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**ARBITRATION UNDER
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Chapter 21

Damages in Investment Treaty Arbitration

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INTRODUCTION

The quantum of damages to be awarded in investment treaty arbitration is often the main preoccupation of the investor and of officials in the respondent State. As a result, it is ironic that investment treaties and investment awards give comparatively little guidance concerning the basis upon which damages ought to be awarded. Investment treaties typically confer a broad discretion on tribunals to “make a decision” or to “award damages” for nonexpropriatory breach. In addition, virtually all investment treaties address the compensation standard for expropriation in somewhat greater detail, usually requiring prompt, adequate, and effective compensation (or some proxy therefore).

The failure to address the standard for compensation comprehensively in investment treaties and awards has left the development of this area largely to academic literature and, to a lesser extent, to the few cases that discuss the topic. In the absence of a detailed treaty standard for compensation, tribunals resort to customary international law on damages. The basic principle at customary international law is that the State must make full reparation for internationally wrongful acts. While there is a fair degree of consensus on such general principles, they do not offer detailed direction on

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EXPROPRIATION AND NONEXPROPRIATORY DAMAGES

The law respecting damages in investment arbitration developed primarily in the context of expropriation. These legal principles have been borrowed by tribunals called upon to address nonexpropriatory breach. However, cases addressing expropriatory and nonexpropriatory breach have distinctive features that sometimes have led to differences in analysis. As a result, these topics are considered separately.

Expropriation Damages

International law distinguishes between lawful and unlawful expropriation. The conditions required for a lawful expropriation are proof of a taking for a public purpose, on a nondiscriminatory basis, with due process and accompanied by compensation for the deprivation. These conditions for lawful expropriation are usually codified in modern investment treaties. Treaties codifying the requirements for lawful expropriation generally require compensation to be calculated at the fair market value of the investment.²¹ Compensation calculated pursuant to the fair market value standard is based on the price a willing buyer would pay a willing seller to purchase the asset in the absence of coercion, where the parties are at arm's length, operate in an open market, and have reasonable knowledge of relevant facts.²² The fair market value standard is often referred to as the objective standard of compensation because it assesses loss from the perspective of a transaction between a hypothetical buyer and seller, and not from the subjective perspective of the disputing investor that actually suffered the loss.

An unlawful expropriation is a complete or substantial deprivation of the investment that does not meet the conditions for lawful expropriation. The challenge is to identify the correct standard for calculating damages for unlawful expropriation. The vast majority of cases have calculated damages for expropriation (lawful or unlawful) in accordance with fair market value and have ignored the distinction between the two types of expropriation for purposes of assessing compensation. As Brower and Ottolenghi observe, "... before the *Siemens* and *ADC* awards, no BIT or multilateral investment treaty had actually applied the *Chorzów* standard in calculating damages due."²³ Despite this practice, there is a debate in investment arbitration about whether the fair market value standard or the *Chorzów* (full restitution) standard should apply to compensation for unlawful expropriation. This debate has revived in recent years.

21 UNCTAD, TAKING OF PROPERTY, UNCTAD/ITE/IIT/15 (2000) at 12–17.

22 See, for example, *CMS v. Argentina*, *supra* note 7, at paras. 402–05; *SEDCO Int'l v. National Iranian Oil Co.*, 15 Iran-U.S. C.T.R. 35 (1987); *INA Corp. v. Iran*, 8 Iran-U.S. C.T.R. 373 (1985).

23 Brower & Ottolenghi, *supra* note 6, at 8–9. In *Siag v. Egypt*, *supra* note 19, at paras. 539–42, the tribunal noted that the expropriation was not lawful and that the treaty standard for lawful expropriation was inapplicable. However, the distinction made no practical difference as the claimants were not seeking lost profit. The tribunal assessed loss based on the value of the property immediately before it was expropriated.

On the one hand, some commentators suggest that treaty codification of expropriation disciplines governs compensation for both lawful and unlawful expropriation. Proponents of this view argue that fair market value is incorporated by treaty as the uniform standard for compensation for any type of expropriation. Others disagree, arguing that investment treaties incorporate fair market value damages only for lawful expropriation, leaving the customary international law rule of full restitution intact for assessment of damages for unlawful expropriation. These commentators argue that compensation for lawful and unlawful expropriation cannot be based on the same standard and that unlawful expropriation must be remedied by full restitution in accordance with the *Chorzów* approach.

There are several practical consequences to accepting a different standard of compensation for lawful and unlawful expropriation.²⁴ First, if the distinction between compensation for lawful and unlawful expropriation is observed, the primary obligation of restitution of the expropriated investment would apply only to unlawful expropriation. Restitution would not be expected in situations of lawful expropriation.

Second, in some cases, applying the fair market value standard to assess compensation for lawful expropriation will result in a lower value award than would full restitution. This is because fair market value is an objective standard that may not include consequential damages and other loss particular to the disputing investor.²⁵ By contrast, recovery pursuant to the standard of *Chorzów* seeks to restore the particular investor to the position it would have occupied but for the breach. Such recovery could be greater than fair market value if the evidence establishes that the investor actually suffered loss over and above the fair market value of the asset.

Third, most treaties addressing compensation for expropriation also require fair market value to be assessed immediately before the fact of expropriation became publicly known. If these provisions govern only lawful expropriation, then events occurring after expropriation could be factored into compensation for unlawful, but not lawful, expropriation. In most cases, events occurring after expropriation are unlikely to result in an increase in compensation. However, there may be circumstances where the expropriating State takes a profitable investment and continues to operate it at an enhanced profit. The capacity to account for post-expropriation events in such circumstances might well affect the net recovery.

24 Helpful articles on the debate concerning the correct standard of compensation for lawful and unlawful expropriation are found in: Wälde & Sabahi, *supra* note 7, at 5–10; Brower & Ottolenghi, *supra* note 6; Martin Valasek, *A "Simple Scheme": Exploring the Meaning of Chorzów Factory for the Valuation of Opportunistic Expropriation in the BIT Generation*, 4(6) TRANSNAT'L DISPUTE MGMT. (November 2007); Audley Sheppard, *The Distinction Between Lawful and Unlawful Expropriation*, in INVESTMENT ARBITRATION AND THE ENERGY CHARTER TREATY 169 (Clarisse Ribeiro ed., 2006); Marboe, *supra* note 6, at 726–34; Michael W. Reisman & Robert D. Sloane, *Indirect Expropriation and Its Valuation in the BIT Generation*, 74 B.Y.I.L. 115 (2003); D.W. Bowett, *State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach*, 59 B.Y.I.L. 49 (1988).

25 *Compañía de Aguas del Aconquija S.A. & Vivendi Universal S.A. v. Argentine Republic* (ICSID Case No. Arb/97/3), Award of August 20, 2007 at paras. 8.2.2.–8.2.11.

The debate concerning the effect of the legality of expropriation on compensation was considered in the recent *ADC v. Hungary* case. *ADC* involved two Cypriot investors that were awarded contracts for airport construction by the Hungarian government. The contracts also included the right to manage and participate in the operation of the new airport terminals after they were constructed. However, the government of Hungary transferred operation of the terminals to a State-owned company and evicted the investors' employees soon after construction was completed. Hungary continued to operate the terminals at significant profit. The tribunal found that Hungary had not met any of the conditions for a lawful expropriation and that this was a case of unlawful expropriation.²⁶ In addressing compensation, the tribunal held that the Hungary-Cyprus BIT stipulated the standard of compensation for lawful expropriation only and did not address the standard for unlawful expropriation. As a result, the default standard of customary international law (the *Chorzów* full reparation standard) applied to the unlawful expropriation found by the tribunal.²⁷ In turn, the requirement to effect full reparation justified accounting for the increase in value of the investment up to the date of the award. The tribunal found it was not required to assess compensation at the time of taking because the standard for compensation was not dictated by the standard for lawful expropriation in the treaty.²⁸

Similarly, the tribunal in *Siemens v. Argentina* noted that the primary difference between the *Chorzów* standard and the treaty standard of compensation for expropriation was that compensation under the *Chorzów* standard had to wipe out all consequences of the illegal act, whereas compensation under the treaty standard was equivalent to the value of the expropriated investment. Further, at customary international law, the investor was not limited to the value of the investment on the date of expropriation, but was also entitled to increases in value gained up to the date of the award, as well as consequential damages.²⁹

It is difficult to resolve the debate concerning the proper approach to the standard of compensation for lawful as opposed to unlawful expropriation through a reading of past investment awards. Many awards do not turn expressly on the distinction between lawful and unlawful expropriation, and most awards do not draw a bright-line distinction between fair market value and full restitution. Terminology is inconsistent from one case to the next; hence, it is hard to discern whether a tribunal perceives fair market value and restitution to be equivalent measures of loss. Further, whether a treaty extends fair market valuation to unlawful expropriation likely depends on the drafting of the particular expropriation obligation and therefore might vary from one treaty to the next. The tribunal in *Biwater v. Tanzania* specifically noted the importance of the wording of the BIT in deciding whether compensation for expropriation is

26 *ADC Affiliate Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16), Award of the Tribunal dated October 2, 2006 at paras. 429–44.

27 *Id.*, at paras. 479–94.

28 *Id.*, at paras. 495–500.

29 *Siemens A.G. v. Argentine Republic* (ICSID Case No. ARB/02/8), Award of February 6, 2007, at paras. 352–53.

governed by the treaty or by customary international law.³⁰ As a result, the debate about the correct standard of compensation for unlawful expropriation that has been revived by the *ADC* and *Siemens* cases is likely to continue in the next few years.

Nonexpropriatory Damages

The distinction between lawful and unlawful conduct does not occur in the nonexpropriatory context, where every breach of an obligation is unlawful. Care must therefore be taken before applying expropriation standards for compensation to nonexpropriatory situations. As noted in *S.D. Myers v. Canada*,

[T]he standard of compensation that an arbitral tribunal should apply may in some cases be influenced by the distinction between compensating for a lawful, as opposed to an unlawful, act. Fixing the fair market value of an asset that is diminished in value may not fairly address the harm done to the investor.³¹

At the same time, the basis for awarding damages for nonexpropriatory breach (typically breach of fair and equitable treatment, the minimum standard of treatment, national treatment or most-favoured nation treatment) is not specifically addressed in investment treaties. The *S.D. Myers* tribunal assumed that the failure to include an express treaty standard for compensation for nonexpropriatory breach indicated that:

... the drafters of the NAFTA intended to leave it open to tribunals to determine a measure of compensation appropriate to the specific circumstances of the case, taking into account the principles of both international law and the provisions of the NAFTA.³²

As a result, in principle the *Chorzów* standard of full reparation applies to such breaches.³³ Further, what is required to effect full reparation in any particular case will be solely within the discretion of the tribunal.³⁴

Damages for nonexpropriatory breach have been addressed in several recent cases. While it is early to draw conclusions, several trends seem to be emerging from these awards.³⁵ First, when tribunals find breach of both expropriation and nonexpropriatory

30 *Biwater v. Tanzania*, *supra* note 1, at paras. 479–83.

31 *Myers v. Canada*, *supra* note 8, at para. 308. *See also* Saipem S.p.A. v. People's Republic of Bangladesh (ICSID Case No. ARB/05/7), Award of June 30, 2009 at para. 201.

32 *Id.*, at para. 309.

33 *Duke v. Ecuador*, *supra* note 1, at para. 469; *LG & E v. Argentina*, *supra* note 6, at paras. 29–32; *MTD Equity Sdn Bhd v. Republic of Chile* (ICSID Case No. ARB/01/7), Award of May 25, 2004 at para. 238, upheld by Annulment Committee, Decision on Annulment of March 21, 2007.

34 *LG & E v. Argentina*, *supra* note 6, at para. 40; *Myers v. Canada*, *supra* note 8; *Azurix Corp. v. Argentine Republic* (ICSID Case No. ARB/01/12), Award of July 14, 2006 at paras. 421–22.

35 *See generally* Cohen Smutny, *supra* note 1, at 16–19; Wälde & Sabahi, *supra* note 7, at 26–35; Kaj Hobér, *Fair and Equitable Treatment—Determining Compensation*, 4(6) TRANSNAT'L DISPUTE MGMT. (November 2007); IOANA TUDOR, THE FAIR AND EQUITABLE TREATMENT STANDARD IN THE INTERNATIONAL LAW OF FOREIGN INVESTMENT 207–28 (2007); Ioana Tudor, *Balancing the*