Conceptuality or Textuality? Understanding the Notion of Expropriation in the Context of *Tza Yap Shum v. The Republic of Peru*

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Although China has been an active 'treaty-maker' in the realm of international investment arbitration as evidenced by its more than 120 bilateral investment treaties, the utility of these BITs has been very limited. Substantive standards such as expropriation and compensation have never been comprehensively tested with respect to these BITs. This article scrutinizes the concept of expropriation by reference to Chinese investment treaty jurisprudence, in particular, the final award of Tza Yap Shum v. The Republic of Peru and China's free trade agreement with Peru, the only Chinese BIT-related ICSID case. This article critically examines, in a comparative context, the treaty interpretation methodologies employed by the tribunal in interpreting expropriation under the China-Peru BIT, which is one of the earlier Chinese BITs. A thorough study of this subject is of great significance to interpreting the terms of indirect expropriation and compensation in Chinese BITs, thereby offering more concrete foreign investment protections based on investment treaties.

Keywords
Chinese BITs, Expropriation, Compensation, Treaty Interpretation, Bilateral Investment Treaties

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I. Introduction

The doctrine and case law on expropriation in international investment law is not fully settled even though a large amount of literature has been written on this topic in the past several decades. A variety of factors have led to uncertainty such as the diversity of interest between capital importing and exporting States, divergence in legal, economic and cultural concepts of property rights and, importantly, the regulatory role and function of the State in cross-border investment activities. 'Expropriation' is a critically important issue in Chinese Bilateral Investment Treaties ("BITs").[1] However, the utility of expropriation clauses in China's 129 BITs and 12 free trade agreements ("FTAs"), including the Peru-China Free Trade Agreement of 2009[2] (hereinafter Peru-China FTA), is unclear considering that extremely few BIT disputes brought before ICSID have involved Chinese BITs. In this sense, the Final Award issued by the tribunal in *Tza Yap Shum v. The Republic of Peru* (ICSID Case No. ARB/07/6)[3] is of great value to understanding how a large number of expropriation clauses in Chinese BITs may be interpreted, applied and eventually utilized for the purpose of foreign investment protection.

The primary purpose of this article is to understand expropriation clauses in China's BITs with special reference to the Award.[4] This article is composed of five parts including a short Introduction and Conclusion. Part two will review what constitutes an 'indirect expropriation.' Part three will examine the lawful conditions for expropriation. Part four will discuss how to calculate compensation in the event of expropriation, which was heavily disputed by Tza Yap Shum (hereinafter Tza) and Peru during the hearing. In conclusion, Part five will analyze the Tribunal's methods of interpreting the concept of expropriation in investment treaties.

1 All the BITs cited herein are available at http://ita.law.uvic.ca/investmenttreaties.htm; http://www.unctadxi.org/templates/DocSearch____779.aspx; or http://www.kluwerarbitration.com/BITs-countries.aspx (all last visited on Oct. 15, 2014).

2 Free Trade Agreement between the Government of the People's Republic of China and the Government of the Republic of Peru, *available at* http://fta.mofcom.gov.cn/bilu/annex/bilu_xdwb_en.pdf (last visited on Sept. 22, 2014) [hereinafter Peru-China FTA].

3 *See* Tza Yap Shum v. Republic of Peru, ICSID Case No. ARB/07/6 [Sr. Tza Yap Shum c. República del Perú] <available only in Spanish>, *available at* http://opil.ouplaw.com/view/10.1093/law:iic/382-2009.case.1/IIC382(2009)DF.pdf. For the full version of the Award, *see* the official website of ICSID, *available at* http://www.worldbank.org/icsid (all last visited on Oct. 15, 2014) [hereinafter The Award].

4 Agreement Between the Government of the People's Republic of China and the Government of the Republic of Peru Concerning the Encouragement and Reciprocal Protection of Investments, *available at* http://tfs.mofcom.gov.cn/aarticle/h/bk/201002/20100206785109.html (last visited on Sept. 22, 2014). [hereinafter Peru-China BIT].

II. What Constitutes an 'Indirect Expropriation'?

The key substantive issue in *Tza Yap Shum v. The Republic of Peru* is the expropriation clause in the Peru-China BIT. On September 29, 2006, Tza Yap Shum, a Chinese national resident of Hong Kong, brought a claim against the Republic of Peru before ICSID alleging a violation of Peru-China BIT. The claim involved an alleged tax debt in the amount of 12 million Peruvian Nuevos Soles (S/.) and a tax lien charged and imposed by the *Superintendencia Nacional de Administración Tributaria* ("SUNAT"), Peru's taxing authority, on bank accounts of TSG Peru S.A.C. ("TSG"), a Peruvian company in the business of manufacturing fish-based food products and distribution and export thereof to Asian markets, which was indirectly owned by Tza who held a 90 percent stake. Tza claimed that the freezing of TSG's bank accounts amounted to an expropriation without compensation, which is prohibited under the Peru-China BIT.[5]

TSG commenced its operations in 2002. In 2004, SUNAT commenced an audit of TSG. SUNAT asserted that TSG had underreported sales volumes. Accordingly, SUNAT imposed on TSG taxes and fines totaling approximately S./10 million.[6] In order to ensure the payment of tax debts under 'exceptional circumstances,' SUNAT imposed interim measures under which all Peruvian banks retained funds passing through them in connection with TSG's transactions. 'Exceptional circumstances' are defined under Peruvian law to refer to the scenarios where the debtor has been uncooperative (i.e., failing to disclose material information), or where the effort to obtain payment of the tax debt would otherwise be unsuccessful.[7] The auditor's report only mentioned TSG's failure to accurately report its total sales volume in its books, but did not offer any support for SUNAT's conclusion.[8]

The Award ruled that SUNAT's imposition of interim measures had constituted an indirect expropriation of Tza's investment. In line with the general BIT practice,[9] most Chinese BITs contain a generic expropriation clause covering 'nationalisation,' 'expropriation' and other 'similar measures' without providing any detailed definitions to these terms. Article 4 of the Peru-China BIT reads as follows:

5 The Award, *supra* note 3.

6 *Id.* ¶¶ 78-81, 103-107.

7 *Id.* ¶¶ 199, 202 & 216.

8 *Id.* ¶¶ 108-124.

9 A. Newcombe, *The Boundaries of Regulatory Expropriation in International Law*, 20 ICSID Rev. – Foreign Inv. L. J. 8-9 (2005).

> Neither Contracting Party shall expropriate, nationalize or take similar measure (hereinafter expropriation) against investments of investors of the other Contracting Party in its territory, unless the following conditions are met: (a) for the public interest; (b) under domestic legal procedure; (c) without discrimination; and (d) against compensation.[10]

In comparison with other Chinese BITs and the Peru-China FTA, the Peru-China BIT does not refer to 'indirect expropriation.' This silence adds uncertainty that an investor may face when it considers whether to bring a claim in investor-State arbitration. Nor does the Peru-China BIT, apart from the phrase of 'other similar measures,' contain a more functionalist definition of 'indirect expropriation,' which consequently may allow the tribunals to adopt a more expansive approach to cover 'indirect expropriation.'[11] Due to the lack of guidance in the Peru-China BIT in applying the treaty standard to specific circumstances, the application of international law seems to be an option. This is legitimate and reasonable when the investor brings a claim to the ICSID arbitration according to the investment disputes clause under the Peru-China BIT.

In this case, deciding whether SUNAT's interim measures constituted an unjustified indirect expropriation of Tza's investment under the Peru-China BIT is a challenging task, given the fact that the field of expropriation is in a state of doctrinal disarray both on semantic and conceptual grounds. The Peru-China BIT contains no rules on indirect expropriation through the reference to "other measures having similar effects."[12] The lack of a uniform definition of 'indirect expropriation' has become the greatest source of trouble not only for host governments but also investment arbitration tribunals.[13]

In determining the legal nature of SUNAT's measures, the Tribunal looked into

10 Peru-China BIT art. 4(1).

11 The Protocol to the Agreement among the Government of the Republic of Korea, the Government of the People's Republic of China and the Government of Japan for the Promotion, Facilitation and Protection of Investment [hereinafter TIT] also includes an identical definition of 'indirect expropriation,' which details some key perspectives of 'indirect expropriation.' The Protocol to the TIT, Article 2a(ii), *available at* http://tfs.mofcom.gov.cn/article/h/at/201405/20140500584828.shtml (last visited on Oct. 9, 2014).

12 China-Finland BIT (2006) art. 4(1), *available at* http://investmentpolicyhub.unctad.org/Download/TreatyFile/733. *See also* Agreement between the People's Republic of China and the Federal Republic of Germany on the Encouragement and Reciprocal Protection of Investments (2003) art. 4(2), *available at* http://investmentpolicyhub.unctad.org/Download/TreatyFile/736; China-Portugal BIT (2005) art. 4(1), *available at* http://tfs.mofcom.gov.cn/article/Nocategory/201002/20100206789767.shtml (all last visited on Oct. 9, 2014). China recognized the concept of indirect expropriation in its Model BIT adopted as early as in the 1980s. *See* N. Gallagher & Wenhua Shan, Chinese Investment Treaties, Policies and Practice Appendix 4 (2009).

13 R. Dolzer, *Indirect Expropriations: New Developments?*, 11 N.Y.U. Envtl. L. J. 64 (2002).

two critical elements: the effects of the measures and the severity of the effects.[14] As discussed, this two-pronged analysis does not appear in the Peru-China BIT but in the Peru-China FTA. In terms of severity, the Tribunal held that the measure taken by SUNAT "constituted a stab to the heart of TSG's operational capacity" as the measure strangled the normal conduits by which TSG received its operating capital and eliminated its possibility of resorting to the banking system to collect letters of credit and pay its debt.[15] In the Tribunal's viewpoint, SUNAT should have been aware of the possible impact its measure might bring to TSG's business operations as the way TSG was using banks should have been known to SUNAT through its investigation.[16]

The Peru-China BIT does not specify the evidentiary requirement of a causal link between a measure of expropriation and subsequent damages. The Tribunal recognized that other tribunals had dealt with this based on general principles of international law.[17] In some cases such as *LG&E Energy Corp et al. v. Argentinean Republic*, the decrease in the investment's capacity to maintain its activities or a loss of profit margins is not sufficient especially when the investment remains operational. The Tribunal found that interim measures had prevented TSG from continuing to transact with those banks it used to do business.[18]

Given TSG's business model and its previous business relationship with those Peruvian banks, SUNAT's interim measures caused a severe and substantial impact on TSG's business. The Tribunal eventually determined that SUNAT's measures created a "direct, close or permanent" effect rather than an "indirect, remote or temporary" one. Therefore, SUNAT's preliminary measures constituted indirect expropriation without compensation.[19]

Apart from the severity of impact, the Tribunal also emphasized the duration of the impact.[20] Duration is related to the denominator problem, a quantitative relationship between the harm suffered and a theoretical unit of reference.[21] Christoph Schreuer stated that: "The intensity and duration of the economic deprivation is the crucial factor in identifying an indirect expropriation or equivalent

14 The Award, *supra* note 3, ¶ 159.

15 *Id.* ¶ 156.

16 *Id.* ¶ 217.

17 *Id.* ¶ 167.

18 *Id.* ¶¶ 160-166.

19 *Id.* ¶ 170.

20 *Id.* ¶ 156.

21 J. Wagner, *International Investment, Expropriation and Environmental Protection*, 29 Golden Gate U. L. R. 465-538 (1999). *See also* G. Christie, *What Constitutes a Taking of Property Under International Law?*, 1962 Brit. Y.B. Int'l L. 307-308.

measure."[22] The deprivation needs to be permanent or for a substantial period of time. SUNAT's interim measures were imposed for a period of one year and subsequently extended to be in effect for an additional two-year period. Although the restructuring proceeding had the effect of suspending SUNAT's interim measures and allowing TSG to continue to operate through Peruvian banks, the Tribunal was of the view that TSG could only resume normal operations once the restructuring proceeding was concluded in June 2006. This loss of operational capacity, as the Tribunal viewed it, however, was permanent.[23]

The Tribunal's approach of paying due regard to the factual setting or "factual particularities of the dispute"[24] seems in line with the existing case law jurisprudence in taxation cases.[25] The Tribunal scrutinized and stressed the 'financial/commercial stability' of the company;[26] it can augment the liabilities or diminish the company's future income over which the investor does not have formal entitlements.[27] However, the Tribunal failed to offer a quantity threshold or formulae to measure the element of severity.

The Tribunal tried to outline a more pragmatic approach to the *ex post* effects of regulation on the investor that may cause the State action to be expropriatory.[28] In other words, the Tribunal managed to avoid the challenging task of defining the concept of indirect expropriation or offering an exhaustive list of key elements, rather focusing on the effect of State action. This approach is somehow disappointing as it removed the doctrinal obstacle that regulations causing deprivation to a particular investor may also be *ex ante* legitimate. It is largely true in rare cases that governments purposely deprive investments under the guise of regulation with the aim of avoiding compensation, which constitutes an actual instance of direct expropriation.[29] Accordingly, the Tribunal seemed to blur the distinction between 'destructive' regulation and 'compensable' indirect expropriation.

22 C. Schreuer, The Concept of Expropriation under the ETC and Other Investment Protection Treaties (2005), *available at* http://www.univie.ac.at/intlaw/pdf/csunpublpaper_3.pdf (last visited on Sept. 22, 2014).

23 The Award, *supra* note 3, ¶ 162.

24 *Id.* ¶ 179.

25 ADM and Tate & Lyle Ingredients Americas, Inc., c. Estados Unidos Mexicanos, Caso CIADI No. ARB(AF)/04/05, Laudo (21 de noviembre de 2007); LG&E; EnCana, Laudo (3 de febrero de 2006); Link-Trading Joint Stock Company c. República de Moldova, Reglamento de Arbitraje de la CNUDMI Laudo (18 de abril de 2002); Amto, LLC c. Ucrania, SCC Caso No. 080/2005, Laudo (26 de marzo de 2008); Mondev International Limited c. Estados Unidos de América, Caso CIADI No. ARB(AF)/99/2, Laudo (11 de octubre de 2002).

26 The Award, *supra* note 3, ¶¶ 221-222.

27 *Id.*

28 *Id.* ¶¶ 219-222.

29 UNCTAD, Taking of Property, UNCTAD/ITE/IIT/15, UNCTAD Series on Issues in International Investment Agreements 2000, *available at* http://unctad.org/en/docs/psiteiitd15.en.pdf (last visited on Sept. 24, 2014).

The Tribunal regarded Peru's tax measures as an expropriation by reference to the case of *Archer Daniels Midland et al v. United Mexican States* regardless of whether TSG remained active in business during the bankruptcy proceedings.[30] The tax measures in this sense constitutes an 'indirect' expropriation.[31] The Tribunal seemed to echo Archer's tribunal in that 'investors' rights to use the asset in question become ineffective or the assets had lost their economic value.[32] Similarly, the Tribunal found that the interim measures taken by SUNAT had significantly interfered with TSG's operations.[33] The Tribunal therefore distinguished the present case from the circumstances in *LG&E Energy Corp. v. Argentinean Republic*, which by contrast held that "the decrease in an investment's capacity and income generation does not constitute expropriation."[34]

Stephan Schill makes a structural distinction between full or substantial deprivations such as disguised expropriations, and lesser interferences (or regulation), often termed as 'regulatory takings,' which refer to measures taken in the context of the modern regulatory State including strangulating taxation.[35] This distinction is not easily sustained;[36] it has been recognized as one of the most contentious issues in international investment law[37] by both international legislative documents[38] and case law.[39]

Traditionally, international law evaluates whether various government interferences have left these essential rights intact.[40] In general, a diminution in value remains uncompensated, so long as rights of use, exclusion and alienation remain

30 The Award, *supra* note 3, ¶ 158.

31 For details, *see* Archer Daniels Midland Company and Tate & Lyle Ingredients Americas Incorporated v. Mexico, Award and Separate Opinion, ICSID Case No. ARB(AF)/04/5, IIC 329 (2007), Sept. 26, 2007, ¶ 238.

32 The Award, *supra* note 3, ¶158 & ¶164.

33 *Id.* ¶¶ 161-162.

34 *Id.* ¶ 160.

35 S. Schill, The Multilateralization of International Investment Law 82 (2009).

36 R. Higgins, *The Taking of Property by the State: Recent Developments in International Law*, *in* 176 Recueil des Cours 331 (1982).

37 T. Waelde & A. Kolo, *Environmental Regulation, Investment Protection and 'Regulatory Taking' in International Law*, 50 Int'l & Comp. L. Q. 814 (2001).

38 OECD Draft Convention on the Protection of Property, *reprinted in* 7 I.L.M. 117, 126 (1968) (The official commentary to the OECD Draft Convention of 1967 states that: "The taking of property, within the meaning of article 3, must result in a loss of title or substance – otherwise a claim will not lie.").

39 Starret Housing Corp v. Islamic Republic of Iran, 4 Iran-US Cl. Trib. Rep. 122, 154 (1983) (It states that: "Measures taken by a state can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated, even though the state does not purpose to have expropriated them and the legal title to the property formally remains with the original owner.").

40 D. Harris, Cases and Materials of International Law 555-561 (5th ed. 1998).

untouched.[41] Most tribunals follow this legal approach, while others integrate some economic elements which are taken into account when assessing questions of causation and damage. Even though some tribunals favor the economic approach, when the question comes to the economic conception, they have not provided any conclusive answer to the threshold of a diminution in value, with some exceptions, *e.g.*, GAMI v. Mexico.[42]

The Peru-China FTA sides with a more legalistic approach by providing that: "The fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred."[43] The Tribunal in this case took both approaches into account, but leaned towards a more legalistic stance.[44] One thing the Tribunal decided was whether Tza was radically deprived of the economic use and enjoyment of its investments. This was regarded by the Tribunal as one of the main elements distinguishing 'regulation' from 'expropriation.'[45] Investment treaty tribunals often follow a 'sole effect' doctrine or 'orthodox' approach, one of the dominant conceptions in international law,[46] by centering their assessments around the effects of government measures.[47] An expropriation is found to be in existence if the government measure's effect is a complete or substantial deprivation of an investment,[48] i.e., a material decline in the value of its assets or an impairment in

41 *Supra* note 39, at 271.

42 Gami Investment, Incorporated v. The Government of the United Mexican States, Final Award (Sept. 15, 2004) Ad Hoc Tribunal (UNCITRAL).

43 Peru-China FTA, Annex 9, art. 4.

44 Ronald S. Lauder v. The Czech Republic, Final Award in the Matter of an UNCITRAL Arbitration, ¶ 200 (2001), *available at* http://www.italaw.com/sites/default/files/case-documents/ita0451.pdf (last visited on Sept. 24, 2014) (The Tribunal held that a 'formal' expropriation is a measure aimed at a "transfer of property" while a '*de facto*' expropriation occurs when a state deprives the owner of his "right to use, let or sell (his) property"). *See also* Nykomb Synergetics Technology Holding AB v. Latvia, SCC Case No. 118/2001, ¶ 4.3.1 (2003). (The Tribunal here went even further. Even if the investment became worthless, the Tribunal still held that: "The decisive factor for drawing the border line towards expropriation must primarily be the degree of possession taking or control over the enterprise the disputed measured entail.")

45 Técnicas Medioambientales Tecmed, S.A. c. Estados Unidos Mexicanos, Caso CIADI No. Arb(AF)/00/2, ¶ 115

46 Newcombe, *supra* note 9, at 10.

47 Dolzer, *supra* note 13, at 64 & 78. *See also* J. Paulsson & Z. Douglas, *Indirect Expropriation in Investment Treaty Arbitrations*, *in* Arbitrating Foreign Investment Disputes 148 (N. Horn & S. Kroll eds., 2004).

48 *Pope & Talbot Inc. v. Government of Canada, Interim Award*, ¶¶ 96 & 102 (June 26, 2000) Ad Hoc Tribunal (UNICITRAL), *available at* http://opil.ouplaw.com/view/10.1093/law:iic/192-2000.case.1/IIC192(2000)D.pdf (last visited on Oct. 9, 2014); *Occidental Exploration & Production Company v. The Republic of Ecuador*, L.C.I.A. Case No. UN3467, (July 1, 2004), *reprinted in* 43 I.L.M. 1248.

ability of the business to function,[49] which would require compensation.[50] The focus in this assessment is the degree of interference with an investment, measured by the severity of the economic impact which is the decisive criterion.[51] Judicial practice confirms the magnitude or severity of this test in deciding whether it is an indirect expropriation.[52] There emerged a tendency to equalize 'indirect expropriation' to "a measure that effectively neutralizes the enjoyment of the property" even if the measure itself does not involve an overt taking.[53] Interferences constitute expropriation if they "approach total impairment,"[54] that is, "wiping out *all or almost all* the investor's investments."[55] This approach has been followed by some tribunals in various cases in deciding whether interference constitutes an expropriation.[56] In sum, a taking does not have to be complete but only "have the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State."[57]

The Tribunal looked into the effect of SUNAT's measures, which was viewed as one of the key factors to determine whether such measures were arbitrary or not. In the Tribunal's view, the results of the preliminary measures were negative.[58] The amount of debt collected from the bank and third parties was very little compared to the tax debt of USD 4 million. By contrast, the preliminary measures severely

49 P. Cameron, *Stabilisation in Investment Contracts and Changes of Rules in Host Countries: Tools for Oil & Gas Investors*, AIPN Research Paper Final Report (2006) 60. *See also* N. Rubins & S. Kinsella, International Investment, Political Risks and Dispute Resolution: A Practitioner's Guide 207 (2005).

50 I. Brownlie, Principles of Public International Law 546 (5th ed. 1967).

51 C. Schreuer, *The Concept of Expropriation under the ETC and other Investment Protection Treaties*, 28-29, ¶ 81, *available at* http://www.univie.ac.at/intlaw/pdf/csunpublpaper_3.pdf (last visited on Sept. 22, 2014). *See also* A. Hoffmann, *Indirect Expropriation*, *in* Standards of Investment Protection (A. Reinisch ed., 2008).

52 Metalclad Corp. v. United Mexican States, ICSID Additional Facility Case No. ARB(AF)/97/1, ¶ 103 (Aug. 30, 2000); *See also* LG&E Energy Corporation and Others v. the Republic of Argentina, ICSID Case No. ARB./02/1 (2007).

53 *Supra* note 44, ¶ 200 (2001). *See also* CME, Czech Republic BV v Czech Republic, Partial Award and separate opinion, UNCITRAL Ad Hoc Tribunal, IIC 61 (Sept. 13, 2001), *reprinted in* 9 ICSID Report 121 (2002); 14(3) World Trade & Arb. Mat'l 109, ¶ 591, *available at* http://opil.ouplaw.com/view/10.1093/law:iic/61-2001.case.1/IIC061(2001).pdf (last visited on Oct. 25, 2014).

54 J. Coe & N. Rubins, *Regulatory Expropriation and the Tecmed Case: Context and Contributions*, *in* International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law 621 (T. Weiler ed., 2005).

55 LG&E Energy Corporation and ors. v. the Republic of Argentina, ICSID Case No. ARB/02/1, ¶ 191 (2007). [Emphasis added]

56 Metalpar SA & Buen Aire SA v. Argentina, Award on the Merits, ICSID Case No. ARB/03/5, ¶¶ 172-73 (June 6, 2008).

57 Metalclad Corporation v. Mexico, Award, ICSID Case No. ARB(AF)/97/1, ¶ 103 (2000).

58 The Award, *supra* note 3, ¶ 219.

impacted TSG whose revenues and annual income dropped substantially,[59] and whose business operations eventually ceased.[60] TSG's further operations after the imposition of preliminary measures was largely due to its own initiation of bankruptcy proceedings and the restructuring of its financing.[61] The Tribunal's approach, *de jure*, is in line with the doctrine codified in the Peru-China FTA, which requires the assessment of "the economic impact of the government action."[62]

There has been some doubt over the question of the 'sole effect' doctrine. It should be the only factor in determining whether a regulatory measure in the field of tax, environment, health, human rights, and other welfare interests of the State affects a taking.[63] The purpose and context of the governmental measure also needs to be taken into account.[64] Peru's argument is reflective of a greatly narrow, restrictive and obsolete approach which requires Tza to prove an expropriatory 'purpose.' This is a purpose-oriented approach focusing on the host State's intention or motivation to expropriate.[65]

International custom and the jurisprudence of international investment apply the concept of expropriation to the full or substantial deprivations of property rights or all or most of the benefits (or value) of the investment.[66] This is because the concept of expropriation must be narrower than "unlawful harm caused by the government" so as to avoid a scenario in which the State bears liability for any injury to investors.[67] Accordingly, a line must be drawn between 'expropriations' and other types of interference referred to as "measures affecting property rights."[68] The Iran-US Claims Tribunal has indicated that "a sufficient degree of interference" is necessary to qualify as 'deprivation.'[69] In identifying the expropriatory nature of SUNAT's actions, the Tribunal appeared to equate expropriations with the presence of destructive harm to TSG. The Tribunal's evaluation of the nature of SUNAT's

59 *Id.* ¶ 221.

60 *Id.* ¶ 222.

61 *Id*.

62 Peru-China FTA, Annex 9 art. 4.

63 Dolzer, *supra* note 13, at 79-80.

64 OECD , *"Indirect Expropriation" and the 'Right to Regulate' in International Investment Law*, (OECD Working Papers on International Investment No. 2004/4), *available at* http://www.oecd.org/daf/inv/investment-policy/WP-2004_4.pdf (last visited on Sept. 24, 2014).

65 Hoffmann, *supra* note 51, at 156-158.

66 Metalclad Corp., ICSID Case No. ARB(AF)/97/1, ¶ 103 (2000). *See also supra* note 53, ¶ 591 (2001).

67 Brownlie, *supra* note 50.

68 *See* The Declaration of the Government of the Democratic and Popular Republic of Algeria concerning the Settlement of Claims by the Government of the United States of America and the Government of the Islamic Republic of Iran, 75 Am. J. Int'l L. 422 (1981).

69 Otis Elevator Co v. Islamic Republic of Iran, 14 Iran-US Cl. Tri. Rep. 293, ¶ 29 (1987).

interim measures turned out to be fraught with difficulty and simplicity.

III. Lawful Conditions for Expropriation

Expropriation is not unlawful under international law as long as certain formalistic conditions are met.[70] Generally, a signatory State is able to expropriate, nationalize or take other similar measures against investments of investors of another Party if the action is: "(a) for the public purpose; (b) under domestic legal procedure; (c) without discrimination; and (d) against compensation."[71] Both the Peru-China BIT and the Peru-China FTA, in a fairly traditional term, clone the Chinese investment treaty practice by imitating these four elements.

The Tribunal examined whether the four-pronged test helps exclude the unlawfulness of the conduct or the international liability of Peru. Peru argued that SUNAT was exercising the State's legitimate and regulatory power, which should not give rise to international liability.[72] Tza, on the other hand, challenged SUNAT's arbitrary, irrational and discriminatory measures in exercising the State's legitimate taxing power.[73] The Peru-China BIT offers little guidance since the key terms such as 'public purpose' and 'discrimination' are not defined.

A. Public Purpose

A 'public purpose' is germane to expropriation as the regulatory measure can be authorized by the government for diverse reasons. The requirement of public purpose for an act of expropriation is a widely accepted principle in customary international law as well as investment treaties.[74] However, the term "for a public purpose" has not been well defined, nor well illustrated. Thus, the application of this criterion in the expropriation analysis leaves the Tribunal with some discretion.

Peru's defense was made on the basis of a 'presumptive legitimacy' doctrine.[75]

70 R. Dolzer & C. Schreuer, Principles of International Investment Law 91 (2008).

71 Agreement on Investment of the Framework Agreement on Comprehensive Economic Cooperation, concluded by the Association of South East Asian Nations and China (Aug. 15, 2009) art. 8(1).

72 The Award, *supra* note 3, ¶ 172.

73 *Id.*

74 Energy Charter Treaty art. 13(1)(a), Apr. 1998, *available at* http://www.encharter.org/fileadmin/user_upload/document/EN.pdf (last visited on Sept. 24, 2014); North American Free Trade Agreement art. 1110(1), *reprinted in* 32 I.L.M. 289 (1993).

75 Memorandum of Respondent ¶¶ 256-265. For details *see* The Award, *supra* note 3.

The Peruvian government argued that promoting a public interest, i.e., the maintenance of order, health or public morals justified the confiscation or seizure of a property.[76] This is similar to the 'general welfare' theory[77] or the "margin of appreciation" doctrine[78] that some tribunals have adopted (or rejected) to justify expropriation even in the absence of express treaty provisions. In weighing the deferential treatment of the State's regulatory power against the exercise of such power *vis-à-vis* the investor,[79] the Tribunal referred to the Peruvian Constitution as well as the General Administrative Procedure Law, both of which subject the exercise of regulatory powers by administrative authorities to the "principles of equality and fundamental rights of the people"[80] and "the constraints of the power attributed to them."[81] In the end, the Tribunal rejected Peru's argument.

B. Due Process

Due process is a required element to satisfy the public interest exception. The tribunal in the case of *Methanex*, *e.g.*, decided the taking question against the investor on more general terms as follows:

> as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, *inter alia*, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.[82]

Any defect in due process may lead a tribunal to invalidate an expropriation. *E.g.*, the tribunal in the case of *Metalclad* equated the fact that the "municipality acted outside its authority" to unlawful prevention of "the Claimant's operation of the landfill."[83] In *Middle East Cement*, the tribunal transformed a lawful seizure to an indirect expropriation because of a lack of due process (*inter alia*, a failure to properly

76 The Award, *supra* note 3, ¶ 171.

77 Saluka Invs. v. Czech Republic, Partial Award, ¶ 255 UNCITRAL Arb. Trib. (2006).

78 Kassi Tallent, *The Tractor in the Jungle: Why Investment Arbitration Tribunals Should Reject a Margin of Application Doctrine*, *in* Investment Treaty Arbitration and International Law 111-136 (I. Laird & T. Weiler eds., 2010)

79 The Award, *supra* note 3, ¶179.

80 *Id.* ¶175.

81 *Id.* ¶177.

82 Methanex Corporation v. US, UNCITRAL Arb. Trib. ¶ 7 (2005).

83 Metalclad Corp., ICSID Case No. ARB(AF)/97/1, ¶ 79 (2000).

notify the investor of the seizure and auction of its vessel Poseidon).[84]

Both the Peru-China BIT and the Peru-China FTA adopt the term "under domestic legal procedure."[85] The reference to the 'domestic law' provides the State with more flexibility and control over the process as the expropriation process will be subject to domestic laws of the expropriating State. In any event, this criterion should be relatively easy to be satisfied by the expropriating State where the domestic review procedure of the expropriatory act, fair hearing and impartial tribunals are available.[86]

The Tribunal reviewed the legitimacy of Peru's regulatory instruments by focusing on two substantive conditions. First, the proceedings must be reasonable. Second, regulatory measures must not be deployed in a confiscatory, abusive or discriminatory manner.[87] These two perspectives constitute the key doctrine of 'due process' enumerated in the Peru-China BIT.[88]

The Peru-China BIT, unlike other Chinese BITs, only lists "under domestic legal procedure," rather than "due process of law,"[89] as one of four conditions that must be fulfilled to justify the right to expropriate foreign property. Legally speaking, "domestic legal procedure" can be interpreted more narrowly than 'due process,' thereby bringing in more local legal elements into play. Since the Peru-China BIT does not offer a functional definition of "under the domestic legal procedure," the Tribunal made a reference to both international and domestic law. This again confirms the hybrid nature of the international investment arbitration jurisprudence composed of both international and municipal law.[90]

The Tribunal's reference to domestic law deserves analysis. The ICSID Convention allows the Tribunal to apply the law of the host State and "such rules of international law as may be applicable."[91] The ICSID Convention's reference to international law provides an illustrative context bringing into play

84 Middle East Cement Shipping and Hanfling Co. S.A. v. Arab Republic of Egypt, ICSID Case No. ARB/99/6, ¶¶ 139-44 (2002).

85 Peru-China BIT art. 4(1)(b); *Supra* note 3, art. 133(1)(b).

86 Dolzer & Schreuer, *supra* note 70.

87 The Award, *supra* note 3, ¶ 95.

88 Peru-China BIT, art. 4(1)(b).

89 China-France BIT art. 4(3); China-Denmark BIT art. 4(1); China-Spain BIT art. 4(1). (Most BITs China signed with European countries adopt "due process of law" instead of "under domestic legal procedure").

90 A. Newcombe & L. Paradell, Law and Practice of Investment Treaties §2.7 (2009).

91 ICSID Convention, art. 42. It provides that: "the Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflicts of laws) and such rules of international law as may be applicable."

the supplementary and corrective effects of international law.[92] The investment arbitration cases have already indicated that the tribunals usually "look to international law in determining the relevant criteria for evaluating the claim of expropriation";[93] it held the general view that "no distinctions have been attempted between the general concept of dispossession and the specific forms thereof."[94] In BIT jurisprudence, there are exceptions that refer to those scenarios in which the State, recognizing that it has deprived the investor's right, can defend itself based on domestic laws.[95] Per Peru's suggestion, The Tribunal looked into both the Constitution of the Republic of Peru and its administrative rules.[96] A subtle distinction needs to be made between the treaties that refer to municipal law – typically through an "in accordance with domestic law" clause – and those that do not. If investment treaties contain such a 'domestic law' clause, the adoption of municipal law is then beyond doubt.

C. Without Discrimination

Non-discrimination in regard to the status and treatment of aliens and property is a well-established principle of customary international law,[97] treaty law, and case law.[98] Breach of the non-discrimination principle gives rise to international responsibility.[99] In practice, discrimination complaints are more likely to be raised with regard to due process and payment of compensation. However, the discriminatory factor, due to the lack of guidance and specificity, is "extremely difficult to prove in concrete cases."[100] Thus, the blanket exception for non-discriminatory measures may create more complexity or a "gaping loophole in international protections against expropriation."[101]

As to the nature of the tax auditing proceedings, whether they were customary,

92 Newcombe & Paradell, *supra* note 90, § 2.19-2.20 & § 2.22-2.26. *See also* S. Jagusch & J. Sullivan, *A Comparison of ICSID and UNCITRAL Arbitration: Areas of Divergence and Concern*, *in* The Backlash Against Investment Arbitration: Perception and Reality 97-102 (M. Waibel et al., eds., 2010).

93 *See* LG&E, ICSID Case No. ARB/02/01, ¶ 191 (2006); Metalpar SA and Buen Aire SA v. Argentina, ICSID Case No. ARB/03/5, ¶ 173; Continental Casualty Company v Argentina, ICSID Case No. ARB/03/9, ¶ 284.

94 *Supra* note 44, ¶ 200 (2001).

95 I. Marboe, *State Responsibility and Comparative State Liability for Administrative and Legislative Harm to Economic Interests*, *in* International Investment Law and Comparative Public Law 377-411 (S. Schill ed., 2010).

96 The Award, *supra* note 3, ¶ 175 & ¶ 194.

97 Alex Genin and Others vs. Republic of Estonia, ICSID Case No. ARB/99/2, ¶ 368 (2001).

98 BP v. Libya, *reprinted in* 53 I.L.R. 329 (1979); Libya v. Libyan Am. Oil Co., *reprinted in* 20 I.L.M. 58 (1981).

99 I. Brownlie, System of the Law of Nations 81 (1983).

100 M. Shaw, International Law 751 (5th ed. 2003).

101 Pope & Talbot Inc. v. Canada, ¶ 99 (June 26, 2000).

abusive or discriminatory, the Tribunal first investigated whether TSG was selected to be audited on purpose. It appears that the selection of TSG for auditing purposes stemmed from TSG's 18 applications in the previous two years requesting a return of General Sales Tax ("GST"). During the period of fiscalization, TSG further filed 12 additional applications requesting more refunds of GST. These facts indicate that the procedure of selecting TSG was not problematic.[102] The tax auditing conducted by SUNAT was therefore viewed routine in nature by the Tribunal.[103]

The Tribunal went on to evaluate the proportionality of SUNAT's actions' as well as the compliance with due process. Peru's General Administrative Procedure Law only excludes the State's liability from those cases in which the public administrative authority had acted reasonably and proportionately: in defense of people's lives, integrity or property; in protection of public property; or in the event of damages that the citizen is legally bound to sustain according to law and circumstances.[104]

It is worth noting that the Tribunal was mindful that, even though the Peru-China BIT makes no mention of any exclusion clause, the Peru-China FTA provides a legitimate ground for indirect expropriation.[105] In this sense, a deprivation of property shall not be discriminatory in its effect, either as against the particular investor or against a class of which the investors forms part; or in breach of the State's prior binding written commitment to the investor, whether by contract, license, or other legal document.[106] Under the Peru-China FTA, an indirect expropriation may be "reasonably justified in the protection of the public welfare, including public health, safety and the environment."[107]

The approach taken by the Tribunal in examining the procedural side of the governmental action represents its concern over the quantum threshold of the interferences as well as the proportionality; it is identified by the Peru-China FTA as one of the three elements for the assessment of 'indirect expropriation.'[108] After reviewing the necessity of SUNAT's imposition of preliminary measures, the Tribunal concluded that SUNAT's actions were arbitrary based on its failure to pay due regard to the effect of the economic capacity and to follow its own procedural rules as well as the weaknesses in the audit report.[109] All these processes resulted in

[102] The Award, *supra* note 3, ¶¶ 95, 103 & 113.
[103] *Id.* ¶ 103.
[104] *Id.* ¶ 177.
[105] *Id.* ¶ 178.
[106] Peru-China FTA Annex 9, art. 5.
[107] *Id.* art. 6.
[108] *Id.* Annex. 5, art. 3(b).
[109] The Award, *supra* note 3, ¶¶ 179 & 199.

unjustified losses on the part of TSG.[110]

IV. Compensation

Payment of compensation is necessary in cases of expropriation.[111] It is difficult to reach consensus on an acceptable standard of compensation for lawful expropriation. While developed countries insist on full compensation according to the so-called Hull Formula, i.e., "prompt, adequate, and effective compensation,"[112] developing countries prefer either 'appropriate' compensation or no compensation at all.[113] The great majority of BITs adopt customary international law on lawful expropriation including the Hull Formula with some variations.[114]

A. Value

The investment treaty jurisprudence in this area has shown an increasing level of convergence that compensation needs to be equivalent to "fair market value."[115] The Peru-China BIT adopts the following compensation clause:

> The compensation mentioned in Paragraph 1, (d) of this Article shall be equivalent to the value of the expropriated investment at the time when the expropriation is proclaimed, be convertible and freely transferrable. The compensation shall be paid without unreasonable delay.[116]

110 *Id*. ¶¶ 117-217.

111 Brownlie, *supra* note 50.

112 *See*, *e.g.*, Treaty between the United States of America and the Oriental Republic of Uruguay concerning the Encouragement and Reciprocal Protection of Investment, U.S.-Uruguay, Nov. 4, 2005, S. Treaty Doc. No. 109-9, art 6(1)(c), *reprinted in* 44 I.L.M. 268. *See also* S. Corey, *But Is It Just? The Inability for Current Adjudicatory Standards to Provide "Just Compensation" for Creeping Expropriations*, 81 Fordham L. Rev. 989 (2012); T. Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance* 6 (Ill. Law and Economics Working Paper No. LE06-027, 2006), *recited from* G. Hackworth, Digest of International Law § 228, 655-665 (1942).

113 1974 Charter of Economic Rights and Duties of States, GA Res. 3281, U.N. GAOR, 29th Sess., Supp. No. 31, UN Doc. A/9631, 50 (1974) For details, *see* F. Francioni, *Compensation for Nationalization of Foreign Property: The Borderland between Law and Equity*, 24 Int'l & Comp. L. Q. 255-6 (1975).

114 *See Bilateral Investment Treaties 1995-2006: Trends in Investment Rulemaking, available at* http://unctad.org/en/docs/iteiia20065_en.pdf, ¶ 52, UNCTAD/ITE/IIT/2006/5 (2007) (last visited on Sept. 22, 2014).

115 *Supra* note 74.

116 Peru-China BIT art. 4(2).

The Peru-China FTA adopts an identical but slightly different 'compensation' clause as follows:

> The compensation mentioned in subparagraph 1(d) of this Article shall be equivalent to the fair market value of the expropriated investment immediately before the expropriation took place ("the date of expropriation"), convertible and freely transferrable. The compensation shall be paid without unreasonable delay.[117]

This provision reflects the conditions such as 'adequate' and 'prompt,' respectively. The first sentence in the quoted clause connects the financial concept of fair market value to the abstract concept of *adequate* compensation as the market value of the taken property is supposed to be adequate to compensatee the investor. [Emphasis added] The fair market value is the price reached between the buyer and seller acting "at arm's length in an open and unrestricted market when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."[118] However, BITs usually do not explicitly define the term "fair market value." Article 133(2) of the Peru-China FTA, *e.g.*, merely stipulates that: "the compensation … shall be equivalent to the fair market value of the expropriated investments immediately before the expropriation took place, convertible and freely transferable." This suggests that the compensation is not reflective of any change in value occurring because the intended expropriation had become known earlier. In other words, this is meant to curb the negative impact on the value of the taken property which may result from the public's advanced knowledge of the fact of expropriation. The China-Germany BIT, however, includes the following clause:

> [t]he compensation shall be paid without delay and shall carry interest at the prevailing commercial rate until the time of payment; it shall be effectively realizable and freely transferrable.[119]

Although both of these two legal instruments are in line with the general 'value' formulae, the differences are also obvious. The Peru-China FTA moves one step further by stipulating that "[compensation shall] be equivalent to the fair market value of the expropriated investment."[120] However, none of these two 'value'

[117] Peru-China FTA art. 133(2).

[118] National Grid plc v. The Argentine Republic, UNCITRAL Arb. Tri. (Nov. 3, 2008) ¶ 263.

[119] The Agreement between the Federal Republic of Germany and the People's Republic of China on the Encouragement and Reciprocal Protection of Investments, F.R.G.-P.R.C., Dec. 1, 2003, art. 4(2), *reprinted in* 42 I.L.M. 609 (2003).

[120] Peru-China FTA art. 133(2).

formulae is operative in a practical sense.

Peru and Tza agreed that the compensation amount should be calculated on the basis of the value of TSG. Nevertheless, there was a stark difference between Peru and Tza in terms of the value of the expropriated company. Tza based his requested damages on the discounted cash flow ("DCF") of TSG,[121] while Peru argued that the appropriate standard was the company's adjusted book value methodology and estimated the value of TSG as of December 31, 2004, the date right before the expropriation being carried out.[122]

The Tribunal noted that using the DCF methodology would allow TSG to benefit from the substantial increases in the fishmeal market from 2005.[123] Given the fact that TSG only operated for three years up to January 2005 when the administrative measures were imposed, the Tribunal agreed that it was not appropriate to use the DCF methodology as TSG did not have a long record of favorable and certain results enough to assume that the company would have continued making profits between 2005 and 2008.[124] As a result, the positive projected results of TSG lack certainty.[125] Such line of analysis is largely correct as DCF calculations contained a "rather high element of uncertainty and speculation"[126] Nevertheless, the DCF method has been universally adopted by many arbitral tribunals as an appropriate method for valuing business assets.[127] The DCF method, as a forward looking calculation, computes the current value of future profits the investment is expected to generate.[128] Using the DCF method relies on the fact that there is an adequate past record to reasonably forecast future profits.[129] In case of a relatively new business like TSG, a short history of operation or profitability does not justify the use of the DCF method.[130] Rather, it makes more sense to use the purchase cost or book value of the investment to calculate compensation.

The Tribunal made some analyses about the distinction between direct and indirect expropriation while determining the compensation.[131] This distinction

121 The Award, *supra* note 3, ¶ 259.

122 *Id.* ¶ 260.

123 *Id.* ¶ 261.

124 *Id.* ¶ 262.

125 *Id.* ¶ 263.

126 *Supra* note 53, ¶¶ 603-604.

127 *Id.* ¶ 416.

128 *Id.* ¶¶ 595-620 (Mar. 2003). *See also* CMS Gas Transmission Co v. Argentina, ICSID Case No. ARB/01/8, ¶ 403 (May 12, 2005).

129 *Supra* note 53, ¶ 420.

130 C. Smutny, *Compensation for Expropriation in the Investment Treaty Context*, 3 Trans. Disp. Man. 5-6 (2006).

131 The Award, *supra* note 3, ¶ 271.

was of great doctrinal significance, which may have an impact on awarding compensation.[132] As to compensation, the Tribunal's approach of measuring damages was to place Tza in the same position but for the expropriation. The Tribunal finally decided that compensation must equate with the company's market value.[133] This is full restitution as opposed to full reparation of the injury caused as a result of an internationally wrongful act. Restitution may not be possible through monetary compensation as it was indicated in the *Case concerning the Factory at Chorzów*[134] and stipulated in the International Law Commission's Draft Articles on Responsibility of States for Internationally Wrongful Acts (hereinafter Draft Articles on State Responsibilities).[135] The Chorzów decision replicates the principle of full reparation as restituion may not make a claimant whole recovery because either it is materially impossible or impracticable. Therefore, reparation is made by way of compensation for the damages caused.[136] Some tribunals have relied upon the full reparation formula of the *Chorzów Factory* case.[137]

In terms of damages, the Tribunal sided with Peru and preferred to accept the adjusted book value method which, as the Tribunal stated, would be more proportional and certain, and more reflective of Tza's original capital investment and net worth of the company.[138] Regarding compensation, the Tribunal's approach of measuring damages was to place Tza in the same position as if there were no expropriation. Neither the Peru-China BIT, nor the Peru-China FTA explicitly adopted this approach. The Tribunal confirmed that the Draft Articles on Responsibilities are the key source of customary international law, according to which the State is under a legal obligation to make full reparation for the injury caused by the internationally wrongful act.[139] Reparation here is meant to wipe off all the consequences of the illegal act and re-establish the status which would have existed if that act had not been committed.[140] In practice, however, the principle of

132 ADC Affiliate Ltd. and ADC & ADMC Management Ltd v. Hungary, ICSID Case No. ARB/03/16, ¶¶ 480-494 (Oct. 2, 2006).

133 The Award, *supra* note 3, ¶ 255.

134 Case concerning the Factory at Chorzów (Germany v. Pol.) 1928 P.C.I.J. (ser. A) No. 17, at 47 (September 21).

135 International Law Commission, Articles on Responsibility for States for Internationally Wrongful Acts (2001), in Report of the International Law Commission to the General Assembly, 56 U.N. GAOR Supp. (No. 10) at 43, U.N. Doc. A/56/10 (2001), *reprinted in* [2001] Y.B. Int'l Comm'n pt. 2 at 20, 47-49, 52-54, U.N. Doc. A/CN.4/SER.A/2001/Add.1, arts. 31(1) & (2).

136 *Supra* note 135, arts. 35 & 36(1).

137 CMS, ICSID Case No. ARB/01/8, ¶ 40 (May 12, 2005); MTD Equity Sdn. Bhd and MTD Chile S.A. v. Republic of Chile, ICSID Case No. ARB/01/7, ¶ 238 (2004).

138 The Award, *supra* note 3, ¶ 264.

139 *Id.* ¶ 254.

140 Chorzów, 1928, P.C.I.J. (ser. A) No 17, at 47.

full reparation is still a vague doctrine, because the exact amount of compensation of damages can be determined only if other disciplines including valuation and calculation are consistently taken into consideration.[141]

To adopt more operative valuation methods and principles is recommended by the World Bank, incorporated by the NAFTA, and endorsed by some tribunals in order to increase the transparency of the valuation method.[142] Another concern is that the Peru-China FTA's compensation formulae is not yet clear if this wording actually refers to the full market value. In this sense, the Peru-China FTA makes little substantial progress in clarifying the issue of how to evaluate an expropriated investment. Certainly, it may be argued that the Peru-China FTA's approach gets closer to the Hull formula since the wording has absorbed some market-orientated factors.

B. Moral Damages

Few investors have sought moral damages under bilateral investment treaties. Actually, the case law granting moral damages in investment arbitration is scarce. There are recent signs of an increasing role for this category of damages. The concept of moral damages encompasses all compensatory but non-pecuniary and non-material damages.[143] The Draft Articles on State Responsibility state that: "the … state is under an obligation to make full reparation for the injury caused by the internationally wrongful act. Injury includes any damage, whether material or moral, caused by the internationally wrongful act."[144] This suggests the real importance of potential moral damages in providing a victim full compensation under international law.

Tza requested compensation for the moral damages he suffered from the expropriation in the value of S/. 15 million, which, as Tza argued, would restore the investor's status where the wrongful act had not occurred.[145] Tza's claim of moral

[141] Case Concerning the Factory at Chorzów (Germany v Pol.), 1927 P.C.I.J (ser. B) No 3, at 21. *See also* J. Crawford, The International Law Commission's Articles on State Responsibility 201 (2002).

[142] World Bank Guidelines on the Treatment of Foreign Direct Investment (1992) *reprinted in* 31 I.L.M. 1366, art. IV.5; NAFTA (listing a set of criteria that must be taken into account by the tribunal, *e.g.*, "going concern value, asset value including declared tax value of tangible property, and other criteria, as appropriate to determine fair market value"). *See also* CME Czech Republic BV v. Czech Republic, Final Award and Separate Opinion, IIC 62 (Mar. 14, 2003), UNCITRAL Ad Hoc Tribunal, ¶ 103, *available at* http://opil.ouplaw.com/view/10.1093/law:iic/62-2003.case.1/IIC062(2003)D.pdf (last visited on Oct. 27, 2014). (recognizing that a discounted cash flow valuation is the most widely employed approach to the valuation of a going concern).

[143] S. Ripinsky & K. Williams, Damages in International Investment Law 307 (2008).

[144] Draft Articles on Responsibility of State for Internationally Wrongful Acts, with commentaries 2001, art. 31, *available at* http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf (last visited on Sept. 23, 2014).

[145] The Award, *supra* note 3, ¶ 274.

damages was largely related to his reputation and image in social and business contexts after the event.[146] Peru argued that Tza had failed to demonstrate the causal link between the adoption of the preliminary measures and his alleged health problem. Nor did Tza prove reputational damage.[147] According to Peru's General Administrative Procedure Law, TGS was entitled to moral damages.[148] Tza, as a shareholder, did not have the status to make this claim.[149] In addition, however, Peru argued that Tza's claim did not qualify as 'exceptional circumstances,' a precondition to grant compensation for moral damages.[150]

Peru's counter-arguments focused on three key elements in determining moral damages in investment arbitration cases.[151] First, causation is the critical issue in determining jurisdiction over moral damages claims in international investment cases. There must be a causal linkage between a State's measures with respect to an investment, and the harm for which moral damages are intended to compensate. A defamatory campaign against the company and its shareholders[152] and the judicial harassment of a company's executives[153] are possible investment treaty claims that provide such causal linkages. Second, who is entitled to moral damages, either the invested company or the investor? The *Desert Line* award seems to support the view that moral damages can be awarded for both economic and/or reputational injuries to the company as well as to the company's executives. It has been even suggested in the case of *Biwater Gauff* that moral damages may be available to an investor in a BIT arbitration even if expropriation bears no economic consequences (in the form of monetary damage).[154] In this sense, the type of claimant for moral damages is less important as long as the jurisdictional hurdle of causation can be overcome in the first place. Third, moral damages are granted only in exceptional circumstances. However, this concept has neither been defined nor exemplified in investment arbitration cases. The emerging jurisprudence is that Respondent State's extreme bad faith as evidenced in a State's coercive acts and improper use of force against

146 *Id.* ¶ 276.

147 *Id.* ¶ 279.

148 *Id.* ¶ 280.

149 *Id.*

150 *Id.* ¶¶ 277-278.

151 *Supra* note 147.

152 Benvenuti & Bonfant v. People's Republic of the Congo, ICSID Case No. ARB/77/2, § 4.96 (Aug. 8, 1980). It holds that the claimant was the object of a series of measures and the proceedings resulting therefrom disturbed the activities of the claimant and harmed the claimant's reputation, resulted in moral damages that required compensation.

153 City Oriente Ltd. v. The Republic of Ecuador & Empresa Estatal Petroleos del Ecuador (Petroecuador), ICSID Case No. ARB/06/21, § IV (2007).

154 Biwater Gauff v. Tanzania, ICSID Case No. ARB/05/22, §§ 24-28 (2008).

foreign nationals, may justify the imposition of fault-based liability and award of moral damages in investment arbitration.[155]

The Tribunal made a reference to the 'exceptional circumstance' principle through the case of *Lemire v. Ukraine*.[156] Here, the circumstances in which moral damage may be granted include as follows:

a. The acts of the State must involve a physical harm or threat to the investor, the standards of behavior foreseeable in civilized nations;
b. The acts of the State must have caused a deterioration in health, stress, anxiety or other mental distress such as humiliation, embarrassment or loss of reputation, credibility and status; and
c. Both the causes and the effects of expropriation must be serious and substantial.[157]

The Tribunal opined that the above three elements all failed. There was no severity or harm to the mental health of Tza. Nor was there causality between the alleged damages and conducts of Peru.[158] In conclusion, the Tribunal rejected Tza's wholesale request for moral damages since none of these elements were satisfied. This is in line with international investment jurisprudence limiting compensation for moral damages to exceptional or specific circumstances.[159]

C. Valuation Date

The appropriate date of expropriation is important in calculating interest.[160] The date is an integral part of the total compensation awarded by the tribunal for expropriation and can be the most keenly contested issue. Chinese BITs usually fix the valuation date by relying on one or two cut-off points, *e.g.*, "immediately prior to the time when the expropriation became public"[161] or "immediately before the expropriation measures were taken."[162] The Greece-China BIT adopts both. It states

155 Desert Line Projects LLC v. Yemen, ICSID Case No. ARB/05/17, § 290 (2008). *See also* Benvenuti & Bonfant, *supra* note 152, § 4.96.

156 Joseph Charles Lemire v. Ukraine, Award, ICSID Case No. ARB(AF)/98/1 (2000).

157 The Award, *supra* note 3, ¶ 281.

158 *Id.* ¶ 282.

159 Yemen, ICSID Case No. ARB/05/17, § 289 (Feb. 6, 2008).

160 However, it has been also suggested to distinguish the "moment of expropriation" from the "moment of valuation" as the former is related to the question of liability while the latter goes to the question of damages. For details, *see* M. Reisman & R. Sloane, *Indirect Expropriation and Its Valuation in the BIT Generation*, 74 Brit. Y.B. Int'l L. 115 (2004).

161 Austria-China BIT (1985) art. 4(1).

162 The Netherlands-China BIT (2001) art. 5(1)(c); New Zeland-China FTA (2008) art. 145(2); Mexico-China BIT (2008)

that: "Such compensation shall amount to the value of the investments affected immediately before the measures … occurred or became public knowledge."[163] This level of clarity helps guarantee that the "value of the expropriated investment" will not depreciate once expropriation is known to the public. It may also guarantee the investor a full and adequate recovery in cases of 'creeping' expropriation.

The Peru-China FTA uses "the date immediately before the expropriation took place" as the date of expropriation. While this may be beneficial to the aggrieved investor, it does not offer much clarity or practicality. The general practice is that the accrual of interest should begin at the time when the expropriation occurs and end on the date when the payment is made. The full compensation principle led the Tribunal to determine the interest due from the date of expropriation to the actual payment of compensation.[164]

D. Interest

Neither the Peru-China BIT nor the Peru-China FTA makes a reference to any specific interest rate. Both, however, require the compensation to "be paid without unreasonable delay."[165] The ambiguity provides the prospective tribunal with some flexibility.

Tza asked for an 11 percent interest rate to calculate the interest for the period from the issuance of the award to the actual payment of compensation due. As the same interest rate paid by TSG for the foreign credit line, this 11 percent rate incorporated a risk factor that the Tribunal determined was no longer applicable post-expropriation.[166] Peru, however, tried to use the US Treasury Bonds rate, which should be lower than 11 percent. The Tribunal rejected Tza's requested interest rate of 11 percent. Instead, the Tribunal sided with Peru that the appropriate interest rate should approximate the rate of return had the damages awarded been re-invested for a favorable return.[167]

Interest shall be compounded semi-annually according to the well-established practice as the desirable method to recognize the realities of trade and to fully compensate the investor.[168] Compounding also counteracts somewhat the risk

art. 7(2)(a).

163 Greece-China BIT (1992) art. 4(2).

164 The Award, *supra* note 3, ¶ 286, ¶ 292.

165 Peru-China BIT art 4(2); Peru-China FTA art 133(2).

166 The Award, *supra* note 3, ¶ 287.

167 *Id.* ¶ 289.

168 Metalclad Corp., ICSID Case No. ARB(AF)/97/1, § 128 (2000). *See also supra* note 44, § 440 (2001).

assumed by the investor against the accrual arising from this Award and ideally is an incentive for its timely payment.[169] The final ruling on this point was that the interest rate on damages would be tied to the average monthly rate on 10-year US treasury bonds.[170]

E. Exchange Rate

More effective compensation should be made in a form usable by the investor. Therefore, the currency of payment must be freely usable or convertible into a freely usable currency.[171]

Some Chinese BITs adopt several formulas such as the "average of the daily exchange rates,"[172] the "official exchange rate" on the day of transfer,[173] and the "exchange rate applicable for the payment of the compensation … on the date used to determine the value of the investment,"[174] all of which are helpful to avoiding the potential dispute in this regard. Unlike some other Chinese BITs, both the Peru-China BIT and the Peru-China FTA do not specify the way to determine the exchange rate between the local currency and the freely usable currency. However, both require compensation to "be convertible and freely transferrable."[175] Tza made his monetary claim in Peruvian Nuevos Soles, but the Tribunal granted damages in US dollars.[176] Likely, the Tribunal took into consideration the required elements of convertibility and free transferability.[177]

F. Arbitration Costs

The Tribunal was aware of the different perspectives of certain arbitral tribunals with respect to awards on costs, *e.g.*, the losing party pays arbitration costs[178] and the more generally accepted public international law principle that costs should be borne equally by the parties, absent egregious conduct by one of the parties in

169 The Award, *supra* note 3, ¶ 291.

170 *Id.* ¶ 290.

171 World Bank Guidelines on the Treatment of Foreign Direct Investment, art. IV.7 (1992), *reprinted in* 31 I.L.M. 1366.

172 Australia-China BIT (1988).

173 Korea-China BIT (1992).

174 Greece-China BIT (1992) art. 4(2).

175 Peru-China BIT (1994) art. 4(2); Peru-China FTA (2008) art. 133(2).

176 The Award, *supra* note 3, ¶ 266.

177 Peru-China FTA, *supra* note 2, art. 133(2).

178 Methanex Corporation v. United States, Final Award on Jurisdiction and Merits, UNCITRAL AD HOC Arb. Tri. ¶ 7 (2005).

arbitration.[179] The Tribunal applied this generally accepted principle in this case by splitting arbitration costs equally between the parties.[180]

A simple comparison of key elements in the two compensation provisions of the Peru-China BIT and the Peru-China FTA and the Tribunal's interpretations is set out in Table 1.

Table 1: 'Compensation' under the Peru-China BIT, the Peru-China FTA and the Award

	Peru-China BIT	Peru-China FTA	Award
Value of the expropriated investment	"value of the expropriated investment"	"fair market value of the expropriated investment"	"adjusted book value," 'market value'
Interest	No mention		US Treasury Bond Rates, "should approximate the rate of return had the damages awarded been re-invested for a favourable return"
Adequate, effective and prompt	No explicit mention[181]		No mention
Without delay, realisable and transferrable	"without unreadable delay", 'convertible' and 'freely transferrable'		Awarding compensation in US dollars even though Tza made his monetary claim in Peruvian Nuevos Soles
Evaluation of value	No mention		"To place Tza in the same position as if there were no expropriation"
Date of calculation	"at the time when" the expropriation is proclaimed	'immediately before' the expropriation took place	Date of expropriation
Exchange rate	"the prevailing exchange rate[182]	"the prevailing market rate of exchange[183]	No mention
Moral damages	No mention		Not granted
Arbitration costs	No mention		Equal splitting

Source: Compiled by the author.

179 Waste Management Incorporated v Mexico, Award, ICSID Case No. ARB(AF)/00/3, (2004), ¶¶ 183 & 184.

180 The Award, *supra* note 3, ¶¶ 296-301.

181 It appears that China indirectly practiced the customary international law of Hull formula after it adopted the reform and opening door policy in 1978. For instance, China signed a lump sum agreement with the US to pay the USD80.5 million for 41% of the US assets that were nationalized by the Chinese government after the founding of the PRC in 1949. China also reached the similar agreements with Canada in 1981 and the UK in 1987 for similar purposes. For details, *see* R. Lillich & B. Weston, *Lump Sum Agreements: Their Contribution to the Law of International Claims*, 82 Am. J. Int'l L. 78 (1988).

182 Peru-China BIT art. 6(2).

183 Peru-China FTA art. 135(2).

V. Conclusion: Conceptuality v. Textuality?: The Tribunal's Treaty Interpretative Methodology

Whether expropriations are lawful depends on compliance with the following list of conditions established by investment treaties: (1) public interest; (2) due process; (3) non-discrimination; and (4) payment of compensation.[184] This well-established four-pronged test, however, is largely ambiguous and depends on how arbitral tribunals may interpret and apply expropriation clauses in a vast array of BITs. In international investment arbitration, tribunals may have indicated patterns or principles in deciding what constitute an expropriation even though those patterns only indicated a certain degree.[185] The ambiguity within the BIT law and practice effectively provides fertile ground for tribunals to balance two extremes of the spectrum: one is public interest, and the other, expropriation.[186] The BIT jurisprudence in this regard at most has only showed an *ad hoc* nature and more uncertainty. As a result, the jurisprudential constraint may constitute a barrier to a potentially excessive reach of expropriation by government authorities.

This Award's headline is important for the following two reasons. First, this is the first ICSID case interpreting and applying substantive terms in a Chinese BIT. Furthermore, the Award ruled on a claim brought to ICSID arbitration involving an assessment of the expropriation clause in the Chinese BIT which was not yet comprehensively defined and arbitrated. Although the Tribunal's jurisprudential and practical contribution to the interpretation and application of the expropriation term in Chinese BITs is limited, it is still useful for the international investment community and investment arbitration circle to understand how a large number of Chinese BITs can be utilized to protect foreign investment[187] in China given the fact that domestically 'taking' law in China has been heavily criticized.[188] Apart from the

184 Peru-China BIT art. 4(1).

185 Christie, *supra* note 21, at 336.

186 Harris, *supra* note 40, at 564-566.

187 The PRC Law on Sino-Foreign Equity Joint Ventures art. 2. It provides: "The State shall not nationalize or requisition any equity joint ventures. Under special circumstances, when public interest requires, equity joint ventures may be requisitioned by following legal procedures and appropriate compensation shall be made." The PRC Law on Wholly Foreign Owned Enterprises States that: "China does not conduct expropriation or nationalization of wholly foreign owned enterprises. Under special circumstances, in public interests, wholly foreign owned enterprises can be expropriated in accordance with legal procedures and appropriate compensation will be provided." The Sino-Foreign Equity Joint Venture Law was passed by the People's Congress on July 1, 1979.

188 Among others, the Regulation concerning the Management and Expropriation of Urban Residences, promulgated by the State Council on 2001, was the principal culprit. It is in clear contradiction with both the Chinese Constitution and the newly enacted Property Law. The regulation of expropriating urban land was enacted with the purpose of clearing

international dimension, the clarity made in this case may, to a certain extent, be also helpful in enhancing the principle of property protection under Chinese law, thereby fostering the development of the rule of law in China.[189]

A doctrinal dimension of this case is to draw a line distinguishing substantial deprivations from mere interferences (or regulation) where the latter are excluded from the scope of expropriation. There is no mechanical, comprehensive, or definitive test[190] to determine the dividing line between indirect expropriation, which is accompanied by compensation, and legitimate non-compensable regulatory measures that interfere with the enjoyment of private property.[191] Another related question is if the invocation of public interests is allowed under the category of acceptable deprivations without compensation. These questions are left open to future jurisprudential developments.

There has been no mechanically straightforward or uniform way of applying the expropriation clause in BIT arbitration. The methodology adopted by the Tribunal in this instant case echoes the pragmatic approach advocated in the investment arbitration circle that "[the constitution of expropriation] cannot be answered in the abstract but only on the basis of particular circumstances and in the context of particular purposes."[192] This pragmatic and realist approach is also in line with the Peru-China FTA which calls for "a case-by-case, fact based inquiry."[193] This common law type of case-by-case method is also codified into other BITs including the 2004 Canadian Model BIT.[194] No BIT has been comprehensively useful in outlining an exhaustive list of elements so that the tribunals can technically rely on in deciding the occurrence of an expropriation. Nor is the Peru-China BIT. It does not provide much guidance on how to interpret or apply the expropriation clause.

At the two extremes of the spectrum are two treaty interpretive approaches to deal with the concept of indirect expropriation. One extreme is marked by a trend

hurdles for rapid urban development in China. The State Council promulgated the Regulation on the Expropriation of and Compensation for Premises on State-owned Land on January 21, 2011. The new regulation is passed for the purposes of protecting public interest and legitimate rights and interests of owners of the premises to be expropriated.

189 S. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 Global Bus. & Dev. L. J. 337 (2007) (offering empirical and doctrinal studies on the causal relationship between BITs and the rule of law).

190 Some tribunals tried to work out a checklist of specific factors such as the facts and evidence of the case, the right of parties under an investment contract, the gravity of the interference, and possible cultural factors. *See* O. Vicuna, *Carlos Calvo, Honary NAFTA Citizen*, 11 N.Y.U. Envtl. L. J. 28 (2002).

191 Paulsson & Douglas, *supra* note 47, at 94 & 100.

192 Oppenheim's International Law 916-17 (R. Jennings & A. Watts eds., 9th ed. 1992).

193 Peru-China FTA, ann. 9 art. 4. An identical terminology also appears in the Protocol to the TIT, art. 2b, ¶ 1.

194 Canadian 2004 FIPA (BIT) Model Annex B 13(1)(b). It provides that: "The determination of whether a measure or series of measures of a Party constitute an indirect expropriation requires a case-by-case, fact-based inquiry…", *available at* http://www.docin.com/p-385197822.html (last visited on Oct. 9, 2014).

of tribunals to conceptualize or theorize the terminology of indirect expropriation with the aim of delineating between takings and police power.[195] At the other end of the spectrum is a focus on semantic components of the concept of indirect expropriation.[196] Interestingly, the treaty interpretation methodology deployed by the Tribunal in this case reflects a hybrid character, combining efforts not only to conceptualize, but also to textualize the notion of expropriation. This hybrid enriches the conceptual framework of indirect expropriation by striking a balance between legalistic and economic elements of 'destructive harms.' It brought the expropriatory acts to investments, while relying on the textual dimensions of indirect expropriation by following the guidance illuminated in the Peru-China FTA rather than the Peru-China BIT. Such a process may inevitably cause tension.[197] Compared to the Peru-China BIT, the Peru-China FTA draws a more comprehensive decisional matrix to activate some key aspects of 'indirect expropriation,' thereby transforming this ambiguous black-letter doctrinal concept into a more practical notion. The Tribunal's teleological interpretation of the Peru-China BIT may reassure the sentiment to favor the protection of the investor and investment.[198]

To rely on the textual framework of the legal instrument is a safe and useful undertaking. However, it is only convincingly helpful if the legal instrument is clear and comprehensive. By contrast, conceptualizing the doctrine of indirect expropriation appears more important when all members of the international community are expected to normatively abide by publicly known and well-crafted limits. The real challenge facing international investment arbitration is to take a more consistent and institutionally coherent approach to the evaluation of indirect expropriation in investor-State arbitration proceedings.[199] Against this backdrop, the Tribunal's hybrid route is a realist one; it combines the conceptual and textual methodologies to more comprehensively address current arbitral inconsistencies in the expropriation arena and to foster a predictable and clear jurisprudence of 'expropriation.' In any event, the Award rendered in this case is definitely not the end, but, perhaps, the end of the beginning in interpreting and applying substantive terms in Chinese BITs.

195 Wenhua Shan, The Legal Framework of EU-China Investment Relations: A Critical Appraisal, ch. 6 (2005).

196 *Id*.

197 S. Franck, *The Nature and Enforcement of Investor Rights Under Investment Treaties: Do Investment Treaties Have A Bright Future?* 12 U. C. Davis J. Int'l L. & Pol'y 47-99 (2005). *See also* A. Joubin-Bret, *BITs of the Last Decade: A Ticking Bomb for States?*, *in* The Future of Investment Arbitration 145-153 (C. Rogers & R. Alford eds., 2009).

198 SGS Societe Generale de Surveillance S.A. v. The Philippines, ¶ 116 (2004).

199 S. Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions*, 73 Fordham L. Rev. 1521-1625 (2005).

International investment law shares similarities with administrative law on the national level in terms of many factual instances of protection of rights or entitlements. Expropriation law and due process are common grounds of both international investment law and municipal legal orders. In this sense, international investment law constitutes the main body of global administrative law.[200] Both bilateral investment treaties and international investment law jurisprudence (composed of a large number of investment arbitration awards) would form the main body of a growing system of international administrative law consisting of the key ingredients of foreign investment protection law and practice. While neither customary international law nor international investment law reveals recognizable consensus on many expropriation-related rules, capital exporting countries have long been in a process of shaping the international legal framework on the basis of idealized versions of their domestic legal doctrines[201] aiming at providing better legal standards for the protection of their outbound investments.

As a consequence, international investment law not only transfers bilateral legal doctrines to the multilateral level, but also cements a foundation for *de facto* heightened judicial review of national laws and regulations. Non-compliance with these often adjudicated ingredients may result in State responsibility under international law.[202] Naturally, internationally recognized rules including minimum standard of treatment, compensable takings, and standard of compensation are expected to influence domestic laws[203] and pro-investment alternatives. This will be the case for China, which is in a transitional process leaning mostly towards global constitutionalism. Likely, legal norms and doctrines of foreign investment law will be applied and embedded locally thereby reshaping property rights and foreign investment protection regime in China.[204]

200 R. Dolzer, *The Impact of International Investment Treaties on Domestic Administrative Law*, 37 N.Y.U. J. Intl L. & Pol. 970 (2005).

201 D. Schneiderman, Constitutionalizing Economic Globalization – Investment Rules and Democracy's Promise 56 (2008).

202 A. Afilalo, *Constitutionalization through the Back Door: A European Perspective on NAFTA's Investment Chapter*, 34 N.Y.U. J. Int'l L. & Pol. 1 (2001).

203 For an account of Latin America, *see* Schneiderman, *supra* note 201, at 59-61.

204 Although China is an increasingly important capital exporting state, it remains a major capital importing country. Different from the US whose goal of using BITs is to entrench customary rights as well as to improve the general investment environment of BIT partners, China's use of BIT has a de facto domestic dimension, which is often overlooked by international investment lawyers. For the account of the American purpose of using BITs, *see* Akira Kotera, *Regulatory Transparency*, *in* The Oxford Handbook of International Investment Law 623 (P. Muchlinki et al. eds., 2008).