equate the concept of arbitrariness with that of illegality.\textsuperscript{186} Thus, the Gami tribunal held that a government’s failure to implement or to abide by its own laws and regulations does not amount to an arbitrary act in violation of the FET relationship between such a purported justification and a legitimate governmental policy. If there is no such relationship (eg if the measure discriminates between investors based on their eye colour), then the measure in question can be considered ‘unreasonable’.”

\textsuperscript{183} UNCTAD, supra note 152, at 78: “In its ordinary meaning, ‘arbitrary’ means ‘derived from mere opinion’, ‘capricious’, unrestrained’, ‘despotic’. Arbitral conduct has been described as ‘founded on prejudice or preference rather than on reason or fact’. Arbitrariness in decision-making has to do with the motivations and objectives behind the conduct concerned. A measure that inflicts damage on the investor without serving any legitimate purpose and without a rational explanation, but that instead rests on prejudice or bias, would be considered arbitrary.”


\textsuperscript{185} Cargill, Inc. v. Mexico, ICSID Case No. ARB(AF)/05/02, Award, ¶293, 296 (Sept. 18, 2009); Glamis Gold, Ltd. v. United States, UNCITRAL, Award, ¶ 617 (June 8, 2009). See also: S.D. Myers Inc. v. Canada, UNCITRAL, First Partial Award, ¶ 263 (Nov. 13, 2000)(referring to treatment that “rises to the level that is unacceptable from the international perspective”); Thunderbird v. Mexico, Award, ¶ 194 (requiring proof of “manifest arbitrariness falling below international standards”); Waste Management, Award, ¶ 115 (speaking of “wholly arbitrary” conduct).

\textsuperscript{186} ADF Group Inc. v. United States, ICSID Case No. ARB (AF)/00/1, Award, ¶190 (Jan. 9, 2003).
standard under Article 1105. The tribunal explained that “something more” is required: a government must have committed a maladministration that amounts to an “outright and unjustified repudiation” of such laws and regulations. The Waste Management tribunal took the same view regarding contracts. Finally, the Cargill tribunal concluded that a government’s “inconsistent” or “questionable” application of its own policy or procedure does not amount to an arbitrary act in violation of the FET standard. For a breach of Article 1105 to occur, the Cargill tribunal insisted that it must be shown that a State’s application of its own policy/procedure “constitutes an unexpected and shocking repudiation of a policy’s very purpose and goals” or that it “grossly subverts a domestic law or policy for an ulterior motive.”

In our view, the type of arbitrary conducts that have been identified by NAFTA tribunals would probably not pass the high threshold of gravity test required by the Lemire and Arif tribunals. Yet, such conduct could certainly cause serious moral damages to its victim. Interestingly enough, the Lemire tribunal also agrees

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187 Gami Investments, Inc. v. Mexico, UNCITRAL, Award, ¶ 91, 103 (Nov. 15, 2004).
188 Id., at ¶91, 103, 104.
189 Waste Management, Award, at ¶ 115. Thus, a mere contractual breach (such as a failure of payment) does not amount to an arbitrary act in violation of the FET standard, unless it can be shown that the government committed an “outright and unjustified repudiation of the transaction” (and prevented the creditor from having any remedy to address the problem), or unless it can be shown that the breach of contract was “motivated by sectoral or local prejudice.”
190 Cargill v. Mexico, Award, ¶ 98, 292, 293, 296.
191 Cargill v. Mexico, Award, ¶ 293, 296.
192 It should be noted, however, that in the specific context of NAFTA Article 1105, the FET protection is offered to investments, not investors themselves. Under Article 1105, an individual investor could therefore not claim moral damages for a personal injury resulting from an arbitrary conduct or denial of justice committed by the host State in breach of the breach of the FET standard. In other words, a NAFTA tribunal could not award moral damages to a person under the heading of Article 1105. Yet, it could certainly do so under other provisions, including Article 1110 (expropriation). In fact, all depends on the actual drafting of the FET clause. According to Newcombe & Paradell, supra note 153, at 262: “The fair and equitable treatment standard in IIAs typically applies only to ‘investments’ or ‘investments of investors’ but not
that certain types of arbitrary conduct can cause moral damages: “The arbitral tribunal accepts that inspections by a regulator, if improperly used as tools of intimidation against regulated entities, constitute egregious behavior and an abuse of power, which can cause extreme stress and anxiety to the supervised and result in an entitlement to be compensated for the moral damage inflicted.”

IV. Conclusion

In this article we have argued that recent awards that have required “exceptional circumstances” to allow compensation for moral damages have applied a restrictive definition of the concept. Such interpretation risks depriving investors of full reparation for real injury actually suffered. Clearly, the burden of proof rests on an investor to demonstrate to a tribunal that it has suffered a significant moral damage as a result of the commission of a wrongful act by the host State. It is indeed for the investor to show a sufficient causal link that is not too remote between the act and the damages suffered. It is difficult to understand why an investor who has successfully made such demonstration should not be compensated in the absence of so-called “exceptional circumstances”. Moreover, the application by tribunals of this higher threshold of gravity misinterprets the basic principles of reparation under international law and misconceives the compensatory nature of moral damages. Our position can be summarized as follows:

- A tribunal should be allowed to award compensation in situations where the State conduct does not involve any physical threat, illegal detention or other similar situations of “ill-treatment [that] contravenes the norms according to which civilized nations are expected to act”;

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193 Lemire v. Ukraine, at ¶ 341. The Tribunal concluded, however, that the case at hand did not involve such situation.

194 Id. at ¶333.
• There should indeed be no requirement that the State conduct be grave for compensation to follow;

• An individual investor simply needs to demonstrate that the commission of a wrongful act by the host State has caused him/her a moral damage in the form of a deterioration of health, stress, anxiety, or any other mental suffering; a loss of reputation needs to be proven for corporations.

Our basic proposition is therefore that proof of grave or “egregious” acts is not a requirement to award compensation for moral damages. Similarly, since the work of the I.L.C. on State responsibility has long adopted the concept of “objective” responsibility of a State, it follows that fault, malice or any other intent is also clearly not a necessary precondition for awarding compensation. But does that mean that the commission of grave and “egregious” acts by a State is completely irrelevant in the context of moral damages?

In our view, a State’s fault or malicious intent as well as especially egregious acts should be taken into account by tribunals when they actually quantify the amount of compensation to be awarded to remedy moral damages. Thus, the amount of compensation should be proportionate to the seriousness of the offence committed by a State and its degree of responsibility. A tribunal may award a greater amount of compensation for moral damages in a situation where the conduct of the State is especially malicious or shocking. Similarly, the amount of compensation should reflect the nature and the extent of the prejudice suffered by the victim. A tribunal should be allowed to award a greater amount of compensation when the prejudice is substantial and significant. This is because the goal of compensation is to cover the actual damage suffered. In other words, while a “grave cause” and a “substantial effect” are not sine qua non conditions for awarding compensation for moral damages, they are most relevant elements for matters of quantification.

195 Coriell & Marhici, supra note 13, at 6-8; Markert, supra note 11, at 31.
196 Ripinsky & Williams, supra note 6, at 312; Markert, supra note 11, at 41.
197 Lemire v. Ukraine, at ¶ 333.
Wrong Direction: “Exceptional Circumstances” and Moral Damages 75

Two writers have recently argued that this position taken by one of the authors in an earlier publication198 “imply that an ‘extra amount’ of compensation is being granted because of the conduct of the state” and that “this ‘extra amount’ is not compensation but punishment”.199 For them, such an “incremental amount of damages awarded for egregious conduct is not compensatory and would have to be treated as punitive damages.”200 In fact, they believe that “as any explicit award of punitive damages is impermissible under public international law, tribunals might seek to camouflage awards of punitive damages by using the terminology of moral damages.”201

In our view, a tribunal expressing strong concerns about State actions through an award of compensation to remediate moral damages must be distinguished from punitive damages. Thus, a State is not being imposed an extra amount of compensation in addition to the actual damages suffered. The amount of compensation awarded is in fact equivalent to the actual damage. It is simply that faced with a graver breach of international law a tribunal may determine that this has caused an investor greater suffering which, in turns, requires a greater amount of monetary compensation. Nothing should prevent a tribunal from adopting such a position considering that they “enjoy almost an absolute discretion in the matter of determining the amount of moral damages.”202 This is all the more so in view of the fact that the quantification of compensation for moral damages “necessarily rests on equitable considerations”203 Ultimately, the goal of awarding compensation for moral damages remains the remediation of the actual damage suffered; it is clearly not to punish the host State.

198 Dumberry, Compensation for Moral Damages, supra note 4, at 273-274.
199 Jagusch & Sebastian, supra note 33, at 60.
200 Id.
201 Id. See also at 61.
202 Ripinsky & Williams, supra note 6, at 312. See also Wittich, Non-Material Damage and Monetary Reparation in International Law, supra note 3, at 333.
WHOSE MONEY IS IT AND SHOULD IT MATTER?
AN ESSAY ON THE COST OF CAPITAL IN INTERNATIONAL ARBITRATION

Mick Smith
Romans Vikis

I. INTRODUCTION

This paper develops some of the themes from the author’s Guest Series on Third Party Funding on OGEMID. During that discussion, particularly on the use cost of capital in quantification of damages, it became clear that many of the concerns that legal practitioners exhibit about Third Party Funding stem from misconceptions about how to apply the cost of capital in general.

During the OGEMID exchanges the discussants appeared familiar with the concept of the cost of capital, but for present purposes we adopt the following as a definition: the cost of capital is the expected annualized return that an investor hopes to receive from an investment. It is not a guaranteed return; simply that which the investor hopes to achieve.

We believe that when the principle of full reparation is used to guide the award of compensation in investment treaty arbitration, the tribunal must think about the capital supplied from the moment of investment to the time of award. This necessitates considering pre-award interest in tandem with damages using a common approach to the cost of capital.

What was more uncertain during the OGEMID discussion was current legal thinking on how the cost of capital concept is or should be used. In particular, discussants seemed to (i) mix cost of capital measures particular to the claimant, with those applicable to the respondent, without any clear legal principle as to which rate is apposite. There also appeared to be little consensus on (ii) what

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is the correct time at which to measure the cost of capital. Similarly, there was disagreement as to (iii) what is the correct asset value to which the cost of capital should be applied. And lastly, little or no consensus as to (iv) whether the damages measure should attempt to wind the clock back from the date of award, or to assess value as at the current day. We examine the construction of the cost of capital below in section 2.1 and its application to these areas of uncertainty.

In truth, the cost of capital is crucial not just for the calculation of damages, but also and equally importantly, we will argue in this article that an appreciation of the relevant cost of capital at the key time is intimately bound with the core issue of causation, and provides arbitrators with a vital commercial marker when assessing liability on the facts. This is most easily seen in the context of creeping expropriation claims, and where the value of the relevant assets has been impacted by exogenous events such as the Global Financial Crisis of 2008-9.

To summarise, the central aim of this paper is to simplify some of the legal principles on which to assess damages, and in particular to remove the arbitrariness that seems to exist when choosing between historic investment costs and fair market value as the correct measure of damages.

II. APPLICABLE COST OF CAPITAL RATES AND ASSESSMENT OF COMPENSATION

We now consider the litigants’ financial position and cost of capital in the context of assessing damages, and its relevance both in estimating quantum of loss, and the correct rate and period of pre-award interest to be applied thereto.

A. The current jurisprudence on applicable interest rates – a very quick survey

An initial observation is to note how few column inches are devoted to the assessment of the correct interest rate given its potential impact on the litigants. This seems true whether you are reading any of the published Awards, the leading texts on damages, or a typical Memorial of Claim.
For example, Ripinsky and Williams’ (2008) leading work\(^3\) covers the debate on the choice of rate of interest in 7 pages out of 400, and Sabahi (2011)\(^4\) covers it in 2 pages out of 191.

Looking at typical recent Awards, the *Impreglio v Argentina* (2011) tribunal covers the subject in less than a third of a page of an 86 page Award,\(^5\) and the *Kardassopoulos v Georgia* (2010) tribunal, which gives the matter one of the deepest treatments of recent decisions, devotes 7 pages out of 228.\(^6\)

Yet, the reference rate chosen in *Impregilo* (of 6% p.a. compound from 2006) would equate to an additional 50% or more of the damages award if paid now, whereas the 15% p.a. sought by the Claimant (with reference to Argentina country risk) would equate to an additional 160% or more.

The *Kardassopoulos* tribunal used a Libor + 4% rate, drawing on the terms of the relevant contract in the dispute, rejecting a rate proposed by the respondents referencing essentially risk free US government bonds. Given that Libor was relatively high for most of the 14 year period up to 2010, the awarded interest added an additional 200% to the sums due to the Claimants. Had the tribunal used an essentially risk free rate of say 3%, the interest element would have most likely been around 50%.

So, in other words, the determination of as much as 60—70% of the total value of the compensation may receive as little as 1-2% of a tribunal’s output (at least measured in written paragraphs).

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\(^3\) Sergey Ripinsky and Kevin Williams, Damages in International Investment Law, British Institute of International and Comparative Law, 2008.


\(^6\) Ioannis Kardassopoulos & Ron Fuchs v. The Republic of Georgia, Award, ICSID Case No. ARB/05/18, ICSID Case No. ARB/07/15, 3 March 2010, paras 650 – 678.
On this analysis, it seems self-evident that more work should be done to ensure tribunals have an appropriate analytical framework to explore the choice of interest rate on a case by case basis. Advocates and academics may enjoy the nuances of debate on subtle points of jurisdiction and liability, and they certainly have a huge impact on the outcome; but, so equally does the correct assessment of compensation. In fact for either party, the linkage between causation and quantification of loss is arguably more important than liability.

B. The Factory at Chorzów case and its implications for time of assessment of damages

The usual starting point to assess the method of compensation in a BIT case of unlawful expropriation (and similar BIT breaches such as a violation of the Fair and Equitable Treatment standard) is to cite the Factory at Chorzów case. It is stated in virtually every BIT Memorial of Claim, and the texts on State responsibility, as follows:

“Reparation must, as far as possible, [1] wipe out all consequences of the illegal act and [2] reestablish the situation which would, in all probability, have existed if that act had not been committed.”

The numbers in brackets are our addition because they highlight a logical gap in the proposition: statements 1 and 2 are mutually exclusive. Reparation granted at the Date of the Award can either (1) reverse all the effects of the illegal act ("Backward Basis"), or (2) compensate the Claimant for what would have been the most likely current situation absent the acts of the State ("Current Basis"), but it cannot do both, or at least, not in respect of the same asset. We also highlight the phrase “in all probability” which we interpret to be an exhortation to the tribunal to choose the most probable measure of damages from the total spectrum of possibilities.

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7 Factory at Chorzów (Claim for Indemnity) (Germany v. Pol.), Judgment on the Merits, 1928, P.C.I.J. (ser. A) No. 17, at 47 (September 13).
The ILC Draft Articles on Responsibility of States of Internationally Wrongful Acts\(^8\) develop this theme (to permit the tribunal to consider the subjective concepts of proportionality, capability of financial assessment and culpability of the State\(^9\)) but the general standard remains that the tribunal should choose the appropriate interest rate to achieve full reparation.

To achieve this, the tribunal needs to determine: (i) whether to look backwards at all; (ii) if so, how far; and (iii) the correct asset value at the relevant time. In summary, the Chorzow principle is in our view best seen as a variant of Occam’s razor\(^10\) – the tribunal must choose the time and method of assessment which yields the most probable results. This will necessarily entail requiring evidence on the litigants’ respective costs of capital at a variety of junctures, from the time of investment up to the time of award. This is explored further in the examples below.

C. A closer look at Impregilo: Sunk Costs or Market Value; Country or Claimant cost of capital?

When assessing the correct measure of damages, tribunals regularly face the difficulty of financial experts producing damages analyses of different orders of magnitude. The implication must be that at least one of them is well wide of the mark and the tribunal has to choose one, or find an alternative or intermediate basis on which to award damages.

This tension is evident in Impregilo where there was no consensus even among the arbitrators whether to award damages on the basis of sunk costs, or the fair market value of the expropriated asset.

But there is a way to reduce to the likelihood of this conflict by taking a more structured approach.

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\(^8\) Draft Articles on Responsibility of States for Internationally Wrongful Acts Adopted by the Drafting Committee on Second Reading, 26 July 2001.

\(^9\) Draft Articles on Responsibility of States for Internationally Wrongful Acts with Commentaries Adopted by the Drafting Committee on Second Reading, 26 July 2001, p. 34.

\(^10\) The principle that among competing hypotheses, the hypothesis with the fewest assumptions should be the one selected.
The majority of work on damages to date appears to divide the world of compensation in investment arbitration claims along the following lines:

1. Investment Costs; or

2. Market Value, being an assessment of some combination of:
   a) asset value, such as by reference to audited statements, i.e. asset-based valuation;
   b) comparable arms’ length transactions, i.e. market-based valuation;
   c) future cash flows, via a discounted cash flow (DCF) analysis, i.e. income-based method.

However, this division is slightly at odds with the principles of the Factory at Chorzów case noted above where reparation might be better divided as follows:

1. **Backward Basis** compensation, which would involve looking back in time to assess the sunken (investment) costs as a reliance loss, and also the historic valuation of a well-established operating business (a “going concern”); or

2. **Current Basis** compensation, which would apply to situations where the tribunal is satisfied that the most certain outcome is to measure damages at the date of the Award with good knowledge of how market conditions developed subsequent to the relevant breach.

This division then helps to frame the applicable cost of capital analysis. Of course this distinction is not black and white and there is plenty of grey area which we analyze further below in several examples (section 3.6). However, to explore the distinction briefly here, we look at Impregilo where the Claimant asked for a fair market value estimated in the region of $50m\textsuperscript{11}. The majority of the

\textsuperscript{11} Impregilo S.p.A. v. Argentine Republic, ICSID Case No. ARB/07/17. ($50m estimated from $87m figure which appears to have blended asset and DCF methods, and include 3 years of compound interest).
tribunal viewed the estimated future profitability as too uncertain due to an absence of operating history\textsuperscript{12}.

It is worth noting that an award of $50\text{m}$ on a market value basis would not be far in excess of the amount that could have been awarded if the damages had been assessed as sunk costs ($20\text{m}$) plus a country risk-related interest rate of $15\%$ per annum over the extended investment period leading up to the breach. So looked at in this light, the dissenters may not have been that far apart if the cost of capital had been correctly measured over the right period. We develop this perspective further below in the examples when we take a fresh look at “sunk investment costs”.

Stepping back from the tribunal’s 2 viewpoints, what is commercially true is that post-treaty breach, the \textit{Impregilo} Claimant necessarily took 5 years or more unplanned exposure to Argentina. So to reverse this effect as at the date of the Award and “wipe out all the consequences”, the interest rate should be derived from Argentina’s sovereign debt yield or the credit default swap spread. In other words, the backward basis will reference the Respondent credit risk.

This of course takes tribunals into uneasy territory, since states such as Argentina or Greece experiencing debt restructuring will necessarily pay more for this money. Hence the subjective criteria to determine the amount of damages provided in ILC articles come into play. But, this high cost is the logical implication of the \textit{Factory at Chorzów} case. A tribunal could then be asked to provide a detailed analysis of these considerations explaining at length which ILC Articles subjective factors were applied to arrive at the rate. And, in the case of \textit{Impregilo}, explain why $6\%$ was chosen in preference to $15\%$? On rough numbers, the difference to the Claimant is $30\text{m}$ in total compensation versus $50\text{m}$ plus. Obviously, such a material element of the decision merits more than 2 short paragraphs.

\textsuperscript{12} \textit{Impregilo S.p.A. v. Argentine Republic}, ICSID Case No. ARB/07/17, para 373.
D. *Some principles to determine the most applicable rate and the relevant period*

Following the above observations, we construct a table of possible approaches to damages methodology, with our suggestions as to when they should be applied. These are designed to reflect an overarching Chorzów principle of attempting to maximise certainty, without violating proportionality. The key additional principles we apply are as follows:

1. For a sunk costs damages assessment, interest should be measured from the date the investment is made;
2. If interest is assessed from the date of the breach of treaty, full reparation requires a consideration of the real cost to the claimant, which potentially includes the cost of pursuing a coerced arbitration claim; and
3. If the damages are assessed at the date of the award, pre-award interest is no longer applicable.

<table>
<thead>
<tr>
<th>Method</th>
<th>Chorzów Basis of Damages</th>
<th>Measure of Damages</th>
<th>Measure of Interest</th>
<th>Duration of Interest</th>
<th>Factual Uncertainty</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Cost</strong></td>
<td>Backward Basis</td>
<td>Sunk Cost at date of investment</td>
<td>Cost of capital originally supplied</td>
<td>From date of supply of capital, i.e. from date of investment</td>
<td>None, unless material operating history post investment</td>
</tr>
<tr>
<td><strong>Market Value</strong></td>
<td>Backward Basis</td>
<td>Market Value of Investment at date of breach</td>
<td>Claimant Cost of Capital at date of breach</td>
<td>From the date of the breach of treaty by which the investment was impaired</td>
<td>Post-breach assumptions re: 1. Claimant 2. Respondent 3. Market for relevant asset 4. Availability of finance for arbitration</td>
</tr>
<tr>
<td><strong>Market Value</strong></td>
<td>Current Basis</td>
<td>Market Value of Investment at date of award</td>
<td>Not applicable</td>
<td>Not applicable</td>
<td>Post-breach assumptions re: 1. Claimant 2. Respondent</td>
</tr>
</tbody>
</table>

We hope this table is fairly self-explanatory, though in particular, the identified uncertainties require some explanation. Let us begin with a quick note on the decision to move from the Investment Cost method to FMV on the basis of factual certainty,
i.e. what would constitute sufficient operating history (positive or negative).

Guidance can be observed from existing investment arbitration awards, and guidelines for using a going concern (FMV) basis might include the following:

1) Is the performance record of a company sufficiently long?
2) Is it possible to establish the future profitability of the investment?
3) Did a company have sufficient finances to complete and operate the investment?
4) How large is the disparity in the amount actually invested and fair market value claimed?

Accordingly, Row 1 of our table is predicated on the assumption that the investment although made, had not become a sufficiently certain going concern at the time of treaty breach, when judged by these criteria. In these circumstances maximizing certainty of full reparation needs the tribunal to wind the clock back to the time the capital was supplied (not the date of breach) as this is the date from which the investment begins, i.e. when the

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14 See, e.g. Metalclad Corporation v The United Mexican States, Award, ICSID Case No. ARB(AF)/97/1, 30 August 2000; Tecnicas Medioambientales TECMED S.A. v Mexico, Award, ICSID Case No. ARB(AF)/00/2, 29 May 2003; SPP (Middle East) Ltd., Southern Pacific Properties Ltd. v Arab Republic of Egypt, The Egyptian General Company for Tourism and Hotels ("EGOTH"), Award, ICC Case No. 3493, 16 February 1983.

15 See, e.g. Wena Hotels Limited v Arab Republic of Egypt, Award, ICSID Case No. ARB/98/4, 8 December 2000; SPP (Middle East) Ltd., Southern Pacific Properties Ltd. v Arab Republic of Egypt, The Egyptian General Company for Tourism and Hotels ("EGOTH"), Award, ICC Case No. 3493, 16 February 1983; Compañía de Aguas del Aconquija S.A., Vivendi Universal v Republic of Argentina, Award, ICSID Case No. ARB/97/3, 20 August 2007.

16 See, e.g. Wena Hotels Limited v Arab Republic of Egypt, Award, ICSID Case No. ARB/98/4, 8 December 2000.

17 See, e.g. Wena Hotels Limited v Arab Republic of Egypt, Award, ICSID Case No. ARB/98/4, 8 December 2000.
principal sum (per ILC Art 38) was originally invested. The tribunal then needs to use the correct cost of capital for the project from the point of supply until the date of the Award.

By contrast Rows 2 and 3 assume that the facts are such that the tribunal decides that the investment has become a going concern by the date of breach, i.e. the Claimant’s business has materially moved on from the date of initial investment. (It may well be that in the context of “contractual” treaty claims such progression from investment to going concern is instantaneous on signing of a contract). However, once that first step is made, a tribunal still needs to decide between Row 2 and Row 3, and a key element of this choice is determining the most plausible cost of capital rate.

In Row 2 we suggest that there are four areas of uncertainty around choosing the appropriate cost of capital basis at the time of breach. To highlight this further, we begin with a theme of recent articles such as Beeley and Walck (2011) and Abdala et al (2011) as well as decisions in Conoco v PDVSA (at ICC) and Occidental v Ecuador. These articles and decisions highlight the prevalence of asymmetric round-trips on interest rates within damages assessments, where cash flows are discounted at one rate to the time of breach (within an FMV DCF valuation) and then interest applied at a different, usually lower rate.

Abdala et al make a core argument that the rate to be applied (in both directions) should be by reference to the claimant’s cost of capital, rather than (a) with reference to the respondent’s position (which they term the "coerced loan" doctrine) or (b) by reference to a lower neutral market rate.

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20 Phillips Petroleum Company Venezuela Limited (Bermuda) and ConocoPhillips Petrozuata B.V. vs. Petroleos de Venezuela, S.A., ICC.
21 Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador (ICSID Case No. ARB/06/11).
A principal objection to using a respondent state rate of interest is that it can lead to disproportionate awards when a respondent state moves into distressed territory.²² A tribunal can control for this through the use of the subjective factors, especially proportionality, listed in the ILC articles. Abdala et al propose a similar modifying approaching to the Claimant’s cost of capital by reference to market rates where a Claimant company is paying a much greater cost than the market rate. Beeley and Walck suggest a blending of claimant and respondent related factors to calculate the appropriate discount and interest rate.

Looking briefly at the two decisions noted above, Occidental seems to evidence an asymmetric round trip (discount at 12%; interest at 4.188%) though it also seems that the Claimant got the interest rate it claimed.

By contrast, the ICC Tribunal in Conoco v PDVSA, albeit in a contractual case made an award of interest at 10.55% with specific reference to the Claimant’s cost of capital (rather than the lower rate in a related contract). They stressed that the Claimant is “a supplier of capital” and should be compensated for the opportunity cost of the capital to achieve full reparation.²³

This concept of capital supply is a very instructive one. For the reasons suggested earlier it fits best with the first limb of the Factory at Chorzów case, i.e. it is backward looking and is the best measure of the Claimant’s reliance loss from the time of capital supply. Looking at the idea of supply of capital more closely, the Claimant’s cost of capital at the time of breach is not a measure of what the Claimant’s investors were seeking at the time the capital was supplied to the Claimant, in relation to a series of expected future cash flows. By contrast the concept of the coerced loan represents the actual ultimate destination (post-expropriation) of the capital supplied by the Claimant. So in this sense the latter measure fits better with an assessment of actual damages at the date of breach.

²² Such as the 1999-2002 crisis in Argentina.

²³ Phillips Petroleum Company Venezuela Limited (Bermuda) and ConocoPhillips Petrozuata B.V. vs. Petroleos de Venezuela, S.A., ICC (C-16849/JRF 17 Sep 2012) paragraph 295.
Looking at the texts on DCF methodology, the calculation of the claimant’s cost of capital will be cited as including the following key elements, some of which may be blended:

1. A risk free rate;
2. A risk premium for country risk subject to a weighting;
3. Duration of investment;
4. Project risk, by reference to management, type of business, capital structure etc.

By contrast, the calculation of the appropriate rate on the coerced loan will focus on:

1. A risk free rate;
2. A risk premium for country risk;
3. Duration of loan.

To summarise the differences, Claimant’s cost of capital uses a blend of country risk (objective factors) and project risk (subjective factors); the coerced loan considers only the country risk, and thus contains fewer unknowns.

There is also some uncertainty in how to assess the duration, i.e. what is the correct reference instrument and time period over which to apply compound interest. Some tribunals refer to 6 month Libor, others to longer dated debt instruments which normally would attract a higher coupon. Again, getting to the right answer depends on adopting the right viewpoint. The Respondent borrower is able to repay the “loan” or provide restitution at any time, but the Claimant creditor is tied until the time of repayment, i.e. post-Award. In other words, the Claimant does not benefit from the reduced risk of a 6 month loan, so it should be compensated accordingly with a longer dated interest rate compounded annually, as it is locked into the Respondent. The upshot of this is that this fixed duration can only be...

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24 See for example, Brealey & Myers, Principles of Corporate Finance.
determined with hindsight as at the date of Award, when the
timing is known\textsuperscript{25}.

There is a further conceptual difficulty with the coerced loan
doctrine in that, in reality, as at the date of treaty breach, the
nature of its business changes fundamentally. The Claimant is
forced to swap the impaired part of the original investment for a
contingent claim to a debt (the Award) on which “full reparation”
interest accrues. It is not so much a “coerced loan” as a “coerced
arbitration claim” (at least from an economic perspective). This
observation highlights the distinction between (1) compensation
for a breach of a BIT and (2) a lawful expropriation, correctly
compensated under a treaty (at a commercial rate) without the
need to undertake the risks of arbitration.

From the date of the “swap” forward, the Claimant’s actual
cost of capital changes dramatically. The Claimant must finance
the pursuit of recovering the Award, so its cost of capital could
now include the following elements:

1. A risk free interest rate, e.g. USD Treasury rate for an
   appropriate duration;
2. A country risk rate;
3. A project risk rate its other activities if any, e.g. referring to
   the sector, management and other subjective criteria;
4. An arbitration funding risk rate, to reflect the cost of using
   existing or raising new capital to finance the arbitration.

The key factors within element 4 would be:

a) Management risks associated with Lawyers, Arbitrators,
   Witnesses, Claimant;
b) Legal Risks, especially as to Jurisdiction and Merits;
c) Quantum risk around the uncertainty of damages;
d) Duration risk of estimating the likely time to resolution.

\textsuperscript{25} This is worth bearing in mind when considering “hindsight” objections
to damages calculated at the date of award.
One further subtlety is that Respondents will argue that by the time of the Award and assessment of quantum, some or all of these risk factors will have disappeared. This argument fails for the obvious reason that all the risks exist from the time of breach up to the Award, and many of them continue to exist until payment of the Award.

The actual construction of this cost of capital is for another day, though it should be noted that an implied cost of capital could be derived from the market data both on the publicly listed funders, and various funded cases26 to arrive at a market rate.

What the analysis above highlights most clearly is that there are additional uncertainties with trying to value assets at the date of breach, and then bring that value forward to the date of the Award. These difficulties arise principally because:

a) the Claimant cost of capital (even when applied in a symmetric round trip) excludes actual post-breach market data;

b) the Respondent cost of capital method (coerced loan doctrine), although more certain than the Claimant cost of capital method, excludes actual post-breach Claimant specific data (the cost of financing the arbitration).

Once a gross damages plus interest amount is arrived at under any of the above scenarios, the ILC Articles (Articles 34-39) suggest the following adjustments might be made:

a) A reduction in the measure of reparation where the Claimant is also culpable;

b) A proportionality limit, to prevent disproportionate compensation.27

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26 See for example the public disclosure around the funding terms of Pac Rim v El Salvador (ICSID Case No. ARB/09/12) and Crystallex v Venezuela (ICSID Case No. ARB(AF)/11/2).

27 Article 36 (on compensation) does not explicitly refer to proportionality, but the concept is written into the articles on satisfaction and restitution, with the implication that the principle must also be part of the compensation standard.
In respect of the first of these, a tribunal would need to be careful in its application. An assessment of market value would necessarily encompass the monetary effect of any culpable actions by the Claimant in reducing the value of the investment. So it is not clear what further reduction could be made. A reduction to damages based on investment costs could however, be made.

As to the second point, it is perhaps best deployed to ensure that the Respondent is not disproportionately exposed to sudden rises in cost of capital (relative to the market norm) specific to the Claimant or Respondent. It could also be used to reduce gross damages when the impairment of the investment can be at least partially attributed to exogenous factors, though as above this could only apply to modify investment costs damages as opposed to market value.

Commenting more generally, any such adjustments by way of percentage reduction are a much more transparent way for a tribunal to arrive at the quantum of damages based on the facts, as opposed to a blurred application of various economic principles.

E. Analyzing (un)certainty

It is a given that every case will be fact specific when it comes to assessing plausibility of the damages methodology. However, looking more closely at the table above, there are certain objective quantitative differences in terms of “known unknowns” between Investment Costs and Market Value, which vary with the time of measurement.

The attractions of using Investment Costs as a basis for damages are clear. They are usually straightforward to verify from the claimant’s financial statements. Likewise, the Claimant’s cost of capital at the point of supply is likely to be well recorded, i.e. the market cost of that capital. Typically, one would expect there to be a DCF model for the expected profitability of a new project, incorporating the Claimant’s Cost of Capital from the time of supply. An assessment of damages based on Investments Costs with cost of capital assessed from the time of Investment requires a tribunal to undertake no hypothetical analysis of (a) what the Investment would have become but for the acts of the parties by
the time of breach, nor (b) how it would have progressed from the
date of breach onwards. In other words it avoids a hypothetical
analysis of either time period within which the facts will be
heavily disputed, relying solely on an observable market cost of
capital at the time of supply.28

By contrast, a Market Value assessment of the assets requires
additional plausible objective input, such as what did the market
assess value to be. To this uncertainty, when Market Value is
assessed at the date of breach i.e. on a backward basis, one adds
additional uncertainty when computing the cost of capital interest
rate. As described above, there are several views on what is the
correct rate. Those chosen by reference to what actually happens
to the Claimant post breach seem to be (relatively) more certain,
as opposed to using the future return expected by the Claimant
from the date of breach onwards assuming certain circumstances
would prevail. The latter necessarily makes assumptions about
both how the claimant will perform and how the market and the
State will perform in the period post-breach.

When market value is assessed at the date of the award, all
market circumstances are known, so the number of “unknowns”
the tribunal must consider is reduced to an assessment of what
the claimant and state would have done in the post breach period.
There are some juristic objections to the hindsight analysis
implicit in a date of award assessment, but it is important to note
that this is not being used in the context of the factual analysis of
the events constituting the breach. Moreover, as we have argued
above, the assessment of the correct cost of capital from breach of
award already requires a hindsight analysis of the duration of the
cost of capital measure.

To summarise, in the absence of any other data on the project,
Investment Costs reflects the most certain measure of value (to
the Claimant). However, as other plausible data becomes
available for the pre-breach period, a factual reassessment is
necessary to analyse whether the project has progressed beyond

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28 This is not to say the method is free from uncertainty; just that (absent
other data) it is less hypothetical.
its investment value to operating status. If it has progressed for the better, is that because the project has become a profitable business? If for the worse, is that attributable to the acts of the State, or the Claimant, or both? In either case, how has the claimant treated the assets on its balance sheet? Has the Claimant received a plausible independent offer to refinance or purchase the assets?

If the tribunal considers a market value assessment more appropriate, it then needs to consider whether certainty is maximised by an assessment as at the date of breach or at the date of the award. For the reasons given above, an assessment as at the date of the award has fewer degrees of freedom, and is thus more likely to maximise certainty absent other facts. Such other circumstances could include the situation where there is good objective evidence of the market value of the relevant asset at the time of the breach, e.g. a credible offer to purchase it, or by contrast, if there no longer exists a market for the asset by the time of the award.

F. Worked Examples

We now attempt to develop the principles suggested above by way of a series of worked examples. To do this we construct a hypothetical investment treaty claim where Company C invested $50m into a metal mining business in State S which was subsequently subject to certain measures by S.

1. Initial Investment

C raised $50m in the international capital markets to be drawn down and injected into in annual instalments S over a period of 3 years, both to purchase assets and to fund operating expenses prior to the time when C was projected to generate positive cashflow from year 4 onwards ($10m p.a.) rising to $20m p.a. from Year 6. The project life span was expected to be 15 years after which it was not expected to have any residual value.

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29 In other words does the tribunal consider that the Going Concern Hypothesis makes fewer non-factual assumptions than the Investment Costs Hypothesis.
The $50 million was to be used as follows:

1. $20 million of Assets to be purchased on Day 1;
2. $30 million of operating expenses for 3 years at $10 million p.a.

The cost of capital in the relevant capital markets for C at the time it raised the $50m was 10% p.a. Pulling all these assumptions together, the discounted projected cash flows and thus the fair market value for C’s business on Day 1 would be $44.5m, calculated as follows:

2. Scenario A

Now let us assume that a tribunal decides at its merits hearing in year 9 that the business of C was subject to a simple expropriation by S at the end of year 5. At this year 5 point S had had 2 years of positive cash-flow ($10m p.a.) following 3 years of investment, out of a total expected project life of 15 years.

There is a good possibility that a tribunal would treat C as a sufficiently certain going concern at the time of expropriation in year 5, and then calculate damages as the FMV of the business in year 5 (plus 4 years of interest).

Assuming that the cost of capital for the business is unchanged at each of the relevant time points, i.e. if it remained constant at 10% p.a. throughout the period of 9 years to the award and C is performing business per the project plan, then the FMV for C’s business at the date of Award would be $179.9m, calculated on a DCF basis as follows:30

30 This calculation is a combination of discounting the assumed cash-flows post breach at 10% back to the date of breach and then applying 10% interest up to the date of the award.
WHOSE MONEY IS IT AND SHOULD IT MATTER?

By contrast the Investment Costs plus cost of capital interest basis for damages would produce an amount of $105.8m.

There are several observations to be made here. Firstly, both the Investment Costs method and the FMV method give valuations which are of the same order of magnitude. Secondly, Investment Costs does not factor in the 2 years (years 4 & 5) of positive cash-flow received by the Claimant: when this is factored in the net sunk costs are really $75m. This however, is noted not really as a mitigation argument, to reduce the size of an Investment Costs claim, but rather, as solid evidence that the business had progressed to a going concern and thus an FMV method better represents reality as at the date of breach.

3. Scenario B

Of course businesses rarely faithfully follow their project plans so let us assume that a tribunal decides at its merits hearing in year 9 that the facts were different. The business of C was still subject to a simple expropriation by S in year 5, but had yet to produce a profit following 3 years of investment.

With Occam’s razor to hand there is a fair chance that a tribunal would treat C as not being a sufficiently certain going concern at the time of expropriation in year 5. But now let us assume that the tribunal finds that as a matter of fact, C had been subject to creeping expropriation during years 4 and 5, but for which interference the project may have been profitable.

Assuming that the cost of capital is unchanged at each of the relevant time points, i.e. it remained constant at 10% p.a. throughout the period of 9 years to the award then the Investment Costs plus interest basis for damages would produce an amount of $105.8m as in Scenario A since nothing has changed in terms of C’s expenditure. Likewise the FMV for C’s
business at the date of Award would be $179.9m, calculated as above. The only difference with Scenario A is that C has foregone 2 years of profits and might claim for those sums in addition, depending on the facts.

The key question for the tribunal remains an assessment of the most certain damages methodology. The choice in this scenario will be finely balanced factually. One would expect there to be a heavy factual enquiry as to the impact of the measures in years 4 and 5 preceding the expropriation, to establish whether C would have delivered 2 years of profitability but for the measures.

It might be that the lost profits are directly attributable to new and unlawful ‘tax’ or foreign exchange measures in which case reasonable certainty of cash flows might well be established; more nuanced operational interference would no doubt give a tribunal less certainty. The tribunal might also investigate how the $50 million investment was currently treated on the company’s balances sheet:

1. $20 million of Assets purchased on Day 1. Are these assets still held at cost on the balance sheet or have they been written down or impaired in some way? What is the cause of the impairment – State measures, Claimant operating performance or something else?

2. $30 million of operating expenses for 3 years at $10 million p.a. It is likely that these items will be shown simply as part of the accumulated deficit in the balance sheet.

4. Scenario C

Thus far, our examples have considered the basic distinction between Investment Costs and FMV, and how certainty is largely dictated by evidence on profitability. To that we now add an (objectively verifiable) increase in the market price (subsequent to the expropriation) of the metal being mined, in the period between breach and award. This necessarily adds a further dimension to the question as to when would be the most certain time to assess compensation.

As in Scenario A the tribunal decides at its merits hearing in year 9 that C was subject to a simple expropriation by S in year 5.
Again, at this end of year 5 point S had had 2 years of profitability ($10m p.a.) following 3 years of investment, out of a total expected project life of 15 years. To reflect the uplift in the metal price we adjust the expected profitability for years 6 to 15 to $22m p.a.

On the assumption that the FMV is felt to be the most certain method, given the history of profitability, then the FMV for C’s business calculated at the date of breach plus interest would be $179.9m, as before, whereas if calculated at the date of the Award using the new market price, the FMV would be $197.9m, both calculated as follows:

<table>
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<tr>
<th>Year</th>
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<tbody>
<tr>
<td>Projected Cashflow</td>
<td>-20</td>
<td>-10</td>
<td>-10</td>
<td>10</td>
<td>10</td>
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</tr>
<tr>
<td>Discounted Cashflow</td>
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<td>-19.5</td>
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<td>-16.1</td>
<td>14.6</td>
<td>26.6</td>
<td>24.2</td>
<td>22.0</td>
<td>20.0</td>
<td>18.2</td>
<td>16.5</td>
<td>15.9</td>
<td>14.3</td>
<td>11.3</td>
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</tbody>
</table>

The date of Award method leads to a larger assessment of damages, i.e. the Claimant benefits from the subsequent improvement in market prices. Or put another way S (which has been found to be in breach) does not benefit from the subsequent price increase, which might seem fair on proportionality grounds.

Returning to the theme of certainty, the date of Award method utilises 2 years of operating history and 4 extra years of actual metal price (then assumed constant for the 6 years beyond Award); the date of Breach method also considers 2 years of operating history but the prices for the 10 years beyond award are all assumed. On this analysis and absent any other facts, surely the date of Award is preferable as it increases certainty of the valuation (and does not offend principles of proportionality).

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31 As noted previously, other such relevant facts might arise if there is objective evidence of the market value of the relevant asset at the time of the breach, e.g. a credible offer to purchase it, or by contrast, if there ceased to be a market for the underlying asset long before the time of the award.
However, what if the tribunal has other objectively established facts to hand, say if the FMV was well evidenced around the time of breach, say by a plausible bid for the business, or if was a widely traded public company with an observable market capitalisation? How do we assess the certainty of these facts at the date of breach which comprise either a single investor's expectation of the future value of the business with total control, or a pool of investors' views on the potential return for a small passive investment in the business? Can we say these views constitute the most certain estimate of fair market value given they may well include a discount for expropriation risk or other subjective risk preferences? This may be true of course, but we reiterate our view that a tribunal needs to look closely at the implicit assumptions in such valuations as evidence of FMV, and be heavily influenced in its choice of method by that which makes the fewest assumptions.

5. Scenario D

In this our final example, we introduce a further dimension to Scenario C. Previously we held constant the cost of capital over the project life, but now let us consider what happens when differing costs of capital are considered. To demonstrate this, we consider 3 possible choices for cost of capital applied to the date of Breach assessment, namely:

1. Respondent State cost of capital (15% - coerced loan). This increased rate reflects the increased risk of default of State S perceived by the international markets. There may or may not be a link between this change and political interference in the mining industry, i.e. the increase in cost of capital may well corroborate evidence of State S measures.

2. Claimant cost of capital (with no assets and the claimant in an international arbitration) (20% - a conservative assumption\(^\text{32}\) as to the cost of capital of an arbitration funder).

\(^{32}\) We use a conservative estimate to adjust for the fact that the pricing of arbitration funding is driven both by the amount of capital supplied, and the quantum of damages sought.
3. Claimant cost of capital (as the owner and operator of the business) (cost of capital now assumed to have increased to 12%). We assume this is driven largely by the increase in cost of capital of State S but also perhaps tempered by a market expectation of increase in metal prices. Again these changes in the cost of capital may serve as a marker on causation. Per Scenario C we include the impact of the metal price increase via an increase in project cash-flow to $22m p.a.

For choices 1 and 2 we assume an FMV of C’s business immediately prior to the breach at the end of year 5, which is consistent with the original project plan. This leads us to an FMV of $122.9m immediately prior to breach.

We then use this number as the starting point to which we apply the new choices of cost of capital, to run from end year 5 to end year 9 (the date of Award) which yields the following results for choices 1 and 2:

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<th>Year</th>
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<tbody>
<tr>
<td>FMV</td>
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<td>141.3</td>
<td>162.5</td>
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<td>FMV plus 15% interest</td>
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</tr>
<tr>
<td>FMV</td>
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<tr>
<td>FMV plus 20% interest</td>
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<td>254.8</td>
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</table>

And the calculation\(^{33}\) for choice 3 is as follows:

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<th>Year</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Projected Cashflow</td>
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<td>-10</td>
<td>10</td>
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<td>22</td>
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<tr>
<td>Discounted Cashflow</td>
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<tr>
<td>FMV at date of Award</td>
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<td></td>
<td></td>
<td></td>
<td>195.6</td>
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</tbody>
</table>

\(^{33}\) This calculation is a combination of discounting the assumed cash-flows post breach at 12% back to the date of breach and then applying 12% interest up to the date of the award.
Thus the FMV plus interest for C's business calculated at the date of Award would be:

1. **$215m** (coerced loan rate);
2. **$254.8m** (external arbitration funding rate);
3. **$195.6m** (claimant rate).

It is immediately obvious that differing rates of cost of capital have a significant impact on the final sum awarded. Analysing this choice of rates for the best fit with the facts (certainty) and the principle of proportionality, we might observe as follows:

1. **$215m** (coerced loan rate).

   This accurately reflects facts from the State's perspective. The State now controls the asset and should compensate the Claimant for providing the loan (equivalent to the market value of the asset).

2. **$254.8m** (external arbitration funding rate).

   This is similar to 1 but reflects the Claimant's actual position, i.e. the asset it now has and the cost of financing it. However, there is an issue on proportionality given the increase to 20% of the cost of capital, i.e. is it proportionate that the State meets the cost of this increase, especially as the cost would be markedly less for a large solvent corporate Claimant compared to a single asset claimant?

3. **$195.6m** (claimant rate).

   Firstly we note that we have avoided mixing restitution (a backward view of what the asset was worth immediately prior to breach – assumed to be $122.9m) with expectation (a view of what the Claimant would have achieved if it still had the asset and was operating it (with more expensive capital). It is also worth noting that in the example the more expensive capital (now applied to increased metal prices) cuts both ways. Cash-flows for years 6 to 9 are brought forward at 12% to the date of Award; but years 10 to 15 are discounted at 12%, and in the end the valuation is fractionally less than in Scenario C second calculation despite the increased expected cash-flow.
III. Final Thoughts

The intention of this paper was to bring more coherence to the assessment of compensation. We hope that in proposing a fuller treatment of reliance losses, and specifically that of wasted investment costs, we have given practitioners a more unified approach to achieving full reparation. If followed, such sunk costs need not be treated as an afterthought to a fair market valuation, but correctly as the other side of the same coin.

Likewise, we believe that using certainty and proportionality as the guiding principles will elucidate the correct (i) cost of capital, (ii) time of assessment and (iii) asset valuation. Of course these elements will be very fact specific in each case but we hope that the examples provided demonstrate how these principles could be applied in practice. In our view, the arbitrator’s role in assessing damages is best viewed as hypothesis testing, with most weight to be given to the most plausible i.e. certain damages hypothesis.

We conclude simply by observing one of the niceties that follow from the arguments raised above. In short, the benefit of deploying the cost of capital measure correctly can prevent either side from trying to have its cake and eat it. For example, a Claimant pleading a high cost of capital rate on sunk costs is exposed to a greater discount rate of cash-flows under the DCF FMV calculation. By the same token, a State will be more reluctant to plead an exorbitant domestic cost of capital rate, if it knows that such a plea will influence the rate of interest applied by the tribunal to investment costs over a lengthy period. In other words, clearer thinking on cost of capital should act as a (partial) brake on excessive damages submissions.
A CASE STUDY IN DAMAGES ESTIMATION:
BOLIVIA’S NATIONALIZATION OF EGSA

Jonathan A. Lesser∗

I. INTRODUCTION

In January 2014, an arbitration tribunal [hereinafter “Tribunal”] awarded almost USD 29 million in damages to Guaracachi America, Inc. and Ruralec Plc [hereinafter “Claimants”] for the nationalization of the two companies’ jointly held shareholding in Empresa Eléctrica Guaracachi S.A. (hereinafter “EGSA”) by the Bolivian Government [hereinafter “Respondent”].¹

To make its damage determination, the Tribunal evaluated the expert reports submitted by Claimants’ and Respondent’s respective experts. The Claimants’ expert estimated future market value damages at USD 77.5 million as of May 1, 2010 (the date of nationalization), plus USD 15.8 million in interest from the date of nationalization on February 29, 2012, when they filed their claim.² The Respondent’s expert countered that, owing to the multiple errors in the Claimants’ expert’s analysis, the future market value of EGSA was nil.³ In other words, according to the Respondent’s expert, EGSA was not a “going concern.”⁴

In economic terms, a “going concern” is a firm with positive expected cash flows over time. Such positive cash flows are necessary to service existing debt and, critically, to access capital markets. The ability to remain a “going concern” and access

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¹ Guaracachi America, Inc. and Ruralec, Plc v. The Plurinational State of Bolivia, PCA Case No. 2011-17, AWARD, January 31, 2014 [hereinafter “AWARD”].

² Id. ¶ 288.

³ Id. ¶ 298.

⁴ The AWARD defines a “going concern” as a company with income generating assets. ¶ 285.
capital markets underlies two seminal US Supreme Court decisions, Bluefield and Hope. These decisions, in turn, lie at the heart of a key aspect of the respective valuations of EGSA, and the Panel’s damage award: the determination of the appropriate discount rate to estimate the company’s future market value [hereinafter “FMV”] based on expected future revenues and costs.

II. ESTIMATING THE ECONOMIC VALUE OF EGSA

The FMV estimates of EGSA prepared by the respective experts, as well as the Tribunal itself, were based on (1) the relevant future period, defined by all parties as from the date of nationalization through December 2038, when EGSA’s operating license expires;6 (2) the projected revenues from the sale of energy, capacity, and carbon credits, (3) the projected operating and capital costs; and (4) the discount rate with which to estimate the present value of the revenue and cost streams and thus determine EGSA’s market value at the time of its nationalization.

A. Estimating Future Revenues

EGSA obtains revenue streams from three distinct products: electric energy, electric capacity,7 and carbon credits. These revenue streams, in turn, are based on the amounts of energy, capacity, and carbon credits produced, although the Claimants and Respondent both agreed on expected future carbon credits.8

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6 AWARD ¶ 453.
7 Electric capacity is equivalent to power, and represents the ability to simultaneously supply energy. For those unfamiliar with electric operating systems, the difference between energy and capacity can best be explained using a garden hose analogy. The amount of water flowing through a garden hose at any moment is equivalent to capacity. The amount of water that flows through the hose over a specific period of time is equivalent to energy. The fire department uses large, high-pressure hoses to douse fires because such hoses can deliver far more water per second than a garden hose. For a brief introduction to basic electric concepts, see Jonathan Lesser & Leonardo Giachino, Fundamentals of Energy Regulation 387-93 (2d ed. 2013) [hereinafter Lesser and Giachino].
8 AWARD ¶ 456.
The demand, supply, and price for electricity are all interrelated. All else equal, increases in the demand for electricity, such as through more robust economic growth, will lead to higher prices. Barring technological innovations, the greater the demand for electricity, the more costly generating resources must be used to meet instantaneous electric demand. Similarly, all else equal, an increase in the cost to supply electricity, such as an increase in the underlying market price for generation fuel, will reduce the quantity of electricity sold. Although regulators can fix the price of electricity in the short run, in the long run regulators cannot ignore basic economic principles affecting market principles, even if the underlying market is price regulated, if the firms they regulate are to remain going concerns. Markets are also inherently self-correcting. Thus, increases in demand that lead to higher prices stimulate new investment, causing prices to decrease. Similarly, decreases in demand lead to lower market prices, which cause previously marginal suppliers to exit the market.

Both parties stated they relied on demand forecasts prepared by Bolivia’s National Power Dispatch Committee (in Spanish: Comité Nacional de Despacho de Carga). Because there is no competitive market for electricity in Bolivia, the price for energy and capacity is established by the Government. Although the details of how these prices are established by the Bolivian Government are beyond the scope of this article, the price of capacity is based on the installed capital cost of a generating unit and the price of energy is determined by the marginal cost of the last generating unit dispatched to meet demand.

As the Award discusses, the Tribunal accepted neither the Claimants’ nor the Respondent’s experts’ determinations of supply, demand, and price because of their internal inconsistencies. The Claimants’ damage estimation was based on a scenario combining high growth in electricity demand, but little growth in generation supply, leading to higher future capacity and energy prices. The

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9 In many cases, the fundamental economic goal of regulation is to mimic a competitive market outcome, even when the underlying market is not competitive. For a discussion of the economic concepts underlying utility regulation, see Lesser and Giacchino, supra note 7, Chapter 2.

10 See Award ¶¶ 139-141, 144-46, and references therein.

11 Id. ¶ 479.
Respondent’s expert assumed the opposite: low electricity demand growth and higher levels of investment in new supply. Neither scenario is consistent with basic market behavior, which is why the Tribunal rejected both parties’ demand-supply-price scenarios.

Instead, the Tribunal used a consistent scenario. First, the Tribunal assumed that the Government would ensure development of sufficient new generating capacity to meet future increases in demand. The Tribunal determined that the Claimants’ assumption of future electricity growth averaging five percent annually was reasonable. It also assumed that a major new hydroelectric plant, Rositas, would enter service in 2019 in response to that growth. As a consequence, unlike either the Claimants’ or Respondent’s estimates, the Tribunal adopted a price forecast which recognized that prices would decline in 2019 when Rositas was expected to enter service.

B. Estimating Future Costs

There was much less disagreement between the Claimants and the Respondent regarding future costs. Both were agreement about the expected future cost of fossil fuels, which account for over 90% of total operating costs. Similarly, there was only minor disagreement about the other component of operating costs, administrative costs.

The major disagreement was over future capital costs, specifically capital costs associated with replacing aging generating units. Claimants assumed that the only additional capital expenditures would be related to expanding the capacity of an

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12 Id. ¶ 475.
13 Id. ¶ 486.
14 Id. ¶ 497. All of the price forecasts assumed that, after 2018, prices would increase at a rate equal to the projected increase in the US producer price index. As further noted by the Tribunal, the effects of Rositas entering service in 2019 would also reduce the amount of EGSA’s installed capacity eligible for capacity payments. Id. ¶ 511. The reason for this stems from the requirements under the regulatory regime that only generating units that are expected to operate (as opposed to units held in reserve) are eligible for capacity payments.
15 Id. ¶ 515.
existing gas-fired combined cycle unit, and assumed that all other capital costs were embedded in the forecasts of future operating costs. Respondent disagreed, stating that the Claimants had failed to incorporate the need to repair aging generating units. The Tribunal found that the Respondent’s assumptions about future capital expenditures were more realistic, and adopted them.

C. Estimating the Discount Rate

All of the parties, as well as the Tribunal, accepted the discounted cash flow model [hereinafter “DCF”] approach for estimating EGSA’s economic value.16 All of the parties also accepted using the weighted average cost of capital [hereinafter “WACC”] as the appropriate discount rate on which to base valuations of EGSA.17 However, while both claimed to use the same approach to estimating the WACC, Claimants’ and Respondent’s experts differed almost entirely on the underlying components used to estimate the WACC.

As its name implies, WACC is simply a weighted average of a firm’s cost of debt and its implied cost of equity—implied, because unlike the cost of debt, the cost of equity cannot be observed directly.18 Although the Claimant’s and the Respondent both agreed on the appropriate cost of debt, they disagreed as to the appropriate capital structure and the cost of equity.

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16 The DCF method is an income-based approach to business valuation. The two other approaches that are also employed are based on the value of comparable businesses and asset-based approaches that value a business based on the individual value of all of its assets. For a discussion, see Leonardo Giacchino & Jonathan Lesser, Principles of Utility Corporate Finance, Chapter 18 (2011) [hereinafter Giacchino and Lesser].

17 For public-sector and nonmarket investments, alternative discount rates are sometimes used. For a discussion, see e.g., Jonathan Lesser and Richard Zerbe, Discounting Procedures for Environmental (and Other) Projects: A Comment on Kolb and Sheraga, 13 J. Policy Analysis and Mgmt. 140 (1994).

18 The cost of equity equals the expected return that must be provided to investors to compensate them for their risk. Because capital markets are competitive, the expected return must be commensurate with other investments having similar business and financial risk. This “comparability” standard underlies how the cost of equity is set by regulators, and stems from the Supreme Court’s Bluefield and Hope decisions.
In regulatory proceedings to establish a revenue requirement, which includes a return on its undepreciated capital investment, a regulated utility generally attempts to demonstrate the highest possible WACC, because a higher WACC translates into a larger return. Thus, it is ironic that in this case, because future income is discounted more heavily as WACC increases, the Complainants, who owned EGSA, sought to demonstrate the lowest possible WACC, whereas Respondent sought to demonstrate the highest possible one. WACC also increases when the percentage of equity increases. Because debt holders have a senior claim to a firm’s assets over equity holders, the cost of equity must be greater than the cost of debt. Thus, a regulated utility will often seek to base its WACC on a more equity-rich capital structure. Here again, for purposes of valuing EGSA, the Complainants and Respondent took exactly the opposite approach, with the former assuming a 55% equity capitalization rate and the latter assuming a 64% rate.

There are a number of methodologies that can be used to estimate the cost of equity, including the DCF methodology. In this case, both parties and the Tribunal all used the Capital Asset Pricing Model [hereinafter “CAPM”] to determine the appropriate cost of equity.

In its simplest theoretical form, the CAPM posits that a firm’s cost of equity equals the risk-free rate of interest, plus a risk-adjusted equity risk premium. Additionally, some argue for inclusion of a size premium, based on empirical observations that the returns to smaller firms appear to be larger than would be predicted by the CAPM, with the difference increasing as firm size decreases. Finally, in international applications, the theoretical CAPM is often augmented by adding a country risk premium, sometimes called a sovereign risk premium, which reflects the additional risk of doing business in a specific country. Thus, in this case, the CAPM model used by both parties was as follows:

\[
R_E = R_F + \beta_{RL} [R_M - R_F] + SP + CRP,
\]

19 See Lesser and Giacchino, supra note 7, 147-57.

20 For detailed discussion of the derivation and components of the CAPM, see Giacchino and Lesser, supra note 15, Chapter 11.
where:
\[
\begin{align*}
R_E &= \text{the implied cost of equity capital for EGSA}; \\
R_F &= \text{the risk-free rate of interest}; \\
R_M - R_F &= \text{the equity risk premium}; \\
\beta_{RL} &= \text{the relevered and adjusted beta for EGSA}; \\
SP &= \text{the size premium for EGSA}; \text{ and} \\
CRP &= \text{the country risk premium for Bolivia.}
\end{align*}
\]

The parties’ experts argued over the appropriate values of all of these CAPM parameters, along with the appropriate capital structure that would be used to calculate the appropriate WACC. The Tribunal was thus forced to weigh numerous competing theories, as well as empirical estimates, to select its own set of parameters.

1. Estimating the Relevered Beta Coefficient

Estimates of a risk-comparable return on equity all rely on a fundamental concept: identifying a proxy group of firms having comparable risk. Because all firms are unique, there is an inherent statistical tradeoff involved: a smaller number of more similar firms or a greater number of firms for statistical robustness.\(^{21}\) The choice matters because a key component of the CAPM—the beta coefficient—is firm-specific. The Claimant’s expert relied on a broad range of all US-based firms in the electric power generation, transmission, and distribution business, deriving an overall unlevered beta value of 0.48.\(^{22}\)

In contrast, Respondent’s expert relied on a narrow group of five U.S-based generating companies, having an average beta

\(^{21}\) Typically, regulators, such as the Federal Energy Regulatory Commission, use heuristic criteria to establish groups of comparable firms. See, e.g., Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity, Policy Statement, 123 FERC ¶ 61,048 (2008). For a discussion of a statistical approach for selecting proxy group firms, see Jonathan Lesser and Emma Nicholson, Abandon all Hope: FERC’S Evolving Standards for Identifying Comparable Firms and Estimating the Rate of Return, 30 ENERGY L. J. 105.

\(^{22}\) A beta value of less than 1.0 implies a firm (or group of firms) has less undiversifiable risk than the market as a whole, and vice-versa. Typically, regulated U.S. electric utilities always have been relatively less risky than the market as a whole, and have been known for paying steady dividends, long-ago earning them the moniker of “widow-and-orphan” investments.
value of 0.68. Respondent argued that these five firms were more representative of EGSA because, like EGSA, they were generating companies.

The Tribunal accepted the smaller proxy group, stating that it had “decided to give precedence to the precision of the sample over its size ... as applicable to a notional unlevered Bolivian generator like EGSA.” Although the size v. precision debate is an empirical one, a more important consideration may have been the fact that EGSA’s prices are regulated by the Bolivian government. Thus, one could argue that the broader sample of regulated U.S. utilities may have been more representative of the business and financial risks faced by EGSA.

2. Estimating the Optimal Capital Structure

Next, the Tribunal evaluated the posited debt and equity ratios to use for relevering the beta values. Complainants’ expert used the average capital structure of its proxy group of U.S. utilities, whereas Respondent’s expert used the more equity-heavy average capital structure for a group of energy companies in emerging countries.

The optimal capital structure for a regulated firm depends on whose perspective—regulators or utility management—is defining “optimum.” Because debt is less costly than equity, it might seem that regulators would prefer regulated utilities to be highly leveraged, so as to reduce their WACC, whereas utility management would seek just the opposite outcome. However, the tradeoff is not so simple, because increasing leverage implies increasing financial risk as a greater proportion of a firm’s cash flows must be used to service its debt. Riskier debt, in turn, is more costly debt. However, because there may not be a one-to-one relationship between leverage and the cost of debt, i.e., each percentage increase in the debt capitalization ratio generally does

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23 Beta values are typically adjusted to reflect the theoretical tendency of firms’ beta values to revert to the market value of 1.0 over time. Furthermore, proxy group beta values must be unlevered and relevered, most often using the Hamada formula, to correct for differences between the capital structures of the proxy group firms and the firm under study. For an explanation of the mechanics of this process, see Lesser and Giacchino, supra note 7, 152.

24 Award ¶ 549.
not lead to a corresponding increase in the cost of debt, the optimal capital structure may not be a single number, but rather a range.\footnote{For a discussion, see GIACCHINO AND LESSER, pp. 75-82.}

The Tribunal rejected both experts’ recommendations and instead assumed that EGSA’s actual capital structure was, in effect, its optimal capital structure.\footnote{\textit{Id.} ¶¶ 553-555.} Not only was that a practical solution to the experts’ competing recommendations, it was also consistent with U.S. regulatory law, which generally assumes that utility management is best suited to determine optimal capital structure and, more generally, does not second-guess management decisions.\footnote{This viewpoint is consistent with definitions of prudence and prudent decisions under what is known as \textit{Good Utility Practice}. For a definition and discussion of implications, see LESSER AND GIACCHINO, supra note 7, 46-49.} Thus, the Tribunal relied on EGSA’s actual capital structure to estimate a relevered beta value for use in the CAPM.

3. Estimating the Equity Risk Premium

To estimate, the equity risk premium, Respondent’s expert used an arithmetic average of historical annual equity risk premiums for the years 1926-2009, as published by Morningstar.\footnote{Morningstar, \textit{SBBI/IBBOTSON VALUATION YEARBOOK}.} Using historic data is perhaps the most common approach to estimating equity risk premiums; the data is well-known, observable, and reflective of many different economic conditions.

The only issue that arises when using historic data is whether to use the entire dataset, as the Respondent’s expert did, or to use a subset of the data. GIACCHINO AND LESSER recommend using the entire dataset, for two reasons: (1) this avoids questions as to why the specific subset was chosen, and (2) because history has a tendency to repeat itself, excluding certain years, such as the 2008 financial crisis, is naïve.\footnote{GIACCHINO AND LESSER, supra note 16, 236.} Because there are now almost 90 years’ of historical equity risk premium observations, the average historic premium is quite stable at around 6.7\%. 

\textsuperscript{25} For a discussion, see GIACCHINO AND LESSER, pp. 75-82.
\textsuperscript{26} \textit{Id.} ¶¶ 553-555.
\textsuperscript{27} This viewpoint is consistent with definitions of prudence and prudent decisions under what is known as \textit{Good Utility Practice}. For a definition and discussion of implications, see LESSER AND GIACCHINO, supra note 7, 46-49.
\textsuperscript{28} Morningstar, \textit{SBBI/IBBOTSON VALUATION YEARBOOK}.
\textsuperscript{29} GIACCHINO AND LESSER, supra note 16, 236.
Claimants’ expert did not use historical equity risk premiums. Instead, their expert relied on a 5% implied (i.e., projected) equity risk premium estimate published by Professor Aswath Damodaran of New York University. Damodaran’s equity risk premium is based on published data of investor expectations over the subsequent five years. Because of this, Damodaran’s estimate, which he publishes annually, can also change annually.30 In 2012, for example, Damodaran estimated a 6% equity risk premium, while for 2013, his analysis showed a value of 5.8%.31

Both approaches to determining the equity risk premium—historic and forecast—have arguments in their respective favor. Proponents of using a historical average generally cite its observability and relative constancy. Proponents of a projected premium believe it better reflects investor expectations and argue that historic behavior is irrelevant to investors. A reasonable compromise that is sometimes employed is to rely on an average of both.

In the proceeding, the Tribunal accepted Claimants’ equity risk premium estimate, based on the Damodaran approach, but did not provide any underlying rationale other than “careful consideration.”

4. Estimating the Risk-Free Rate of Interest

The parties also differed on the appropriate risk-free rate of interest. For those not well-versed in financial theory, that it is possible for multiple risk-free rates to exist may seem counterintuitive; after all, if one had a choice of investing in identical risk-free securities, and the return on one was higher than the other, the higher of the two would always be selected.

Reality, alas, is a bit more complicated. First, there are no truly risk-free investments. In the short-term, the value of even the highest-rated government securities can fluctuate if governments


31 Id. at 79.
affect the money supply through so-called open market operations. In the longer term, the value of risk-free securities can be affected by inflation.

The Respondent’s expert determined a risk-free rate based on the timeframe of the valuation analysis. As such, he determined that the 4.36% average yield on 20-year U.S. Treasury bonds. In contrast, Claimants’ expert used a 3.58% average yield on 10-year U.S. Treasury bonds over the period May 2009 – April 2010, based not on the expected lifetime of EGSA (through 2038), but instead on the average duration of EGSA’s cash flows. Because the Tribunal found this duration to be close to 10 years, it accepted Claimant’s expert’s risk-free rate.

Claimants’ use of a cash-flow duration concept, however, and the Tribunal’s acceptance of that concept, contains a troubling element of circularity. Specifically, the cash flow duration estimate depends on the discount rate used to calculate it, but that duration value appears to have been the basis for the Tribunal’s acceptance of Claimants’ expert’s choice of the risk-free rate. This is evident from the language of the AWARD, which states

The “duration” of EGSA’s cash flows (in discounted terms) would in fact be even shorter—and even closer to that of the 10-year bond—if a higher discount factor than Compass Lexecon’s 10.63% is used for discounting purposes, since that will significantly diminish the discounted present value of EGSA’s most distant cash flows.

32 For a discussion, see GIACCHINO AND LESSER, supra note 16, Chapter 16. Other, nonmarket and nondiversifiable risks may also affect returns (e.g., war, asteroid collision, attacks by Godzilla, etc.).

33 Cash flow duration measures the sensitivity of future cash flows to interest rate risk. In essence, cash flow duration measures the sum of the ratios of the present value of future cash flows to the estimated overall present value of those cash flows. For bonds, the discount rate used is the coupon rate. For an example of how bond duration is calculated, see GIACCHINO AND LESSER, supra note 16, 193-5.

34 AWARD ¶ 534.

35 Id.
5. Estimating the Size Premium for EGSA

As discussed previously, there is some empirical evidence that returns for smaller firms are greater than the returns that would be predicted by the CAPM. Because of this, some practitioners include a size premium based on market capitalization. However, both the existence of a size premium, and the underlying cause if it exists, are disputed in the literature.36

Claimants’ expert argued that no size premium adjustment should be included. Respondent’s expert recommended a size premium of 6.28%, based on EGSA’s market capitalization. The Tribunal rejected a size premium for EGSA, instead concluding that an illiquidity premium should be included, “because the shares of non-listed companies, like EGSA, should be considered illiquid.”37 The Tribunal determined that an illiquidity premium of 4.5%, based on the work of Damodaran, was appropriate.38


The final component used to estimate the appropriate discount rate for EGSA was the country risk premium [hereinafter “CRP”]. Although both parties, and the Tribunal, agreed that including a CRP into the WACC was appropriate, as with most of the other components, there was disagreement between the Claimants’ and the Respondent’s experts as to how to estimate the CRP.39

Claimants’ expert included a CRP based on bond default spreads, that is, the spread between government bonds issued by countries with different sovereign credit ratings. The most well-known such index is the Emerging Market Bond Index, which tracks yields for a number of developing countries. Because Bolivia is not part of the index, however, Claimants’ expert calculated a proxy rate for countries with similar sovereign credit ratings as Bolivia, determining a CRP of 7.02%.

36 See id. ¶¶ 587-93 for a summary of the different arguments for and against a size premium.
37 Id. ¶ 600.
38 Id.
39 For a summary of the CRP calculation methodologies, see LESSER AND GIACCHINO, supra note 7, 170-4.
Respondent’s expert took used that same value, but then multiplied it by a factor of 1.5, yielding a CRP of 10.53%. This multiplier also stems from previous Damodaran’s empirical work, and reflects the fact that equity markets are more volatile than bond markets.40

The Tribunal rejected the Respondent’s expert’s use of the volatility multiplier. The Tribunal cited to Damodaran, who concluded that the multiplier was a short-term effect. Because of the long-term nature of the valuation, the Tribunal rejected the multiplier.41

Incorporating all of the individual components, the Tribunal determined a cost of equity of 20.33%, in contrast to the Complainants’ and Respondent’s cost of equity values of 14.45% and 27.66%, respectively. Given the Tribunal’s determination that EGSA’s capital structure was optimal, it derived a WACC of 14.33% as the appropriate discount rate with which to calculate EGSA’s FMV.

III. CONCLUSIONS

As evidenced by the numerous components, estimating a DCF valuation for EGSA was a nontrivial exercise. Reasonable practitioners can, and will, disagree on the appropriate values for many, if not all, of these components. Moreover, the reasons for the disagreements will often appeal to common sense.

Such “on the one hand ... on the other hand” damage valuations may create dilemmas for attorneys representing opposing parties, both in terms of determining the reasonableness of their own expert’s damage valuation and the weaknesses of the opponent’s valuation.42 These challenges may be magnified for the neutral arbitrators who must sort through the parties’ competing views.

40 Damodaran 2013, at 61, calculates a multiplier of 1.86. However, he notes that he continues to use a value of 1.50 for the multiplier. He refers to this as the “melded approach,” as it combines both bond default spreads and relative volatility of equity and bond markets.

41 AWARD ¶¶ 578-83.

42 Whether there is even a legal basis for damages is, of course, not the purview of damage valuation experts.
Perhaps a few suggestions from this economist on how attorneys and tribunals can best evaluate these claims and counterclaims may be useful.

First, if damages are based on estimates of future supply and demand, and resulting prices, remember they are interrelated, whether the underlying market is competitive or, as in the case of EGSA, regulated. Thus, demand and supply estimates must be consistent with one another. As the Tribunal correctly reasoned, in the case of EGSA both parties’ demand-supply assumptions were inconsistent and neither correctly recognized the basic impacts of adding new supply. This may have been the result of an insufficient understanding of the underlying energy market. More broadly, any damage models should be consistent with standard economic theory. The most sophisticated econometric model known to mankind will be of little benefit if, for example, it estimates an upward sloping demand curve with which damages are calculated.43

Second, when estimating damages associated with long-lived assets, as was the case with EGSA, the discount rate—and its components—are crucial. Here again, consistency is key. Recall that, in part because he estimated a 20.33% WACC, the Respondent’s expert determined that EGSA had no market value and thus EGSA was not a going concern. Yet, if EGSA had no economic value, why would the owners continue to operate it for the next 28 years?

The Respondent’s expert’s use of such a high discount rate, together with the inconsistent assumptions about future demand and supply, implied that EGSA’s owners would be better off by simply shutting the company down and selling the generating equipment, for which there is an international market. However, the Respondent’s expert appears to have ignored this inconsistency. Equivalently, in financial terms, he failed to consider the option value associated with early shutdown, which led to an economically irrational damages estimate. In effect, the

43 A fundamental assumption in basic economics is that demand curves slope downward: the lower the price of a good or service, the more of it will be consumed.
Respondent’s expert determined that the Bolivian government did the Complainant a huge favor by nationalizing EGSA.

As the Tribunal itself noted, damage estimation is not an exact science. Economists (and attorneys) will always disagree, and there will (almost) always be good reasons for those disagreements. That is what makes arbitration cases challenging and thought-provoking.

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44 Award ¶ 453.

20 JULY 2012
DECIDED BY:
CHARLES N. BROWER, TOBY T. LANDAU, JAN PAULSSON

**I. INTRODUCTION**

In *Quasar de Valores SICAV S.A., Orgor de Valores SICAV S.A., GBI 9000 SICAV S.A., ALOS 34 S.L. v. The Russian Federation*, an SCC tribunal found that the Russian Federation’s actions amounted to an expropriation of the Yukos Oil Company pursuant to the Agreement for Reciprocal Promotion and Protection of Investments between Spain and the USSR (“BIT”). As a result, the Tribunal awarded the Claimants\(^1\) approximately USD $2 million plus interest for the destruction of the value of their proportionate share of the what the company’s market value would have been but for the expropriatory measures.

**II. BACKGROUND**

Article 6 of the BIT states that any expropriation by either Party on the grounds of public use and in accordance with the legislation must be non-discriminatory and must adequately compensate the investors. Additionally, Article 10 provides for arbitration in the absence of amicable settlement “between one Party and an investor of the other Party relating to the amount or method of payment of the compensation due under article 6 . . .”\(^2\)

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\(^1\) The Claimants consisted of Quasar de Valores SICAV S.A., Orgor de Valores SICAV S.A., GBI 9000 SICAV S.A., and ALOS 34 S.L.

\(^2\) *Id.* at 4.
Relying on Article 6 and 10, “[t]he Claimants allege[d] that [Russia] unlawfully dispossessed Yukos of its assets and expropriated its shareholders by means of a variety of abuses of executive and judicial power,” resulting in the destruction of the value of American Depository Receipts (“ADRs”) equivalent to a certain fraction of ordinary shares in Yukos. Specifically, the Claimants argued that (1) Russia imposed massive tax claims brought against Yukos; (2) prevented Yukos from paying the tax liabilities in a manner of its choosing so that Russia could have a pretext to seize Yukos’ most valuable asset and to transfer it to Rosneft, a state-owned oil company; and (3) that Russia was responsible for initiating a bankruptcy proceeding against Yukos that led to the liquidation of the remainder of the company’s assets.

Russia, on the other hand, argued that the Claimants engaged in an abuse of process because the only real party-in-interest was Group Menatep Limited (“Menatep”), “a Gibraltar entity with no rights under the Spain/Soviet bilateral investment treaty.” Additionally, Russia argued that all the taxes imposed were both lawful and legitimate.

III. TRIBUNAL’S DECISION

A. Liability

The Tribunal noted at the outset that Article 6 of the BIT excluded the Tribunal’s authority to determine whether the expropriation is internationally unlawful. Thus, its findings with respect to liability were limited to determining (1) if the measures taken by Russia were part of the ordinary process of assessing and collecting taxes, or if they were instead part of an expropriatory pattern, and (2) if such measures were considered an expropriation, whether the Claimants were adequately compensated, regardless of whether the acts at issue were lawful or unlawful.

3 Id. at 9.
4 Id. at 12.
5 In the Award on Preliminary Objections, the Tribunal upheld jurisdiction with respect to the claims of four of the seven original Claimants and also found that the Claimants’ proof of ownership of the ADRs was satisfied.
The Tribunal first addressed both Parties' reliance on the analysis and decisions reached in RosInvest and Yukos v. Russia, two decisions that dealt with similar claims against Russia. Although the Tribunal expressed that it would pay respectful regard to these decisions, the Tribunal stated that it was not bound by either decision. Next, the Tribunal addressed Russia's claim of the alleged abuse of process, specifically that Menatep, the third-party funder, not the Claimants, were the true parties in interest. Although the Claimants' costs were paid entirely by Menatep, the Tribunal determined that the Claimants purchased shares in Yukos and could rightfully claim that Russia destroyed their value.

Next, the Tribunal analyzed the taxes imposed on Yukos. Eight months after an audit of fiscal years 2000 and 2001 in which no criticisms against Yukos were raised, “the Ministry of Taxation began a series of re-audits of Yukos' tax years 2000-1, which concluded that Yukos had unlawfully underreported income by routing it through low-tax regions of the Russian Federation.”6 As a result, Yukos' tax benefits were revoked and additional taxes associated with income of the trading companies were imposed. Moreover, Yukos was denied VAT credit that it undoubtedly qualified for.

In response, Russia claimed Yukos violated a rule of good faith in that its tax benefits were disproportionate to the investments it had made within a low-tax region, and that Yukos engaged in sham transactions. The Tribunal was not persuaded by Russia's arguments, and concluded that Russia intentionally prevented Yukos from discharging the tax debts by seizing Yuganskneftegaz (“YNG”),7 and failing to consider Yukos' proposals of alternative means of paying the tax assessments.

The Tribunal then addressed whether Yukos' tax delinquency was a pretext for seizing Yukos assets and transferring them to Rosneft. “As a result of the asset freeze that took place on 15 April 2004, Yukos defaulted on a one billion-dollar loan issued by a consortium . . . ."8 That consortium obtained a judgment against

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6 Id. at 46.
7 YNG is “the corporate owner of a large Siberian oil field” that was one of Yukos’ main production subsidiaries. Id. at 2.
8 Id. at 134.
Yukos, eventually forcing Yukos into bankruptcy. Yukos later proposed a restructuring plan, but “[t]he Claimants maintain that Russia used its control of the meeting of creditors to ensure that this restructuring proposal put forward by Yukos’ management was rejected, and instead that decision was taken to liquidate the company’s remaining assets.” The Tribunal concluded that the liquidation auctions, which resulted in Russia owning 93% of Yukos, “were part of the same overall scheme of confiscation.” In conclusion, the Tribunal found that “Yukos’ tax delinquency was indeed a pretext for seizing Yukos assets and transferring them to Rosneft . . . [and] that the Russian Federation’s real goal was to expropriate Yukos, and not to legitimately collect taxes.”

B. Damages

1. Adequate Compensation

The Claimants argued “that they should be compensated in an amount equal to their proportionate share of Yukos’ market value on 23 November 2007 as it would have been but for Russia’s expropriatory measures.” Collectively, the Claimants held 73,000 shares and Yukos as a whole had about 2.2 billion outstanding shares. According to the Claimants, Yukos’ overall value would have been $83 billion, “leading to proportionate compensation to them in the amount of $2,625,810, plus interest.” The Tribunal acknowledged that such “compensation purports to be consonant with the customary international law standard for recovery in the event of lawful expropriation and Article 6 of the BIT.”

Specifically, the Claimants claimed “[t]he date of 23 November 2007 corresponds to the ‘time of the taking’ or, in this case, the date when Yukos was removed from the Unified Register of Companies in the wake of the end of the bankruptcy proceedings . . .
Russia, however, denied that 23 November 2007 was the alleged expropriation date. Russia questioned “how Claimants [could] argue that the alleged expropriation occurred in November 2007, which was several years after most of the alleged expropriatory events of which they now complain [occurred], and over a year after they gave notice of their expropriation claim.”16 Moreover, Russia argued that no expropriation occurred at all, so it did not offer an alternative date on which such a non-event may have occurred. As a result of Russia’s failure to provide alternative dates, the Tribunal accepted the Claimants’ logic in putting forward the date of 23 November 2007.

Next, the Tribunal explained that “[t]he notion of ‘expected’ value refers to the fact that the market value on 23 November 2007 was nil, and therefore must be compensated by reference to what one may conclude the valuation of Yukos as a going concern would likely have been if the business had been unimpeded by Russia’s expropriatory conduct.”17 Additionally, the Claimants argued that compensation “‘should exclude any decline in value attributable to the threat of the taking’ . . . and therefore ‘the appropriate methodology is for the Tribunal to base its valuation on the last stock price before the threat of a taking rendered the stock price an unreliable indication of Yukos’ worth.’”18 The Claimants proposed the date of 14 April 2004 as the last reliable stock price, which was $14 per share, because “this was immediately before the news of the Tax Ministry’s tax claim for Y2000 and the asset freeze of 15 April [2004] . . . .”19

The Claimants relied on the expert evidence of Professor Richard S. Ruback of the Harvard Business School, who proposed a value of $35.97 per share on 23 November 2007. Professor Ruback considered “the relationship between the evolution of Yukos’ share price as compared to a cohort of four of its Russian oil and gas competitors prior to 14 April 2004, and then [projected] that relationship from 14 April 2004 to 23 November

15 Id. at 189.
16 Id. at 190 (citation omitted).
17 Id. at 191.
18 Id.
19 Id. at 192.
2007 in order to estimate Yukos’ share value in the absence of Russia’s measures.” Additionally, Professor Ruback confirmed his estimate by assessing the value of Rosneft, finding that the value of “legacy-Yukos assets owned by Rosneft’ was somewhere between $72-$91 billion at the valuation date, to which should be added the proceeds from the liquidation auctions of other Yukos assets, leading to a [total] valuation of Yukos in the range of $83-$102 billion.”

Turning to the decision in RosInvest, the Tribunal rejected the “reasoning with respect to the discount applied to the valuation of the investors’ shareholding inasmuch as it focused on their having made a ‘speculative investment.’” The Tribunal stated that RosInvest involved a number of different features that were not present in the current case, most importantly the timing of stock purchases. “At the time of RosInvest’s purchases, Yukos was all but doomed and retained only the residual value of hope for recovery through a process of legal claims.” The Tribunal stated that here, however, the present Claimants purchased stock at a time when Yukos’ demise had not yet occurred. Moreover, the Tribunal noted that “[i]t is a familiar tenet of international law that compensation cannot be reduced on the basis that anticipation of expropriating conduct has depressed the market value of the asset.” So, unlike the RosInvest tribunal who limited its award to the purchase price per share, the Tribunal here held that the present Claimants were free to seek the potential value of their shares.

The Tribunal then assessed the central question of what was the value of the “investment” destroyed. The Tribunal noted that the determination could not be based on the underlying value of the assets owned by Yukos because the Claimants were only minority shareholders with little power to make policy decision within the company. Instead, the Tribunal agreed with Professor Ruback that “the value of a portfolio investment is simply given by

\[\text{Value} = \text{Portfolio Value} - \text{Risk Premium}\]

\[\text{Portfolio Value} = \sum_{i=1}^{n} \text{Asset Value}_i \times \text{Shareholding}_i\]

\[\text{Risk Premium} = \sum_{i=1}^{n} \text{Risk}_i \times \text{Shareholding}_i \]

\[\text{Total Value} = \text{Portfolio Value} - \text{Risk Premium}\]
the market.” 

Still, the Tribunal acknowledged that determining the market value involves both the selection of a reference date of the last reliable stock price and projections as to the future market evolution, two elements that require judgment decisions.

In fact, Russia argued that the Claimants’ last reliable stock price date was an arbitrary judgment decision. Russia criticized Professor Ruback’s model in a number of ways, including the use of a two-year period rather than any other length of time to establish the relative profitability coefficient, the failure to consider if one of the cohorts made a major oil discovery in the post-14 April 2004 period, and the omission of a constant term, “one of the most obvious and widely used explanatory variables in asset return models . . . .” In response, the Claimants contended that the Tribunal could adjust Professor Ruback’s model by subtracting any legitimate taxes Yukos owed and any Yukos assets that were removed from Russia by Yukos’ majority shareholders and managers.

The Tribunal recognized that Dr. Ruback’s model may be flawed. Still, the Tribunal stated that “[Russia]’s presentation itself has a critical flaw: it [did] not set forth an alternative, more reliable forecast.” The Tribunal stated that the obvious reason for Russia’s lack of a more reliable forecast was due to the fact that “it [was] overwhelmingly clear that the value of Yukos’ shares would have substantially increased over the relevant time frame.” Therefore, the Tribunal stated that, in determining the Claimants’ damages, “[Russia] is simply ordered to pay for what it took, valued at the time of the taking, and without any consideration of the benefits it may since have enjoyed by reason of its actions – whether in terms of pure revenue or in the achievement of policy objectives.”

In determining a specific number for the Claimants’ damages, the Tribunal first stated that “[i]t is trite law that an international

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25 Id. at 206.
26 Id. at 211.
27 Id. at 212.
28 Id.
29 Id. at 214.
tribunal which has found liability and loss is not impeded from granting compensation only because the latter cannot be computed with certitude." As a result, "with the tools available to it, the Tribunal effect[ed] a downward adjustment of the claim which [was] intended to take into account the various challenges raised against the claims."30 The Tribunal replaced Dr. Ruback's starting point of $14 per share, Yukos' share price on 14 April 2004, with $10.80, Yukos share price on 19 December 2003, the date the Claimants made their first purchase. This led to a predicted Yukos' share price of $27.76 for the 23 November 2007 dates. The Tribunal's reasoning for this downward adjustment was a result of Russia failing to provide an alternative forecast and the Claimants' acceptance of the Tribunal's authority to adjust Professor Ruback's model. The Tribunal noted that, "[w]hile this downward adjustment might lack precision, it is the Tribunal's view that under the present circumstances its approach adequately compensates the Claimants for the expropriation of their investments and avoids awarding a windfall."31

Additionally, the Tribunal rejected "[Russia]'s argument that Professor Ruback's valuation of Yukos [was] speculative because '[a]fter the Claimants purchased their ADRs . . . the Yukos share price never went close to US$35.97.'"32 Although the Tribunal acknowledged that Yukos' share price never increased to $35.97 or the Tribunal's downward adjustment of $27.76, "the reason is straightforward: [Russia] never gave Yukos the opportunity."33 Russia also argued that "the quantum of recovery in this case must in any event be reduced by reference to the evidence of the Claimants' [behavior] as investors, which was said to be focused on speculation in distressed stock, with the investors manifestly willing to dispose of or require their shares at a moment's notice (so-called 'flipping')."34 Again, the Tribunal rejected this argument, stating that "[t]he possibility that individual shareholders, for an infinite variety of reasons, may choose to trade their holdings does not change the value of such rights for

30 Id. at 215.
31 Id. at 217.
32 Id. at 215.
33 Id.
34 Id. at 219.
the time being or the approach as a matter of law to the quantification of loss.”

"Based on [the Claimants’] respective holdings (the equivalents of their ADRs in ordinary shares)”, the Tribunal awarded the Claimants’ individual recovery as follows: USD $305,360 for Quasar de Valores SICAV S.A. (11,000 shares); USD $943,840 for Orgor de Valores SICAV S.A. (34,000 shares); USD $499,680 for GBI 900 SICAV S.A. (18,000 shares); and USD $277,600 for ALOS 34 S.L. (10,000 shares).

2. Costs

The Claimants sought an award of costs in the overall amount of USD $14,572,671.57, and Russia sought USD $9,412,260.73. While acknowledging that the Claimants may have been unsuccessful in certain areas and also may have created unnecessary complications, the Tribunal stated that the overall result was a finding of liability that should result in an order for compensation. The Tribunal stated that for ordinary cases “Articles 43 and 44 of the SCC Rules, as well as Section 42 of the Swedish Arbitration Act of 1999, provide support for the proposition that the prevailing party is entitled to recover costs incurred by it.”

The Tribunal, however, noted that this particular case was not ordinary because it was admittedly financed entirely by a third party, Menatep. The Tribunal stated that “[t]he usual arguments about the recoverability of costs where a party’s participation in a case has been financed by a third party are inapposite here, because such third-party financing is typically part of a legally enforceable bargain [where] . . . the prevailing party in the arbitration has given up something in return for that [financial] support.” Here, the Claimants had no legal duty to compensate Menatep with any of the recovery, and instead, compensation depended on a “sense of moral obligation rather than a legal

35 Id.
36 Id. at 218.
37 Id. at 221.
38 Id. at 223.
While the Claimants did not expend money or incur obligations on account of the costs of pursuing their claims, the Tribunal noted that Menatep had no standing before this Tribunal or indeed more generally under the BIT.

"The SCC . . . determined the costs of the arbitration as follows: Mr. Paulsson, fee of EUR 400,000 and reimbursable expenses of EUR 17,483; Judge Brower, EUR 240,000 and EUR 13,216, respectively; Mr. Landau, EUR 240,000 and EUR 6,830, respectively; SCC administrative fee, EUR 60,000."40 The Tribunal also stated that Russia failed to provide the full half of the advance payments required to meet these costs, and the advances made on behalf of the Claimants represented about 86% of the total. Additionally, after the Tribunal received both parties’ money and paid the arbitration costs, there still remained a credit of EUR 134,043. Despite Russia’s failure to meet what is in principle a joint duty to provide equal advances, the arbitrators decided not to order payment by Russia of the shortfall of its contribution for two principle reasons, (1) Menatep was financing the entire cost of arbitration for the Claimants, and (2) the Claimants did not have a legal obligation to pay Menatep for its assistance. Moreover, because Russia “consented to these proceedings under the terms of the BIT, and given the outcome of the case,” the arbitrators considered it within their discretion to apply Russia’s partial advance “to the cost of the arbitration.”41 In conclusion, the Tribunal determined the Claimants were liable for EUR 837,655 Russia was liable for EUR 139,874, and the credit balance would be remitted to the Claimants.

3. Interest

The Claimants sought pre-award interest on the sums awarded to them from 23 November 2007 until the date of this Award. Both the BIT and the Russian law relied upon by the Parties were silent on the subject of interest. In such circumstances, the Tribunal stated that, under the general principles of international law, the Claimants’ should be put in

39 Id. at 224.
40 Id. at 225.
41 Id.
“the position they would have been if there had been compliance with the BIT; that is to say compensation would have been paid to the Claimants upon the expropriation of Yukos and they would have been in a position to earn interest thereon.” The Tribunal recognized that this included the compounding of interest. Russia did “not question[] the Claimants’ assertion that as of 23 November 2007, Russian sovereign medium-term dealt in US Dollars had a yield of 6.434%”.

IV. CONCLUSION

As a result of Russia’s uncompensated expropriation of the Claimants’ investment through various abuses of executive and judiciary powers, the Tribunal ordered Russia to make the following immediate payments: USD $305,360 to Quasar de Valores SICAV S.A; USD $943,840 to Orgor de Valores SICAV S.A.; USD $499,680 to GBI 9000 SICAV S.A.; and USD $277,600 to ALOS 34 S.L. Additionally, the Tribunal stated that “interest shall run on these four amounts at a rate of 6.434%, compounded annually, from November 2007 until the date of effective payment.”

Editorial Note: On 18 July 2014, a third arbitration case involving Yukos and the Russian Federation, Yukos Universal Limited (Isle of Man) v. The Russian Federation, was decided. Similar to the previous cases (RosInvestCo UK Ltd. v. The Russian Federation and Quasar de Valores SICAV S.A. et al. v. The Russian Federation), the tribunal found the Russian Federation’s actions amounted to an expropriation of the claimants’ assets. However, the tribunal’s damage analysis differed markedly compared to the two previous cases.

First, the tribunal held that the claimants were “entitled to select either the date of expropriation or the date of the award as the date of valuation.” Consequently, the two dates considered were 19 December 2004, the date of the YNG auction, and 30 June 2014, the established date of the award. In comparison, the

42 Id. at 226.
43 Id. at 227.
44 The tribunal ultimately used the date of the award because the amount of damages was higher.
RosInvestCo tribunal set the valuation date at 24 January 2007, the date RosInvestCo’s Participation Agreement (which “transferred 100% of [RosInvestCo’s] interest in the Yukos shares to Elliott International, a Cayman Islands company not eligible for investment treaty protection.”) was terminated because at that date, RosInvestCo became the beneficiary of Yukos’ stock. As mentioned above, the Quasar tribunal elected 23 November 2007, the date Yukos was delisted as a registered company.

Next, in regards the appropriate interest rate, the Yukos tribunal chose the rate on a ten-year US Treasury Bond, after rejecting the LIBOR rate, the rate for a Russian sovereign bond issued in U.S. dollars, and the U.S. Prime rate plus two percent. The pre-award interest rate was thus the average yield of the ten-year U.S. Treasury bond, which equaled 3.389%, while the post award interest rate would be based on the yield of the ten-year U.S. Treasury bond as of 15 January 2015, the date when the grace period to pay the claimants would end. Moreover, the tribunal decided to award the claimants “simple pre-award and post-award interest compounded annually.” In comparison, the RosInvestCo tribunal awarded “interest using LIBOR, without any compounding,” and the Quasar tribunal set its interest rate at 6.434% “(corresponding to the relevant average yield of medium-term Russian sovereign bonds dealt in USD) compounded annually.”

Taking these differences into consideration and the fact that the three claimants in the Yukos case collectively held 70.5% of Yuko’s shares outstanding, the latest tribunal awarded the largest quantum for damages (disregarding the cost of arbitration and legal expenses): USD 1.846 billion. In contrast, the RosInvestCo tribunal’s award was USD 3.5 million, and the Quasar tribunal’s award was about USD 2.0 million.

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ANATOLIE STATI, GABRIEL STATI, ASCOM GROUP S.A., TERRA RAF TRANS TRADING LTD. v. REPUBLIC OF KAZAKHSTAN, CASE NO. 1:14-CV-00175-ABJ, AWARD

12 DECEMBER 2013

DECIDED BY:
DAVID R. HAIGH QC (CO-ARBITRATOR), PROFESSOR SERGEI N. LEBEDEV (CO-ARBITRATOR), PROFESSOR KARL-HEINZ BÖCKSTIEGEL (CHAIRMAN OF TRIBUNAL)

I. INTRODUCTION

In Anatolie Stati, Gabriel Stati, Ascom Group S.A., Terra Raf Trans Trading Ltd. v. Republic of Kazakhstan, a Stockholm Chamber of Commerce (SCC) Tribunal found that, through a “string of measures of coordinated harassment” of Claimants’ investments related to the Borankol and Tolkyn Fields and Munaibay Oil, to the Contract 302 Properties, and to the LPG Plant,” Kazakhstan violated the Fair and Equitable Treatment provision of the Energy Charter Treaty (ECT). As a result, the Tribunal awarded USD 497,685,101 in damages, plus interest at “the rates of 6 months US treasury bills over the relevant period,” compounded semi-annually. In addition, the Tribunal ordered

1 The Claimants consists of Anatolie Stati and his son Gabriel Stati along with their companies, Ascom Group S.A. (Ascom) and Terra Raf Trans Trading Ltd. (Terra Raf). Anatolie Stati and his son Gabriel Stati are nationals of Moldova and Romania. Ascom is a joint stock company incorporated in Moldova, and Terra Raf is a limited liability company incorporated in Gibraltar. Through Ascom and Terra Raf, the Claimants owned and controlled Kazpolmunay LLP (KPM) and Tolkynneftegaz LLP (TNG), which are energy companies located in Kazakhstan that “held Subsoil Use Contracts and subsoil use licenses” from the Kazakhstan government “for the exploration and production” of oil and gas. Stati v. Republic of Kaz., Case No. 1:14-cv-00175-ABJ, Award, at 117, ¶ 808, Arbitration Inst. of the Stockholm Chamber of Commerce (Dec. 2013), http://www.encharter.org/fileadmin/user_upload/Investor-State_Disputes/Ascom_Award.pdf. In particular, TNG “owned the subsoil use rights to the Tolkyn field and the Taby Block” under Contract 302, and KPM “owned the subsoil use rights to the Borankol field.” Id. at 81, ¶¶ 211-12.
Kazakhstan “to pay Claimants 50% of Claimants’ costs of legal representation [amounting to USD 8,975,469.40],” and to bear ¾ of the arbitration costs [amounting to EUR 1,069,470.98].

II. BACKGROUND

Seeking energy “investment opportunities in Kazakhstan,” the Claimants located two viable energy companies in 1999 already established in Kazakhstan, KPM and TNG. By 2004, the Claimants had acquired one hundred percent of each company’s equity. The Claimants then set out to explore and extract gas and oil from the Borankol and Tolkyn fields pursuant to the Subsoil Use Contracts TNG and KPM had previously secured from the Kazakh government.

Throughout the early 2000s, the Claimants rearranged their business operations: Ascom kept control of KPM while TNG transferred ownership to Gheso, S.A. ("Gheso"), Ascom’s subsidiary. Then, without objection from the State, Gheso transferred all of TNG to Terra Raf, another company the Claimants owned. In addition, to fund their investments, the Claimants created Tristan Oil Ltd., a “special purpose vehicle with the purpose of issuing notes.”

From 2000, when the Claimants first attained a controlling share of KPM and TNG, to October 2008, the Claimants operated their businesses without problems in Kazakhstan. However, in October 2008, the then-President of Moldova sent a letter to President Nazarbayev, Kazakhstan’s President, accusing Anatoli Stati of using the profits generated from his Kazakh investments to fund operations that would damage both countries’ reputations. Subsequently, in mid-October 2008, President Nazarbayev issued an order to “‘thoroughly investigate’ . . . all of [the] Claimants’

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2 Stati, SCC at 82, ¶ 221.
3 Id. at 83, ¶ 228. Id. at 84, ¶ 244.
4 Gheso, S.A. was a subsidiary of Ascom.
5 Id. at 81, ¶ 209.
6 The Claimants discovered oil and gas deposits in its Tabyl Block location with its Munaibay-1 well on 24 July 2008. Id. at 89, ¶ 282.
7 Id. at 90, ¶ 291. Id. at 211, ¶ 949.
business activities in Kazakhstan.” From that point on, the Claimants’ began to experience increasing difficulties of doing business in Kazakhstan.

First, as part of the order to investigate, the State of Kazakhstan Ministry of Energy and Mineral Resources (MEMR) and other governmental agencies conducted numerous disruptive inspections of KPM and TNG, which consequently inhibited the companies’ operations. Next, under the Republic’s influence, Kemikal, “TNG’s largest non-local customer,” suddenly “failed to post the bank guarantees that were part of its required payment terms,” which compelled TNG not to renew its contract with Kemikal. Then, later in 2008, INTERFAX, a non-governmental news agency, “issued a report accusing [the] Claimants of having altered documents in order to defraud [Kazakhstan] of its pre-emptive right to purchase the companies.” Consequently, Credit Suisse, the Claimants’ primary financial loaning institution, refused give the Claimants’ a bridge loan, citing the report as one of its main reasons. To combat their liquidity problems, the Claimants were forced to obtain an unfavorable loan from the Laren Facility. Combining all these events, Moody’s and other credit rating agencies downgraded the Claimants’ Tristan notes.

The State further increased the Claimants’ burden of operating in Kazakhstan by stalling and eventually terminating the Claimants’ agreement with government entities for the sale of gas, threatening to cancel the sale of TNG to Terra Raf, and declining TNG’s request to extend its exploration period of the properties under Contract 302. The Financial Police also arbitrarily reclassified the Claimants’ gas and oil pipelines, which put the Claimants in violation of Kazakh law because they did not possess

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8 Id. at 91, ¶ 296.
9 Id. at 297, ¶ 1365.
10 Id. at 297, ¶ 1265.
11 Id. at 97, ¶ 348. “On 1 December 2004, Kazakhstan passed a law giving the State a pre-emptive right over certain transfers of subsoil users,” which was eventually amended to grant “Kazakhstan a pre-emptive right to acquire shares in subsoil users.” Id. at 85, ¶ 245-46.
12 The terms included “35% interest on a USD 60 million note, plus the issuance of USD 111 million of new Tristan notes.” Id. at 109 ¶ 461.
the proper operating licenses for the new classification. \(^{13}\) Thereafter, the State arrested Mr. Cornegruta, the general manager of KPM, seized and attached KPM and TNG’s assets on 30 April 2009, to ensure the court retained jurisdiction over and secured potential payment from Mr. Cornegruta, and ultimately found him guilty of illegal entrepreneurial activity in September 2009. Notably, the 30 April 2009 seizure “prevented KPM and TNG from selling or depreciating the value of those assets.” \(^{14}\)

Kazakhstan immediately sought to collect taxes the Claimants allegedly owed, including taxes which the companies had previously been exempt from paying, and after taking the Claimants to trial, the Supreme Court of Kazakhstan ultimately affirmed the Claimants’ tax liability. \(^{15}\) As a result, the Claimants diverted many of KPM and TNG’s receivables to Ascom in order to protect their assets from being seized and used as payment.

Because of these governmental impediments, the Claimants were unable to complete Project Zenith, which was a plan to sell KPM, TNG, and the LPG Plant. Consequently, with the assets still under the Claimants’ ownership, in mid-July 2010, Kazakhstan publicly declared “the takeover and abrogation of the Claimants’ Subsoil Use Contracts.” \(^{16}\) Subsequently, on 26 July 2010, the Claimants filed their Request for Arbitration with the Arbitration Institution of the Stockholm Chamber of Commerce (SCC) pursuant to the Energy Charter Treaty (ECT). \(^{17}\) The Claimants’ argued that Kazakhstan’s actions violated the Fair and Equitable Treatment (FET) clause of the ECT, resulting in over USD 1.05 billion in damages.

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\(^{13}\) In order to operate “trunk” pipelines, the owner has to have a special license. Because the Claimants did not have this license, they were in violation of Kazakh law.

\(^{14}\) Id. at 222, ¶ 1044.

\(^{15}\) Id. at 127, ¶ 627.

\(^{16}\) Id. at 228, ¶ 1094.

Kazakhstan sought to dismiss the claims, arguing that it did not breach the ECT because it had treated the Claimants fairly: specifically, the State asserted it was justified for seizing KPM and TNG’s assets because the Claimants violated Kazakh law and were struggling financially, thus necessitating the seizure in order to “preserve [the assets] from decay.” Kazakhstan also alleged “the Claimants’ own conduct, as well as external circumstances” diminished the companies’ values.

III. JURISDICTION

The Tribunal first ruled that it had jurisdiction over the dispute. The Tribunal explained Claimants Anatolie and Gabriel Stati are Moldova and Romania nationals, “which are Contracting Parties to the ECT,” thus qualifying them as investors under Article 1(7) of the ECT. The Tribunal also noted that Claimant Ascom was incorporated in Moldova (a contracting party to the ECT) and Claimant Terra Raf was incorporated in a state that was part of the broader European Community, which itself is a member of the ECT. Thus these two companies were also valid claimants. Finally, the Tribunal held the Claimants were able to bring this dispute to the SCC because their investments fell within the definition of Article 1(6) of the ECT.

IV. APPLICABLE LAW

The Tribunal found that Article 22(1) of the SCC Rules and Article 26(6) of the ECT required the Tribunal to “decide the merits of the dispute in accordance with the ECT and applicable rules and principles of international law,” in addition to Kazakh law where appropriate.

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18 Id. at 15, ¶ 59.
19 Id. at 16, ¶ 59.
20 Article 1(7) of the ECT states “Investor means […] (i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law." Id. at 161, ¶ 742-43.
21 Id. at 188, ¶ 851.
V. THE MERITS

A. Liability

1. Whether Kazakhstan Provided the Claimants’ Investments with Fair and Equitable Treatment According to Article 10(1) of the ECT

The Claimants argued that Kazakhstan’s actions breached Article 10(1) of the ECT, which obliges Kazakhstan “to treat Claimants’ investments fairly and equitably.”22 The Tribunal determined that it must apply the term to the specific circumstances of the case in order to decide whether Kazakhstan violated the FET standard. The Tribunal emphasized that FET is not necessarily violated based on one action, but instead, Kazakhstan can be found to have broken the standard from its cumulative actions.

The Tribunal concluded that based on “(1) the picture of [Kazakhstan’s specific actions affecting the Claimants’ investments] seen cumulatively in context to each other and (2) the difference of treatment of Claimants’ investments before and after the Order of the President of the Republic on 14/16 October 2008,” Kazakhstan breached its obligation under Article 10(1) of the ECT “to treat investors fairly and equitably.”23 Specifically, the Tribunal found the following actions by Kazakhstan violated the FET clause: 1. the Financial Police’s arbitrary reclassification of the Claimants’ pipelines as “trunk” pipelines; 2. The Kazakh agencies’ numerous sudden inspections between June and July 2010 to assess the Claimants’ “compliance with their Subsoil Use Contracts;” 3. improperly charging Claimants for illegal entrepreneurial activity; and 4. the Republic’s influence in “Kemikal’s failure to provide the requisite bank guarantees to TNG” in 2008.

Having concluded that the Republic of Kazakhstan was liable for breaching the FET standard in Article 10(1), the Tribunal decided it did not need to address the Claimants other claims of breach of the ECT against the Republic of Kazakhstan because all the damages the Claimants sought were compensable as a result of the breach of Article 10(1). Thus finding violations based on

22 Id. at 195, ¶ 891.
23 Id. at 228, ¶ 1086.
other provisions of the treaty would not impose further damage awards than those the Claimants already requested.

B. Causation

The Tribunal and both parties agreed that “as reflected in Articles 36 and 39” of the International Law Commission’s Articles on State Responsibility, the Claimants had the burden to demonstrate causation between the State’s actions and the compensation claimed. Kazakhstan argued that the Claimants’ actions broke the causal link. The Tribunal, however, ruled that Kazakhstan bore the burden of proving the Claimants’ self-inflicting actions “caused the damage alleged, unless ... the injury can be shown to be severable in causal terms from that attributed to the state.”25 The Tribunal divided its analysis into two parts: (1) whether Kazakhstan’s breaches of the ECT caused the Claimants’ alleged damages; and (2) whether the Claimants’ own actions affected the damages they sustained.

1. Whether the Republic of Kazakhstan’s Breaches of the ECT Caused Claimants’ Alleged Damages

The Tribunal held “Kazakhstan’s series of actions starting in October 2008, which are breaches of the FET standard of the ECT ... harmed Claimants’ investments and prevented Claimants from proceeding with their investment from that moment; forward.”26 The Tribunal cited numerous causal events, which emanated from the October Presidential Order, namely the INTERFAX publication; “the formal initiation of the criminal investigation against KPM;” the myriad inspections of KPM and TNG; the asset seizures on 30 April 2009; the government’s influence over Kemikal; and its actions with regard to Contract 302.

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24 Id. at 290 ¶ 1330.
25 Id. at 290, ¶ 1332.
26 Id. at 302, ¶ 1408.
2. INTERFAX Publication

The INTERFAX article quoted MEMR representatives accusing the Claimants of “forgery and violations of registration requirements.” Although these accusations were false, they detrimentally affected the Claimants: credit rating agencies downgraded their Tristan notes and Credit Suisse, citing the article as its main source of concern, refused to “provide [a] bridge loan until [the] Claimants resolved their disputes with Kazakhstan.”

Though Kazakhstan claimed it was not responsible for the article because it was not issued by a government official or agency, the Tribunal dismissed this defense, stating the INTERFAX publication was a direct result of the President’s order in October 2008. As a result, the Tribunal held Kazakhstan liable for the revoked Credit Suisse loan and the downgraded notes.

3. Agency Investigations, Arrest, & Asset Seizures

The Tribunal also ruled Kazakhstan had caused the decline in the Claimants’ credit ratings, which ultimately resulted in the Claimants being forced to accept unfavorable loan terms from Laren Loan Facility. The Tribunal found that the Claimants’ credit ratings were negatively affected by a series of actions, particularly the President’s order to investigate KPM and TNG and subsequent inspections by governmental agencies. These investigations and inspections continued for about two years starting November 2008 and quickly became “daily intrusions into the operations of KPM and TNG,” which distracted employees and ultimately affected the companies’ performance. As a result of these inspections, the Financial Police arrested Mr. Cornegruta and seized the companies’ assets and equity on 30 April 2009, including Contract 302 along with other properties, which created further destabilization and inoperability within the companies. Following the arrest of Mr. Cornegruta, Anatolie Stati “decided to pause construction on the LPG Plant and to reduce planned

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27 INTERFAX is a news agency with subsidiaries in various states.
28 Id. at 291, ¶ 1335.
29 Id. at 97, ¶ 349.
30 Id. at 297, ¶ 1362-63.
development efforts at Tolkyn and Borankol.” Consequently, in the summer of 2009, because many of KPM and TNG’s senior managers left Kazakhstan, Credit Suisse “refused to provide financing, and the companies urgently needed to renew financing arrangements in order to meet their tax and interest obligations,” the Claimants were compelled to enter into the terrible terms of the Laren Loan. Accordingly, the Tribunal determined that Kazakhstan, not the economic conditions or the Claimants’ own actions, was responsible for Claimants’ negative credit rating and subsequent agreement with the Laren Facility.

4. Claimants’ Separation with Kemikal

Kazakhstan claimed it was not responsible for Kemikal’s inability to post bank guarantees as part of the sales agreement with the Claimants. However, the Tribunal found Kazakhstan responsible for Kemikal’s actions because “Kemikal’s sudden refusal to post bank guarantees required by its credit terms was a change of its earlier business pattern,” suggesting this was “part of Kazakhstan’s aggressive actions against the Claimants.”

5. Government Actions Related to Contract 302

The Tribunal ruled that MEMR and other government agencies had disrupted the Claimants’ operations and damaged their oil and gas areas and facilities. Specifically, the Tribunal found that, in December 2008, MEMR threatened to cancel the transfer of TNG from Gheso to Terra Raf because MEMR claimed the transfer breached the “State’s statutory pre-emptive right to acquire TNG,” which was a violation of Contract 302. Furthermore, even though MEMR and TNG had been in negotiations to extend TNG’s exploration rights under Contract 302 since 2008, the MEMR never officially extended Contract 302. As a result, when the contract’s termination date arrived, “TNG was . . . prevented from further exploration” of the area, which

31 Id. at 301, ¶ 1393.
32 Id. at 301-02, ¶ 1398.
33 Id. at 303-04, ¶ 1416.
34 Id. at 304, ¶ 1418.
35 Id. at 299, ¶ 1378.
included the oil discovery at the area designated as Munaibay.\textsuperscript{36} As these findings demonstrate, the State’s actions directly inhibited the Claimants’ operations.

6. Whether Kazakhstan’s Actions Prevented Claimants from Selling Their Investments

The Tribunal declined to address whether Kazakhstan had prevented Claimants from selling their investments because the Claimants’ damages claims were based on “violations related to the Borankol and Tolkyn Field and Munaibay Oil, to the Contract 302 Properties, and to the LPG Plant,” not the selling price of the properties and investments.\textsuperscript{37}

7. The Existence of Intervening Causes

The Tribunal also examined whether the Claimants’ own actions or inexperience affected the Claimants’ losses. Kazakhstan asserted that intervening and independent factors caused the Claimants’ losses: these factors included (1) the Claimants’ companies were overleveraged and had cash constraints, (2) the decline in oil prices, and (3) the Claimants’ abandonment of their companies in 2009 and 2010.\textsuperscript{38} The Tribunal found that the various market factors Kazakhstan cited were only temporary, and not the cause of the severe damages experienced by the Claimants. In addition, the Tribunal found the Claimants did not abandon their investments when they were diverting KPM and TNG’s accounts receivable to Ascom and issuing dividends after both Mr. Cornegruta was found guilty and KPM was fined USD 145 million.\textsuperscript{39} Instead, the Tribunal stated this was a wise business decision because the companies’ assets would have been seized and used to pay off their outstanding penalties and debts to Kazakhstan.

\textsuperscript{36} \textit{Id.} at 300, ¶ 1389.
\textsuperscript{37} \textit{Id.} at 307, ¶ 1432.
\textsuperscript{38} \textit{Id.} at 310, ¶ 1442.
\textsuperscript{39} \textit{Id.} at 225, ¶ 1066.
C. Quantum

Turning to quantum, the Tribunal noted that Article 13 of the ECT, which describes the appropriate date and value to assess the investment taken under lawful expropriation, could nevertheless be used as a guide to determine the amount of damages and the valuation date for its case. When an investment is taken under the pretext of lawful expropriation, the appropriate compensation under this article is “the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way to affect the value of the Investment.”\(^{40}\) The Tribunal explained that the value attained under this method would be the lowest amount it would award to the Claimants because Kazakhstan did not lawfully expropriate the investments.

1. Valuation Date

The Claimants proposed that the proper valuation date for assessing damages was 14 October 2008, the date President Nazarayev issued his order to further investigate KPM and TNG. Citing customary international law and the Chorzów Factory\(^{41}\) case, the Claimants chose 14 October 2008, because this was the last date to “re-establish . . . the situation that existed before [Kazakhstan’s] wrongful conduct” began, permitting the Tribunal to properly evaluate the fair market value of the Claimants’ investments.\(^{42}\)

By contrast, Kazakhstan proposed 21 July 2010, as the appropriate valuation date. Kazakhstan asserted that the valuation date should be when “the actual expropriatory effect” occurred.\(^{43}\) Because the Claimants’ investments were not expropriated on 14 October 2008, Kazakhstan stated the Claimants’ date was too early,

\(^{40}\) Id. at 314, ¶ 1460.

\(^{41}\) (Ger. v. Pol.), P.C.I.J (Series A) No. 13 (1928).

\(^{42}\) Stati, SCC at 315, ¶ 1464.

which appreciated the investments' value. Instead, the State asserted the Claimants were only “deprived of their ownership rights of KPM and TNG” on 21 July 2010, when Kazakhstan terminated KPM’s Subsoil Use Contract 305 covering the Borankol field and TNG’s Subsoil Use Contract 210 covering the Tolkyn field and then put these investments into trust management with KMG’s subsidiary, KMT. The State further claimed that no event before 21 July amounted to an indirect expropriation either because the “Claimants [were not] . . . deprived of their property rights.”

The Tribunal ultimately selected a valuation date between the two proposed dates. The Tribunal rejected the Claimants’ 14 October 2008 date because Kazakhstan’s actions did not affect the investments until December 2008. In addition, Kazakhstan’s later date was disregarded because by that time, most of the damages had occurred. The Tribunal stated it was “in a position to select another valuation date if it [believed the new date was more] appropriate” because the Claimants not only suggested other dates, but the RBS Assessment of TNG and KPM the Claimants cited contained sufficient evidence of damage calculations for dates between 14 October 2008, and 21 July 2010, that the Tribunal could use to assess the investments’ values. Consequently, the Tribunal had three primary dates to choose from that were detailed in the RBS Assessment: 18 December 2008, when MEMR threatened to cancel the transfer of TNG from Gheso to Terra Raf; 30 April 2009, when Kazakhstan sequestered KPM and TNG’s equity and assets; or 18 September 2009, the date Mr. Cornegruta was found guilty. The Tribunal elected 30 April 2009, because “actual, and permanent damages could be identified for the investments,” “the State sequestration made it impossible for Claimants to continue with their investments[,] and the damages continued to occur from thereon.”

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44 Stat. SCC at 320, ¶ 1485.

45 Id. at 321, ¶ 1489.

46 Id. at 323, ¶ 1495. RBS is a consulting firm, which provided valuations of the Claimants’ assets.

47 Id. at 323, ¶ 1498.
2. Enterprise or Equity Value: What to Do With the Debt

The Tribunal next addressed whether KPM and TNG’s debt should be deducted from the value of the assets when determining the investments’ value. The Claimant suggested using “enterprise value,” or the “value of the companies’ assets without deducting their debt,” while Kazakhstan asserted the only appropriate valuation methodology was equity value, which subtracted the debt from the assets. According to the Claimants, enterprise value was the most appropriate measurement because Kazakhstan only seized the assets from KPM and TNG, leaving the Claimants still liable for the debts. Kazakhstan argued equity value was the best valuation approach because the debt was part of the companies’ financial structures.48

The Tribunal turned to the Chorzów Factory case for the appropriate formula to apply: “damages awarded ‘must as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.’”49 Based on this principle, the Tribunal stated that the “award should include future cash flows of the assets taken”50 and that debts that would be subtracted from the assets were those for which the Claimants were “no longer liable and for which Kazakhstan, or the new owner to which the assets were transferred, [was] now solely liable.”51 Thus, the Claimants had the burden of proving they remained liable for the various debts.

The first debt examined was the Tristan notes debt, which was used to finance KPM and TNG’s operations. Both Ascom and Terra Raf were still liable to Tristan noteholders “pursuant to Section 6 of the Pledge Agreement,” so the Tribunal held the Tristan debt could not be subtracted.52 Kazakhstan argued that the pertinent section did not oblige the Claimants to distribute their award proceeds to the noteholders, but the Tribunal stated the language

48 Id. at 327, ¶ 1517.
49 Id. at 329, ¶ 1527.
50 Id. at 330, ¶ 1531.
51 Id. at 330, ¶ 1532.
52 Id. at 330, ¶ 1537.
was broad enough to encompass such money, thus making the Claimants still liable.53

Next, the Tribunal addressed the debts associated with the Reachcom Facility Agreement, the Limozen Facility Agreement, and the Reachcom Receivables Purchase Agreement. Finding the Claimants did not prove they were still liable for these debts, the Tribunal designated these debts as deductible from the assets’ value.

The Joint Operating Agreement between VITOL and the Claimants to build and operate the LPG plant created a debt obligation for the Claimants if the Government interfered with the LPG plant.54 Because Kazakhstan did seize the plant, the Claimants were still liable for the fair value price of VITOL’s percentage of the plant. Therefore, the Tribunal withheld deducting this obligation from the damages.

The Laren debt was addressed next. The Tribunal held the Claimants had been liable for this debt because of Kazakhstan’s conduct, so even though the Claimants paid it off by the time the Tribunal received the case, there was no reason to subtract the value from the assets.

Finally, the Tribunal assessed the back tax obligations. Kazakhstan asserted the Claimants owed taxes on their underreported profits, but the Tribunal found that the alleged tax liability, similar to the Laren debt, was a result of Kazakhstan’s conduct. The Tribunal admitted that investors must pay taxes, but the Tribunal suggested “tax assessments may be abusively made in breach of the ECT.”55 Here, the tax obligations were only imposed after the October 2008 Presidential Order, consequently, the Tribunal reiterated that it was another part of the State’s conduct

53 Id.

54 VITOL provided advanced debt financing to Claimants for the construction of the LPG Plant, and as part of the agreement, if the government used its right of preemption, VITOL would be “entitled to payment from ASCOM of the fair value price and that ASCOM shall seek to recover such amounts from the Government.” Id. at 331, ¶ 1539.

55 Id. at 393-94, ¶ 1799.
culminating in the breach of the ECT. Further, even though the State cited the Supreme Court’s decision to uphold the Claimants’ tax liability, because the review was conducted without the Claimants’ knowledge, the Tribunal determined the trial did not “show a fair and independent assessment.” Therefore, the Tribunal found Kazakhstan had not proven “the tax assessment would have been valid even without” the State’s actions and decided to withhold deducting the tax obligations from the asset values.

i. Damages Related to Borankol Field and Tolkyn Field

The Tribunal agreed with the Claimants that Kazakhstan’s conduct “forced [the] Claimants to reduce development efforts at Borankol and Tolkyn fields and that, in particular, this caused Claimants to decide not to drill or recomplete 13 wells at Borankol and Tolkyn in 2009-2010.” As a result of the impeded operations, the Claimants experienced three types of damages: “(1) KPM and TNG lost revenue that they would have earned from their planned production;” (2) the Claimants experienced reduced productivity from the areas that were in operation; and (3) the “Claimants were unable to sufficiently respond to the watering issues at the Tolkyn field.”

The Tribunal analyzed the expert reports and focused on two: the Ryder Scott reports and Deloitte reports. The Tribunal noted that the Ryder Scott “reports [offered by the Claimants] on reserve estimates [were] convincing in their approach and results,” its valuation date was close to 30 April 2009, and it utilized the discounted cash flow method, which both parties and the Tribunal agreed was the most appropriate method to calculate damages. The Tribunal also found that it could use Deloitte’s report (offered by Kazakhstan), which set forth a

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56 Id. at 393, ¶ 1799.
57 Id. at 393, ¶ 1800.
58 Id. at 331, ¶ 1541.
59 Id. at 351, ¶ 1618.
60 Id. at 351, ¶ 1619.
61 Id. at 352, ¶ 1625.
comparable transactions analysis to value the assets.\textsuperscript{62} Because the State conceded to Deloitte’s “alternative damage calculations,” and because the report based its analysis “on the Ryder Scott Reports,” the Tribunal decided to use Deloitte’s comparable transaction analysis to value the Borankol Field and Tolkyn Field: the assets were valued at USD 277.8 million.\textsuperscript{63}

\textit{ii. Quantum Related to Contract 302 Properties}

The Tribunal then turned to valuing the Contract 302 Properties, consisting of the Claimants’ Munaibay oil well and the Interoil Reef. First, the Tribunal agreed with the Claimants that Kazakhstan was liable for "the Claimants’ investment of out of pocket expenses of USD 31,330,000," primarily derived from "exploring and analyzing the Contract 302 property, excluding the investment in the Munaibay-1 well."\textsuperscript{64} With respect to Claimant’s claims for lost profits, the Tribunal commented that the Claimants had to meet a high standard of proof to establish a claim for lost profits given the degree of economic, political and social exposure of such long-term investment projects.\textsuperscript{65} According to the Tribunal, this threshold is met when the investor shows that the “project either has a track record of profitability rooted in a perennial history of operations, or has binding contractual revenue obligations in place.”\textsuperscript{66} Here, the Tribunal found no such proven track record or contractual revenue obligations and thus excluded future profits from the damage calculations. The Tribunal specifically cited several of the Claimants’ own actions to prove the uncertainty associated with the Claimants’ oil extraction: the Claimants never explored the Interoil Reef over the eleven years they controlled Contract 302; they did not have enough time to finish drilling an exploration well;\textsuperscript{67} the Claimants submitted

\textsuperscript{62} Id. at 353, ¶ 1625. Deloitte used a valuation date of 14 October 2008, which the Tribunal saw as comparable to April 2009.

\textsuperscript{63} Id. at 353, ¶ 1625.

\textsuperscript{64} Stati, SCC at 367, ¶ 1686.

\textsuperscript{65} Id. at 368, ¶ 1688.

\textsuperscript{66} Id.

\textsuperscript{67} "TNG did not start drilling the Munaibay-1 well until February 2008," and because the well broke at a depth of 4700 meters, it would have taken about 2.5 more years to reach the goal of 6000 meters. Even then, the Tribunal found that
slower drilling times as part of its working program on 14 October 2008; they were inexperienced at drilling ultra-deep wells; and even the Claimants’ own geologists were unsure of the precise depth of the Interoil Reef. Therefore, the only damages recovered from Contract 302 were the direct investment expenditures.

iii. Quantum Related to LPG Plant

Kazakhstan claimed that no damages were due for the LPG Plant because it was a failed project and had a negative net present value. The Tribunal disagreed. It noted that if the plant had no value, Kazakhstan would not have been so ready to invest in the completion of the plant after taking control of it and government documents indicated that Kazakhstan was planning to open the plant in the near future.69

With respect to determining the value of the Plant, the parties had submitted vastly different damage calculations ranging from the Claimants’ USD 408.3 million to the Kazakhstan’s USD 0. The Tribunal considered “the best source for the valuation in the period of the [30 April 2009] valuation date . . . [was] the contemporaneous bids that were made for the LPG Plant by third parties after [the] Claimants’ efforts to sell the LPG Plant, both before and after October 14, 2008” because the third parties were anticipating to use the plant, meaning they would provide the best estimate of the plant’s fair market value.70 The average valuation of the LPG Plant from the third party bidders was USD 150 million, in particular, state-owned KMG valued the plant at USD 199 million. The Tribunal found KMG’s valuation the most appropriate calculation given the fair bidding process for Project Zenith and the fact that the value came from a state entity. Consequently, the Tribunal awarded Claimants USD 199 million for the LPG Plant.

the Claimants did not prove “they could have declared a commercial discovery of the Interoil Reef within the extended period to 30 March 2011.” Id. at 368, ¶ 1690.

68 Id.
69 Id. at 381, ¶ 1745.
70 Id. at 381, ¶ 1746.
iv. Moral Damages

Both Parties and the Tribunal agreed that moral damages, which are damages based on the “Claimants’ moral suffering,” were to be awarded only in exceptional cases, such as where:

- the State’s actions imply physical threat, illegal detention or other analogous situations in which the ill-treatment contravenes the norms according to which civilized nations are expected to act;
- the State’s actions cause a deterioration of health, stress, anxiety, other mental suffering such as humiliation, shame and degradation, or loss of reputation, credit and social position; and
- both cause and effect are grave or substantial.71

The Tribunal noted that parties seeking such damages “must meet a very high threshold to show a liability for moral damages.” It concluded that the Claimants did not meet this high burden of proof and, therefore, it did not need to address “the general question whether and under which exceptional circumstances awarding moral damages might be justified . . . .”72

v. Tax Claims

The Tribunal stated Kazakhstan had the burden of proving the back taxes the Claimants allegedly owed were normal lawful obligations of any investor and not just part of Kazakhstan’s conduct in breach of FET. As mentioned earlier, the Tribunal emphasized its earlier finding that the imposition of back taxes amounted to a breach of Kazakhstan’s obligations. Consequently, the Tribunal held the tax claims would not be deducted from the award because the State failed to meet the burden of proof.

vi. Interest

The Claimants argued that the proper interest rate to apply to the damages was the 10.5% interest rate on its Tristan notes

71 Id. at ¶ 1772.
72 Id. at ¶ 1772.
because it “was tailored toward what an investor like [the] Claimants could have earned by investing the funds” and it reflected the “Claimants’ actual borrowing costs.” 73 By contrast, Kazakhstan asserted that the more accurate interest rate to use was the “rate for 6 month US Treasury Bills,” because the award was denominated in United States dollars and “other arbitral decisions” have similarly used such rates even when the “only contact with the USA was that damages were awarded in USD.” 74 The Tribunal agreed with Kazakhstan, and set the rate at which interest accrued at the relevant 6-month US Treasury Bill rate. However, the Tribunal noted the “Claimants could be expected to reinvest their interest gains every 6 months,” so it ruled that interest should be compounded, on a semi-annual basis starting 30 April 2009 until the Kazakhstan paid the debt in full. 75

vii. Arbitration Costs

The Claimants had sought an award of costs and fees. The Tribunal noted that there exists “a certain practice in investment treaty arbitration that each party bears its own costs and that the parties divide tribunal costs equally.” 76 It stated, however, that that practice is not binding on it and that, under Articles 43 and 44 of the SCC Rules, the Tribunal has discretion to “apportion the Costs of the Arbitration between the parties, having regard to the outcome of the case and other relevant circumstances.” 77 Consequently, the Tribunal held Kazakhstan liable for 50% of the “Claimants’ costs of legal representation,” and three-quarters of the arbitration costs 78 because the “Claimants prevail[ed] on jurisdiction, liability, causation, and part of quantum,” which were

73 Id. at 403, ¶ 1842.
74 Id. at 404-05, ¶ 1849.
76 Stati, SCC at 414, ¶ 1882.
77 Stati, SCC at 412, ¶ 1880.
78 The SCC Board calculated the total arbitration costs for the Tribunal to be ERU 1,069,470.98. Id. at 413, ¶ 1885.
“the greatest part of the work of the Parties and of the Tribunal in this procedure.”

The SCC’s arbitration costs equaled EUR 1,069,470.98, making Kazakhstan responsible for EUR 802,103.24 of it. The Claimants’ total arbitration costs (including its portion of the SCC arbitration costs) amounted to USD 17,950,992.87, of which Kazakhstan was ordered to pay approximately half or USD 8,975,496.40. This amount included the USD 712,724.47 portion of EUR 802,103.24 SCC costs which Kazakhstan was ordered to pay.

D. Conclusion

The Tribunal ruled that Kazakhstan’s actions amounted to a breach of the FET clause of the ECT and thus the Claimants were entitled to USD 497,685,101 in damages as follows:

The value of Claimants’ investments was determined to be USD 508,130,000.00:

- Borankol and Tolkyn Fields: USD 277,800,000.00
- Contract 302 Properties: USD 31,330,000.00
- LPG Plant: USD 199,000,000.00

The Tribunal then subtracted USD 10,444,899.00 in debts from the investment value for which the Claimants’ were no longer liable:

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79 Id. at 413, ¶ 1883-84.

80 The Claimants’ total arbitration cost was USD 17,950,992.87 of which USD 1,425,448.95 was allegedly paid to the SCC for tribunal costs. The State’s total arbitration cost was USD 17,625,116.33. Id. at 4013, ¶ 1885, 411, ¶ 1872.

81 In the Claimants’ total cost of arbitration calculation, the Claimants made $1,425,448.95 advanced payments to the SCC. Consequently, when the Tribunal held the Respondent liable for 50% of the Claimants’ total costs, this also included the 50% prepayment to the SCC. Consequently, $712,724.47 (half of the Claimants’ $1,425,448.95 prepayment value that the Respondent is liable for) is payment that will go towards the SCC arbitration costs – i.e. the Respondent’s EUR 802,103.24 portion.
• Reachcom Facility Agreement: USD 335,624.00
• Limozen Facility Agreement: USD 10,049,442.00
• Reachcom Receivables Purchase Agreement: USD 59,853.00

The Tribunal then awarded USD 8,975,496.40 to the Claimants’ for their arbitration costs, plus a portion of the costs of the Tribunal. The Tribunal also awarded interest to accrue on damages at rate of a 6-month US Treasury Bill from 30 April 2009, compounded semi-annually, until the award is paid.
I. INTRODUCTION

In Micula v. Romania, an ICSID tribunal found that the Government of Romania had breached the Agreement Between the Government of the Kingdom of Sweden and the Government of Romania on the Promotion and Reciprocal Protection of Investments (“BIT”) by prematurely revoking certain economic incentives that the Claimants had relied upon in making substantial investments in disfavored regions of Romania. As a result, the Tribunal awarded the Claimants approximately USD 250 million in damages and interest.

II. BACKGROUND

In December of 1989, Romania found itself in economic and social crisis following the overthrow of the Ceaușescu regime. It thus sought to attract both foreign and domestic investment through a variety of economic incentives programs. One such program, Emergency Government Ordinance 24/1998 (“EGO 24”), was promulgated to aid the development of certain disfavored regions in Romania. In these regions, investors were required to meet certain criteria, which would then allow them to enjoy certain

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1 The Claimants consisted of Mr. Ioan Micula and Mr. Viorel Micula (collectively known as the “Individual Claimants”) and European Food S.A, Starmill S.R.L, and Multipack S.R.L. (collectively known as the “Corporate Claimants”), which are part of the European Food and Drinks Group (“EFDG”).
tax incentives and customs duties exemptions. In return, the investors were required to create new jobs and to stay in the disadvantaged region for twice the period they received incentives. On 25 March 1999, Romania designated Ştei-Nucet-Drăgăneşti as a disfavored region for a period of ten years, starting 1 April 1999.

Prior to EGO 24, the Claimants relied on other incentive regimes for their initial investments, specifically their beverage production business, in the disfavored region of Ştei-Nucet-Drăgăneşti. After the introduction of the EGO 24, however, the Claimants alleged that they expanded their operations in reliance on EGO 24's incentives by building a large, highly integrated food production platform, and that they obtained Permanent Investor Certificates (“PICs”) from the Romanian North-West Regional Development Agency that provided for the right to receive the incentives until 1 April 2009.

At the same time Romania was trying to attract investors to disfavored regions, it was also trying to gain accession to the European Union (“EU”). During the application process, the EU raised the issue that the incentives granted under EGO 24 were inconsistent with the EU’s body of laws. In order to align its state aid laws with the laws, regulations and ordinances of the EU, on 22 February 2005, Romania revoked the EGO 24 incentives, with the exception of the Profit Tax Inventive.

The Claimants argued that, under EGO 24 and the PICs, it was entitled to receive the incentives for a ten year period and that Romania’s revocation of EGO 24 had wrongfully terminated its benefits approximately 4 years before they were set to expire. It thus filed for arbitration with ICSID, alleging that Romania breached the umbrella clause and the fair and equitable treatment provisions under the Sweden-Romania BIT. They sought damages amounting to approximately RON 2.6 billion (approximately €597 million) and interest. In addition, they sought an order enjoining Romania from collecting any taxes from Claimants until any damages award has been paid.2

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2 Originally, Claimants also sought restitution, but abandoned this request during the proceedings.
Romania responded \textit{inter alia} that (1) EGO 24 and the PICs did not constitute a binding commitment to Claimants that the incentives would continue for a period of ten years, (2) the Claimants did not rely on the EGO 24 incentives in making their investments, and (3) its revocation of EGO 24 was justified in order to comply with EU requirements. Romania also disputed Claimants’ claims regarding damages and argued that the Claimants actually benefitted from Romania’s accession to the EU.\footnote{Romania also challenged the Tribunal’s jurisdiction. In a separate decision, the Tribunal determined that it had jurisdiction over the dispute, finding that the Tribunal’s jurisdiction was determined by Article 25 of the ICSID Convention and Article 7 of the BIT, that the Individual Claimants were Swedish nationals at all times relevant to the Tribunal’s jurisdiction, that the investments made by the Corporate Claimants qualified as such for the purposes of the ICSID Convention, that the dispute arose after the entry into force of the BIT and therefore fell within the scope of the application of the BIT \textit{ratione temporis}, and that the Tribunal has powers to order restitution both under the ICSID Convention and the BIT.}

\section*{III. TRIBUNAL’S DECISION}

\subsection*{A. Liability}

The Tribunal first addressed the Claimants allegation that Romania entered into a specific obligation with Claimants through the EGO 24 and the PIC. According to the Claimants, Romania violated the BIT’s umbrella clause, which provided: “[e]ach Contracting Party shall observe any obligation it has entered into with an investor of the other Contracting Party with regard to his or her investment.”\footnote{\textit{Id.} at 343.} The Tribunal dismissed this claim, ruling that the Claimants had failed to prove with sufficient evidence and legal arguments that an obligation existed.

The Tribunal then turned to the claim that Romania’s actions amounted to a breach of the fair and equitable treatment clause, which stated that “[e]ach Contracting Party shall at all times ensure fair and equitable treatment of the investments by investors of other Contracting Party and shall not impair the management, maintenance, use, enjoyment or disposal thereof, as well as the acquisition of goods and services or the sale of their
production, through unreasonable or discriminatory measures.” According to the Tribunal, Romania did not act unreasonably or in bad faith with its decision to revoke the incentives because it was a rational plan to pursue EU accession. The Tribunal, however, found that “[t]he exception to this conclusion was Romania’s decision to maintain the investors’ obligation [to stay in the disadvantaged region for twice the period they received incentives] despite the repeal of the incentives.” Additionally, the Tribunal concluded “that Romania violated the Claimants’ legitimate expectations that those incentives would be available, in substantially the same form, until 1 April 2009. Romania also failed to act transparently by failing to inform the Claimants in a timely manner that the regime would be terminated prior to its stated date of expiration.” Thus, the Tribunal found that Romania breached the fair and equitable treatment standard in the meaning of Sweden-Romania BIT.

B. Damages

The Tribunal first addressed the legal standards applicable to an award of damages. Quoting the Factory at Chorzów case, the Tribunal stated that “reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if the act had not been committed.’ This principle has been generally understood to mean that the claimant must be placed back in the position it would have been ‘in all probability’ but for the international wrong.”

The Tribunal also noted the general principle that the Claimant bears the burden of proving loss and that damages must be established by “a causal link between the internationally wrongful act and the injury for which compensation is due.”

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5 Id. at 460.
6 Id. at 826.
7 Id. at 872.
8 Id. at 917 (discussing Case Concerning Factory at Chorzów (Germany v. Poland), Judgment 13, Permanent Court of International Justice, 13 Sept. 1928 (1928 PCIJ, Series A. No. 17). The Tribunal also cited ILC Art. 31.
9 Id. at 923.
Turning to Claimants’ claims for damages for Romania’s breach of the fair and equitable treatment clause in the BIT, it noted that the Claimants had presented three alternative methods to calculate the damages. Under the first approach, Method A, the damages represented “the expected return from continuation of the ten year plan that Claimants undertook in reliance on the Incentives, a plan intended to both capitalize on the Incentives themselves during their duration, and to complete a platform that would have performed profitably after the Incentives statutorily expired,” amounting to an award of RON 2,655.35 million. Under the second approach, Method B, the damages represented “the expected returns from the platform that the Claimants actually constructed, had the Claimants been able to maintain their respective market shares in their existing and proven product lines,” amounting to an award of RON 2,698.25 million. The third approach, Method C, provided an alternative to the expectation loses in Methods A and B. Under this approach, the reliance damages represented “the consequences of [Romania’s] unlawful act by calculating the value of the investment actually made by the Claimants in reliance on the promised, ten-year duration of the Incentives, which [had] been lost,” amounting to an award of RON 874.65 million.

The Tribunal decided to focus on the damages represented in Method A because the Claimants presented Method A as their primary expectation damages, and the methodology used in the report for Method B was less complete and less robust than the methodology used in Method A. Additionally, the Tribunal rejected Method C because “[t]he Tribunal [did] not see any reason to deviate from the Claimants’ primary expectation damages approach which, in the Claimants’ own submission, should place them in the position they would have but for Romania’s breach of the BIT . . . .” As such, the Tribunal divided the Claimants’ claims under Method A into three main groups: (1) claims for the increased cost of raw materials; (2) claims for lost profits; and (3) claims for tax penalties. Additionally, although the damage calculation provided by the Claimants referred to

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10 Id. at 892-93.
11 Id. at 894-95.
12 Id. at 948.
damages suffered by the entire EFDG, including non-claimant companies, the Tribunal stated that “[t]he Individual Claimants [could] claim for damages they have suffered by virtue of the harm to [non-claimant companies] as well as the harm to the Corporate Claimants” because the companies in the EFDG were at least 99.96% owned by the Individual Claimants.13

1. Claim for Increased Cost Raw Materials

The Tribunal first addressed the Claimants’ claim of RON 81.5 million for the increased cost of sugar. It accepted the claim and quantification, as “[b]oth the existence of the damage and the casual link between the revocation of the incentives and the damage suffered [had] been adequately proven.”14 Moreover, the quantification of the damages was “based on reliable documentary evidence,” including sugar invoices.15 The Tribunal stated that there was no dispute that the Claimants paid a higher price for sugar due to the revocation of the Raw Materials Incentive.

Romania, however, argued that “the damages should exclude sugar produced by non-Claimant EFDG companies after revocation of the incentives.”16 Romania based this assertion on the fact that European Food was importing a majority of the sugar before the revocation, but each EFDG company began importing its own sugar after the revocation. Romania argued that the Corporate Claimants should not “be compensated for an outlay from someone else’s pocket.”17 The Tribunal rejected Romania’s defense, noting that the fact “this more expensive sugar was bought by a different company of the group does not eliminate the loss to the Individual Claimants, who the Tribunal [had] confirmed [were] the ultimate shareholders of the entire


14 *Id.* at 953.

15 *Id.* at 953-54.

16 *Id.* at 955.

17 *Id.*
Additionally, the Tribunal allowed the Claimants to include the arm’s-length transaction losses European Food experienced after the revocation: European Food no longer sold intermediate sugar products to European Drinks and Rieni Drinks. This amount was included in the damages because “European Food lost that ‘business’ as a result of the revocation.” In addition, although Romania argued that the Claimants could not establish that they would have been entitled to the benefits from the Raw Materials Incentive after the EU accession on 1 January 2007, the Tribunal rejected this argument because Romania did not establish that the Claimants could not have done so, especially because Romania did not even try to negotiate “a specific derogation allowing the Claimants to import duty free sugar into the EU.”

Next, the Tribunal assessed the Claimants’ claim of RON 6.3 million for the increased cost of PET. Rejecting this claim, the Tribunal stated that “the Claimants never benefitted from the Raw Materials Facility in respect of PET imports because their PET equipment was not located in the Stei-Nucet region.” Although the Claimants stated that they intended to relocate their PET equipment in late 2004 or early 2005 to the disfavored region in order to take advantage of the incentives, the Tribunal found that such a claim for future losses did “not meet the burden to prove the existence of a lost opportunity; therefore, they [could not] claim a loss for increased cost of PET if the repeal of the Raw Materials Facility did not in fact cause them to incur greater costs in purchasing PET.” Additionally, the Tribunal did not find that the Claimants proved they would, in fact, relocate their PET equipment to the disfavored region because the Claimants’ only evidence was one witness statement that the Tribunal found unconvincing. Moreover, the Tribunal found that “the modest scale of the cost and effort allegedly required to move the equipment [undermined] the credibility of the claim.”

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18 Id. at 956.
19 Id. at 958.
20 Id. at 959-60.
21 Id. at 963-64.
22 Id. at 965.
23 Id. at 967.
result, the Tribunal rejected the Claimants’ claim for the increased cost of PET.

The Tribunal also assessed the Claimants’ claim of RON 17.5 million for the increased cost of raw materials other than sugar and PET. The Tribunal accepted this claim, stating that “[a]s in the case of sugar, it is undisputed that following the revocation of the incentives, the Claimants were required to pay more for the other raw materials they purchased, including tomato paste, juice concentrates, wheat and corn flower, vegetable fats, and potato flakes and granules.”24 Although Romania argued that the total loss should be discounted to RON 14.5 million because only 20% of the amount claimed was supported by documentary evidence and because most of the increased costs were paid by non-Claimant companies within the EFDG, the Tribunal dismissed both arguments. The Tribunal acknowledged that the documentary evidence provided by the Claimants was only a sample, but Romania failed to state a compelling reason why the sample was not a valid representation of the total claimed loss. Additionally, the Tribunal again affirmed that the Claimants could claim damages for non-claimant EFDG companies because the Individual Claimants own at least 99.96% of companies in the EFDG. As a result, the Tribunal accepted the claim for a total of RON 17.5 million.25

Additionally, the Claimants claimed a loss of RON 62.5 million for the lost opportunity to stockpile sugar. According to the Claimants, they intended to buy large quantities of sugar before the incentives would end in order to save money in the months following the expiration of the incentives.26 They explained that, “in late 2004/early 2005, after they heard that the incentives would be revoked, they stockpiled what they could, but not as much as they would have liked to do.”27 The Claimants were able to stockpile around 30,000 tonnes prior to the revocation. They claim that they would have been able to amass around 75,000 tonnes, but were unable to do so because they did not have enough time

24 Id. at 971.
25 Id. at 974.
26 Id. at 976.
27 Id.
and did not have the proper funding due to the revocation of the incentives. “Despite the absence of hard evidence on the Claimants’ future intentions, the Tribunal [considered] that the Claimants’ established past practice of stockpiling [provided] sufficient certainty that, but for the revocation, the Claimants would have stockpiled sugar in early 2008 in anticipation of the expiry of the incentives.”\textsuperscript{28} Additionally, the Tribunal found a causal link between the damages asserted and the revocation of the incentives. But, the Tribunal found that the volume alleged to be stockpiled was too speculative and stated that, “[i]nstead, it [was] more reasonable to use as counterfactual data the 30,000 tonnes\textsuperscript{29} that were actually stockpiled in 2004/2005.”\textsuperscript{30} As a result, the Tribunal recalculated the damages for the lost opportunity to stockpile to RON 18,133,229.  

2. Claim for Lost Profits  

Next, the Tribunal focused on the second category of the Claimant’s claims: those for lost profits.\textsuperscript{31} Article 36(2) of the ILC Articles states that “compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”\textsuperscript{32} The Tribunal accepted Romania’s argument that lost profits must be established with sufficient certainty. The Claimants argued that the Tribunal must be more lenient with regard to the degree of certainty. The Tribunal stated “[o]nce causation has been established, and it has been proven that the in bonis party has indeed suffered a loss, less certainty is required in proof of the actual amount of damages; for this later determination Claimant only needs to provide a basis upon which the Tribunal can, with reasonable confidence, estimate the extent of the loss.”\textsuperscript{33}  

In the case of lost profits, the Tribunal stated that the “the Claimants must first prove that they would have actually suffered  

\textsuperscript{28} Id. at 983.  
\textsuperscript{29} Id. at 986.  
\textsuperscript{30} Id.  
\textsuperscript{31} Id. at 989.  
\textsuperscript{32} Id. at 990.  
\textsuperscript{33} Id. at 1008 (relying on Joseph C. Lemire v. Ukraine (ICSID Case No. ARB/06/18), Award, 28 March 2011).
lost profits . . .”34 The Tribunal stated this “requires proving (i) that the Claimants were engaged in a profit-making activity . . . and (ii) that that activity would have indeed been profitable . . .”35

The Tribunal first assessed the Claimants’ claim for no less than RON 427 million for the lost profits on sales of finished goods. According to the Claimants, the revocation of the incentives caused the Claimants to raise their prices, which resulted in a loss of market share and loss of profits. The Tribunal agreed with the Claimants’ analysis, finding “that the increased cost of raw materials caused by the revocation of the incentives would have an impact on the prices of the Claimants’ products, thereby probably leading to a decrease in market share and lost sales, consequently lost profits.”36 By considering the Claimants’ proven record of profitability regarding the sale of their own brand and the fact that the increased prices started at the same time Prime Minister Nastase announced the revocation, the Tribunal found that “the Claimants have proved with sufficient certainty that, as a result of the revocation of the incentives, they were deprived of profits that they would otherwise have earned.”37 The Tribunal, however, used its discretion to establish the exact amount of damages by excluding the products that did not contain sugar, resulting in an award of RON 255.7 million.

Additionally, the Claimants claimed lost profits on sales of sugar containing products (“SCPs”) in the amount of RON 492.3 million. “[T]he Claimants assert that, from 2005, they planned on manufacturing SCPs and selling those SCPs to industrial third parties.”38 The Claimants, however, never sold SCPs to industrial third parties. Still, the Tribunal acknowledged that the absence of a proven record of profitability is not fatal to a lost profits claim. The Claimants, however, failed to prove they would, in fact, have sold SCPs to industrial third parties but for the revocation, resulting in the Tribunal dismissing this claim.

34 Id. at 1009.
35 Id.
36 Id. at 1016.
37 Id. at 1020.
38 Id. at 1035.
Next, the Claimants claimed that their primary expectation damages were “premised on the existence of an alleged ten-year plan to capitalize on the incentives and to complete an expanded manufacturing platform that would have performed profitably after the incentives expired,” including a malt manufacturing plant, a can manufacturing plant, and a co-generation plant.\(^{39}\) Although the Claimants acknowledged that none of these facilities existed in complete, revenue-generating form at the time of the revocation, the Claimants argued that they intended to complete these facilities. The Tribunal rejected this claim for lost profits incurred as a result of the Claimants’ inability to complete the Incremental Investments. The Tribunal reasoned that the Claimants failed to prove with sufficient certainty that they would have implemented the Incremental Investments because they relied on witness testimony instead of evidence of a business plan. Thus, the Tribunal rejected all of the lost profits claims relating to the Incremental Investments.

3. Claims for Financial Penalties for Failure to Pay Taxes

Following the revocation of the incentives, the Claimants failed to pay certain tax debts to Romania, resulting in substantial financial penalties. According to the Claimants, these financial penalties “were ‘a direct result of the financial constraints caused by Revocation.’”\(^{40}\) The Claimants claimed damages for two sets of financial penalties. The first damage claim was for the financial penalties incurred but not yet paid as a result of the revocation, in the amount of RON 63.65 million unless “Romania [waived] the tax penalties and [declared] that it [should] waive or reimburse all additional financial penalties imposed or assessed until the date of Romania’s full and final satisfaction of the award.”\(^{41}\) The second damage claim was for “[f]inancial penalties incurred and paid by the EFDG companies in the period 1 April 2005 to 30 September 2010,” in the amount of RON 40 million.\(^{42}\)

\(^{39}\) *Id.* at 1058.

\(^{40}\) *Id.* at 1120.

\(^{41}\) *Id.*

\(^{42}\) *Id.*
The Tribunal stated that a causal link must exist between Romania’s breach of the BIT and the losses alleged, requiring that the Claimants must prove that they could not pay their taxes after the revocation, that the dominant cause for their insufficient funds was the revocation of the incentives, and that they would have paid their taxes if the revocation did not occur. The Tribunal found that the Claimants did have sufficient funds to pay their taxes and that their decision not to pay was a strategic choice instead of an inability to pay. As a result, the Tribunal dismissed this claim.

4. Romania’s Defense that EU Accession Benefitted Claimants

After assessing all of the Claimants’ damage claims, the Tribunal then assessed Romania’s defense that accession to the EU benefited the Claimants. Specifically, Romania argued “that the EU accession process brought ‘price stability, increased trade, FDI, reduced risk premia, strong institutions and a marked acceleration in economic growth.’” Noting that EU accession brought both costs and benefits, the Tribunal rejected Romania’s defense because it had “failed to prove the extent, if any, of the benefits of EU accession to the Claimants.”

5. Claimants’ Claim that Any Damages Awarded Be Net of Taxes

The Claimants also requested that “any damages and interest payable be grossed up for taxes, as follows: ‘Claimants’ Permanent Investor Certificates, valid until April 1, 1990, contained profit tax exemption provisions. Therefore, Romania would not have taxed the additional profit arising from lower costs on raw materials from the customs tax exemption. But-for cash flows after April 1, 2009, reflect the 16% profit tax.’” The Tribunal rejected this claim because the damages were reimbursements, not profits. Additionally, although Claimants requested that all damages be

43 Id. at 1156.
44 Id. at 1157.
45 Id. at 1172-74.
46 Id. at 1175.
awarded to the Individual Claimants, the Tribunal dismissed this request. For one, the Claimants did not request “the discontinuance of the proceedings with respect to their claims.” Moreover, “[t]he Corporate Claimants [had] sought the same relief as the Individual Claimants and [had] not withdrawn their claims.” Instead, the Tribunal decided to “award any damages, interest and costs to all five Claimants collectively, without allocating the damages among them.”

6. Interest

The Claimants requested “pre- and post-award interest at 3-month ROBOR plus 5% compounded on a quarterly basis,” emphasizing that compound interest is the generally accepted standard in international investment arbitrations. The Tribunal agreed that compound interest is appropriate because it ensured “the Claimants would be placed in the position that would have been had the breach not occurred.” “Accordingly, the Tribunal award[ed] interest, at 3-month ROBOR, the ROBOR being computed at an average annual rate to be applied for each period of one year or part of year, plus 5%, compounded on a quarterly basis,” calculated from the midpoint approach for each damage claim awarded. This approach was used because “it would have been difficult and next to impossible for the Claimants to point out to the exact date on which [the] damage was suffered . . . .”

7. Setoff

Romania argued that any monetary award in favor of the Claimants should be subject to set-off against all of the EFDG companies’ tax debts. As a matter of principle, the Tribunal declined to declare that Romania had a right to set-off the amounts awarded because it was a matter of Romanian law.

47 Id. at 1232.
48 Id. at 1235.
49 Id. at 1246.
50 Id. at 1252-53.
51 Id. at 1265.
52 Id. at 1276.
53 Id. at 1274.
8. Request to Enjoin Further Tax Collections

The Claimants requested that the Tribunal enjoin Romania “from any further tax collection measures of any kind in respect to the Claimants and the [EFDG] until such a time as the damages awarded by the Tribunal [had] been paid in full, and include a pecuniary alternative in case of non-performance.”\textsuperscript{54} Alternatively, the Claimants requested that Tribunal permit “the Claimants to add a specific request for injunctive relief to their Request for Relief pursuant to Rule 40 of the ICSID Rules.”\textsuperscript{55} Although the Tribunal acknowledged that it has the power to grant injunctive relief in a final award, the Tribunal stated that such a relief must be definitive and not provisional, such as the relief requested by the Claimants. The Tribunal found the Claimants’ alternative request for definitive injunctive relief untimely and dismissed both claims.

C. Attorney’s Fees and Costs

The Claimants and Romania requested an award of costs for legal fees and the expense and cost of arbitration. “The Claimants’ legal fees and expenses amounted to . . . RON 86,478,476. They [had] advanced USD 1,510,000 on account of the fees and expenses of the Members of the Tribunal and the ICSID administrative fees and expenses, including the lodging fee of USD 25,000.”\textsuperscript{56} The Claimants requested “an award of the entirety of these costs and compound interest at a rate of 3-month ROBOR plus 5% until the date of payment.”\textsuperscript{57} Romania’s “legal fees and expenses amount[ed] to EUR 11,499,347.97,” and it “advanced USD 1,485,000 to ICSID.”\textsuperscript{58}

The Tribunal noted that there were numerous procedural issues and difficult legal questions for both parties, and the Claimants were only successful in some of their damage claims.\textsuperscript{59} As a result, the Tribunal “concluded that it [was] fair overall” to

\textsuperscript{54} Id. at 1295.
\textsuperscript{55} Id. at 1300.
\textsuperscript{56} Id. at 1324.
\textsuperscript{57} Id.
\textsuperscript{58} Id. at 1325.
\textsuperscript{59} Id. at 1327.
make both sides "bear the costs of the arbitration . . . in equal shares," and to make each side responsible for its "own legal and other costs incurred in connection with [the] case."60

IV. CONCLUSION

As a result of Romania’s breach of the fair and equitable treatment clause of the Sweden-Romania BIT, the Tribunal awarded Claimants RON 376,433,229. Specifically, it awarded RON 85,100,000 for the increased cost of sugar, RON 17,500,000 for the increased cost of raw materials other than sugar or PET, RON 18,133,229 for the lost opportunity to stockpile sugar, and RON 255,700,000 for the lost profits on sales of finished goods. The Tribunal also ordered Romania to pay interest on these amounts at 3-month ROBOR plus 5% compounded on a quarterly basis, calculated by midpoint-approach date.61 With respect to the costs and fees to resolve the dispute, the Tribunal ruled that the parties would bear the costs of the arbitration in equal shares, and that each party would bear their own legal and other costs incurred as a result of the arbitration.

60 Id. at 1328.

61 Id.