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Change of Trend: Award Condemns Peru to Compensate Investor for Breach of the Peru-USA FTA

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Despite the good results obtained for several years in its defense from investment arbitration claims, the Republic of Peru has become one of the countries with the highest number of arbitration claims filed against it. To date, nineteen cases have concluded, and twenty-three cases are pending resolution.

In December 2022, an award was issued in the *Gramercy vs Peru* case (Award) declaring that Peru has breached the Minimum Standard of Treatment (MST) required by customary international law, including the Fair and Equitable Treatment (FET) standard, guaranteed in Art. 10.5 of the Free Trade Agreement between the United States of America and Peru (Treaty).

The Award analyses in detail whether the measures taken by Peru to update the value of the "Bonos Agrarios" (Bonds) were contrary to the Treaty. To resolve this claim, the Tribunal first had to, among others, determine whether Grammercy was a protected investor, whether the Agrarian Bonds acquired by Gramercy are considered an investment under the Treaty and whether their acquisition by Gramercy constituted an abuse of rights.

We will first explain the origin of the Agrarian Bonds and the measures taken by Peru that gave rise to the claim, and then will describe how the Award substantially rejected Peru's jurisdictional defences and decided that there was a breach of Treaty guarantees that justified compensation to the investor.

Background

In 2016, two American companies, Gramercy Funds Management LLC and Gramercy Peru Holdings LLC (Gramercy), both incorporated under the laws of Delaware, filed a claim under the Treaty, which entered into force on February 1, 2009.

The story of the case goes back to 2006 and 2008 when Gramercy acquired Bonds from their legitimate holders (local Peruvian individuals). All of these transactions took place in Peru, and the money Gramercy invested in the Land Bonds amounted to US$ 33.2. million. The Bonds were endorsed in favor of Gramercy and a notarized contract was executed with each bondholder.

The Bonds were issued by Peru in the 1970's as a deferred payment to landowners for the land expropriation by the Peruvian Government, through the "Decreto Ley 17716 "*Ley de Reforma Agraria 1969.*" This was part of several measures of a de facto government in power from 1968 until 1980.

Due to the effects of accumulated inflation, the Bonds practically lost all value. Although the government of President Fujimori issued a law (the Legislative Decree 653) at the beginning of the 90s, declaring that the value of the expropriated land should be paid in cash at market value, this law was repealed by Congress through Law 26597, which established that any outstanding bonds would be paid according to their face value (which, as indicated above, was practically worthless), even without applying indexation.

Several years before the acquisition by Gramercy, the Peruvian Association of Engineers filed a lawsuit before the Peruvian Constitutional Court (Court) to have the Law 26597 declared unconstitutional. In 2001, the Court through Judgment TC 2001 declared the Law 26597 unconstitutional, considering it had confiscatory effects. The Court concluded that the Law 26597 violated the principle of property and ruled that "*principio valorista*" should be applied for the Bonds readjustment. In sum, the "*principio valorista*" is a general principle of Peruvian law that seeks to preserve the value of a debt, protecting it against fluctuations caused by inflation (or deflation) that might affect the original balance of the parties' rights and obligations. Despite the fact that this ruling applied the "*principio valorista*", the Court did not give any further guidance on how revaluation of the Bonds was to be made.

After two years, in 2013 the Court issued an enforcement order. The general thrust of this resolution was that the Bonds should be revaluated and the correct methodology for such revaluation was the dollarization of the historic debt using the parity exchange rate. The Resolución TC Julio 2013 required the Government to issue a Decreto Supremo (Supreme Decree) setting forth the procedure for identification and registry of bondholders, for the quantification of the outstanding debt, and the methodology for payment.

Allegedly aiming at giving an appropriate solution to the Bonds readjustment, between 2014 and 2017 Peru issued several Supreme Decrees, the last of them DS 242/2017, establishing the methodology and formulas to update the value of the bonds. Gramercy based its claim against Peru on the allegation that the various Supreme Decrees did not fulfil the alleged purpose; far from that, they constituted arbitrary measures in violation of the MST of aliens under Article 10.5 of the Treaty (Award, para. 683).

The Tribunal in a majority Award (with dissent of arbitrator Stern) dismissed Peru's jurisdictional and admissibility objections detailed below. On the merits, the Tribunal declared that Peru breached Article 10.5 of the Treaty through issuance of DS 242/2017, by imposing an arbitrary method for revaluation and payment of the Bonds. As a consequence, the Tribunal ordered Peru to pay Claimants US$ 33,222,630, plus interest.

Peru's jurisdictional objections

An important part of the Award was dedicated to analyzing and rejecting the various jurisdictional objections raised by Peru. Peru responded to Gramercy's claims with an impressive list of objections of all kinds, and the Tribunal carefully resolved each of them. Particularly, whether:

1. the Bonds constituted a protected investment in terms of the Treaty;
2. Claimants were seeking the retroactive application of the Treaty or incurring in abuse of rights;
3. Claimants met the Treaty's waiver requirement;
4. the claims were time barred;
5. Gramercy was an investor;
6. Peru could deny the benefit of the Treaty; and
7. Lack of authentication of the Bonds (a requirement to obtain payment under DS 242/2017).

Peru's procedural objections were aimed at disqualifying Gramercy's claim as not covered under the Treaty. Although Peru's attack was made on many fronts, the strongest arguments were that the Bonds were not an investment due to their characteristics, and the acquisition made by Gramercy could not be subject to protection, because it was made through an abuse of rights.

Of relevance, on the first issue, the Award emphasized that the Bonds did qualify as an investment under the criteria of the Treaty and case law. It also stated that what was at issue in the claim were neither the measures taken in the 70s and 80s, nor the measures issued in the 1990 s, which were later declared unconstitutional in 2001. What Gramercy was challenging were the Supreme Decrees issued after it acquired the Bonds, and through which the State impacted the value that Gramercy would have recovered. The Award further distinguished the measures that were subject of the claim from its historical background and concluded that there was no dispute as to when the Bonds were acquired, and that the challenged measures could not have been foreseen by Gramercy. The Tribunal rejected that Gramercy had made its investment to accede to the Treaty, noting that it had even initiated regular proceedings before domestic judges to obtain the payment of the Bonds.

On the second issue, the Tribunal emphasized that abuse of rights is a principle recognized by civilized nations but concluded that the threshold for finding an abusive initiation of the investment is high and has not been proven in this case.

Peru's substantive claims

In its analysis of the merits, the Tribunal concluded that the Supreme Decrees constituted measures against the MST provided under article 10.5.2 of the Treaty. The arbitrators highlighted that: (i) there was no explanation for the various changes to the Bonds payment that occurred in a short time between the four decrees; (ii) there was no documentation in the file explaining the amendments to the formulas introduced by Peru modifying the payment formulas; and (iii) neither Peru nor the experts had been able to explain the justification for these changes. In short, the Tribunal found that the measures adopted by Peru constituted a breach of the MST. In their words:

"these measures do not properly transpose the mandate received by the Constitutional Court but rather create an unjust regime, the sole purpose appears to be to minimize the amounts payable by the Republic to the holders of the Land Bonds, including (in particular) Gramercy" (Award, para. 986)

Finally, regarding the amount of compensation to be granted to Gramercy, the Tribunal indicated that:

"Claimants who have invested a total of US$ 32.2 million in the purchase of the Bonds are seeking compensation in a range between US$ 550 million and US$ 1.8 billion while the Republic says that any compensation must be based on the original amount invested, US$ 32.2 million, brought forward to present date or alternatively, on the amounts claimants would have collected under Supreme Decree 242/2017, US$ 33.57 million." (Award, para. 1287).

However, the Tribunal did not agree with Claimants' methodologies for the calculation of compensation. It rather adopted Respondent's proposal stating that:

"In situations where the breach does not lead to the total loss of the investment, the purpose of compensation must be full reparation, i.e., to place the investor in the same pecuniary position in which it would have been if the State had not violated its obligations under the BIT" (Award, para. 1302).

In the present case, the investor bought the Bonds in 2006-2008 and paid a total of USD 33,222,630 at a time when the Judgment TC 2001 had established that the principal of the securities had to be revalued to compensate for inflation, but the methodology to be applied was still unsettled.

Claimants presented five different alternatives of compensation. The first of them was based in the allegation that the current value of their Bonds, applying CPI indexation plus interest accruing at a compounded rate of 7.22%, summed USD 1.8 billion. The other four alternatives proposed different valorisations and the lowest of them proposed a compensation of around USD 550 million.

The Tribunal found that compensation should respect the full reparation criteria, through payment of a sum of money which, delivered to the investor, produces the equivalent economic value which, in all probability, the investor would benefit, "but for" the State's breach. Accordingly, the Tribunal rejected each of the Claimants' proposals.

The Dissenting Opinion

In arbitrator Brigitte Stern's dissenting opinion, she qualified the Award issued by the majority as utterly wrong in law and justice and considered it an abuse of process. For Stern, the Tribunal was wrong when they rejected Peru's defense of abuse of rights as not being sufficiently proven, since she considered it is clear from the record that Gramercy acquired its investment when the dispute had already arisen and did so in order to take illegitimate advantage of the Treaty.

Conclusion

The *Gramercy v. Peru* award confirms a change in the positive trend shown by Peru in previous years, as Peru has now been held responsible for the breach of an important investment treaty.

We have seen that although the Tribunal did not consider that all the guarantees mentioned by Gramercy had been violated, it did consider that the measures adopted by Peru, constituted a relevant breach of the MST, including the FET standard. However, it should be mentioned that the amount ordered by the Tribunal to compensate was far below from the amount requested by Gramercy and the Respondent's defences were accepted, particularly on this issue.

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