Kluwer Arbitration Blog

Using Investment Arbitration to Enforce Peruvian Agrarian Bonds

Karen Halverson Cross (The John Marshall Law School) · Tuesday, August 2nd, 2016 · Institute for Transnational Arbitration (ITA), Academic Council

Gramercy Funds Management LLC, a U.S.-based hedge fund ("Gramercy"), recently filed a notice of arbitration against the Republic of Peru pursuant to the investment chapter of the U.S.-Peru Trade Promotion Agreement ("U.S.-Peru TPA"), seeking USD 1.6 billion in damages. Although Peru announced that it filed an initial response to Gramercy's notice in early July, the full response is not yet publicly available. The dispute has a fascinating history and raises important questions regarding the use of investment treaty protections to enforce sovereign debt obligations.

Background

In 1969, the revolutionary military government of Juan Velasco Alvarado expropriated millions of acres of agricultural land from wealthy Peruvian families, converting it to worker-managed cooperatives. In compensation, the government issued agrarian reform bonds to the landowners (Bonos Agrarios or "Land Bonds"). The instruments are bearer bonds, governed by Peruvian law and denominated in Peruvian currency. Indeed, due to years of hyperinflation in Peru, the currency in which the bonds were denominated is no longer in circulation. The government began defaulting on the Land Bonds during the 1980s, ceased payment in 1992, and has not made any payment on the bonds since 1992.

In a 2001 decision, Peru's Constitutional Tribunal upheld the validity of the Land Bonds, finding that the government was still obligated to repay the bonds in an amount adequate to make up for the supervening effects of hyperinflation and changes in the currency. Between 2006 and 2008, Gramercy paid an undisclosed amount to acquire over 9,700 Land Bonds from hundreds of Peruvian bondholders. Thereafter, Gramercy began to seek judicial enforcement of the debt in Peruvian courts.

The events forming the basis for Gramercy's investment arbitration claim include a controversial 2013 decision of Peru's Constitutional Tribunal and two 2014 government decrees. In July 2013, the Constitutional Tribunal issued a decision, finding that the Land Bond debt should be repaid pursuant to a valuation approach that, according to Gramercy, would significantly undermine the bondholders' position. Gramercy alleges that the chief justice of the court gave in to pressure from President Ollanta Humala and used illicit means, including forged signatures, to reverse the court's previous position. In 2014, the government issued decrees implementing the 2013 decision. The decrees provide for a valuation formula that Gramercy alleges would wipe out most of the actual value of the Land Bonds, and establishes an order of repayment priority that places speculators at the end of the repayment line.

In order to bring its claim within the three-year limitation period specified in the U.S.-Peru TPA, Gramercy submitted a notice of intent to Peru in February 2016, followed by the notice of arbitration in June 2016. Gramercy alleges that Peru has expropriated its investment in the Land Bonds, denied it the minimum standard of treatment, and discriminated against Gramercy in breach of the TPA. Gramercy also alleges that, by issuing the 2014 decrees, Peru denied it effective means to judicially enforce the Land Bonds.

Discussion

As a threshold matter, Peru may argue in response to the claim that Gramercy's purchase of the Land Bonds is not a protected investment under the U.S.-Peru TPA. In *Poštová Banka and Istrokapital v. Hellenic Republic*, a tribunal found that a Slovak bank's interest in Greek bonds was not an "investment" under the Slovakia-Greece bilateral investment treaty for purposes of establishing ICSID jurisdiction. An appeal to annul the *Istrokapital* decision is currently pending; additional discussion of the decision's applicability to Gramercy's claim can be found here. Although the *Istrokapital* decision suggests that sovereign debt might not constitute a protected investment for purposes of establishing ICSID jurisdiction, Gramercy's claim is clearly distinguishable from that in *Istrokapital*. In contrast with the Slovakia-Greece BIT, whose definition of "investment" expressly includes loans but not bonds, the U.S.-Peru TPA expressly includes bonds in its definition of "investment." Additionally, the U.S.-Peru TPA includes an annex on public debt that, while establishing limits on investor claims, also confirms that sovereign debt falls within the scope of protected investments under the TPA. Finally, since Gramercy filed its notice of arbitration under UNCITRAL arbitration rules, it sidestepped the controversial question of whether the ICSID Convention imposes a test independent of the applicable investment agreement as to what constitutes a protected "investment."

It is notable that Gramercy invoked UNCITRAL arbitration rules. The U.S.-Peru TPA allows investors the choice of ICSID or UNCITRAL arbitration, and Peru and the U.S. are both parties to the ICSID Convention. Most known investment arbitrations have been conducted under ICSID rules; UNCTAD's Investment Dispute Settlement Navigator database includes 390 investment disputes adjudicated under ICSID rules (plus 42 under ICSID's Additional Facility rules) as opposed to 212 under UNCITRAL rules. One of the touted advantages of ICSID awards has been their perceived enhanced enforceability. This perception is being challenged by an increasing unwillingness on the part of states to voluntarily comply with ICSID awards, along with a split among U.S. courts over whether the U.S. Foreign Sovereign Immunities Act applies to petitions in U.S. court to enforce ICSID awards (addressed in this Kluwer Arbitration Blog post).

An issue that likely will be decisive to the merits of *Gramercy v. Peru* is whether Gramercy had legitimate investment-backed expectations of profit when it purchased the Land Bonds. Gramercy has not disclosed what it paid for the bonds, although it is likely that the bonds were purchased at a substantial discount from the USD 1.6 billion that Gramercy is claiming they are worth. In addition to the hyperinflation and currency changes that rendered the face value of the bonds meaningless, the debt has been in default for decades. To the extent that the true value of the bonds is highly uncertain, or that the market had discounted their value based on the probability that the debt would ever be repaid, a tribunal may find that the Constitutional Tribunal's decision and the subsequent decrees did not breach the treaty, or if they did, that Gramercy's damages were minimal.

In addition to the investment arbitration claim, Gramercy has put pressure on Peru by retaining Columbia Law Professor John Coffee to issue a legal opinion on whether the offering documentation for Peru's publicly-traded debt securities is materially misleading. In January 2016, Coffee issued an opinion letter, concluding that Peru's failure to adequately address its history with the Land Bond debt in its disclosures to investors is materially misleading, in violation of U.S. securities law.

Unlike Peru's publicly-traded debt securities, the Land Bonds at issue in *Gramercy* are unregistered domestic debt instruments, subject to local law and denominated in local currency. In this respect, Gramercy's claim raises distinct issues from those of another sovereign debt arbitration, Abaclat and others v. Argentine Republic, the mass claim against Argentina that settled earlier this year. The bonds at issue in Abaclat were denominated in foreign currency, subject to foreign law, and provided for resolution of disputes in foreign courts. In contrast with Gramercy, the unique challenges in *Abaclat* related less to the character of the debt than to the logistics associated with arbitrating mass claims under ICSID rules.

Istrokapital, *Abaclat* and *Gramercy* could be harbingers of a trend in favor of investment arbitration to enforce sovereign debt claims. However, the facts of *Gramercy* are unusual. Typically, creditors seeking enforcement of sovereign debt claims, including NML Capital and most other bondholders enforcing defaulted Argentine debt, have done so by bringing suit in London or New York. This option does not appear to be available to Gramercy; the Land Bonds presumably lack provisions selecting a foreign forum or waiving sovereign immunity. In any event, it is quite possible that the *Gramercy* dispute will end similar to *Abaclat*, with a negotiated settlement. Newly-elected Peruvian President Pedro Pablo Kuczynski, an Oxford- and Princeton-educated economist with experience in business as well as on Wall Street, may be more inclined to settle Gramercy's claim than his predecessor has been.

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