



International Arbitration Case Law

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TZA YAP SHUM V. REPUBLIC OF PERU (ICSID CASE NO. ARB/07/6) AWARD

Case Report by Kenneth Juan Figueroa*
Not Yet Edited

Final Award on Merits rendered on 7 July 2011, under the Agreement between the Government of the Republic of Peru and the Government of the People's Republic of China for the Reciprocal Promotion and Protection of Investment (the "BIT") and in accordance with the ICSID Convention.

- Tribunal:** Judd Kessler (President), Hernando Otero, and Prof. Juan Fernández-Armesto.
- Claimant's counsel:** Orlando Siu, Carlos Paitán and Christian Carbajal of Estudio Paitán y Abogados.
- Defendant's Counsel:** Carlos Valderrama of the Ministry of Economy and Finance of Peru and Louis B. Kimmelman, Stephen Jagusch, Nicole R. Duclos, and Anthony Sinclair of Allen & Overy LLP.

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Digest

1. *Facts of the Case*

Tza Yap Shum (“Tza”), a Chinese national commenced this arbitration against the Republic of Peru (“Peru”), claiming violations of the BIT that affected his investment in TSG del Perú S.A.C. (“TSG”), a Peruvian company involved in the purchase and exportation of fishmeal, primarily for Asian markets. Tza is a 90% indirect shareholder of TSG, having made an investment of US\$ 400,000. (para. 59-60, 74, 98)

TSG commenced its operations in 2002 and between 2002 and 2004 was among the 12 largest exporters of fishmeal in Peru, with sales greater than US\$ 20 million per year. TSG’s business model consisted of contracting with, and financing, fishing vessels for the purchase of raw materials. Such raw material would be delivered directly by fishing vessels to third-party transforming plants, with which TSG contracted for the production of fishmeal. The produced fishmeal was warehoused at the third-party plants until ready for export. Thus, TSG never handled any products directly and served primarily as a coordinating and financing agent. TSG’s comparative advantage in the industry consisted of access to financing from Tza’s network of personal relationships with businesses and individuals. While TSG did not obtain financing from Peruvian banks, it used Peruvian banks to conduct its transactions, including the receipt of loans from abroad, the execution letters of credits from buyers abroad, and generally keeping track of its payments, costs, and accounts receivables. (para. 74-76, 98-102).

In 2004, Peru’s taxing authority, the *Superintendencia Nacional de Administración Tributaria* (“SUNAT”), commenced an audit of TSG, which was conducted with the company’s cooperation. The audit appeared to be routine in nature and stemmed from TSG’s requests in the prior two years of refunds of certain amounts paid in connection with sales taxes. During the audit, SUNAT concluded that TSG’s books did not adequately reflect values for the raw material used in the production of fishmeal. SUNAT therefore, pursuant to the Peruvian tax code, utilized a “presumed basis” in its analysis rather than a basis based on TSG’s books and records. Based upon the presumed basis, SUNAT concluded that TSG had underreported sales volumes. SUNAT, therefore, imposed back taxes and fines totaling approximately 10 million Peruvian soles (“S/.”). (para. 78-81, 103-107)

Shortly after the audit, SUNAT also imposed interim measures which had the effect of attaching certain limited assets of TSG and directing all Peruvian banks to retain any funds passing through them in connection with TSG’s transactions. SUNAT is permitted under Peruvian law to impose interim measures to ensure the payment of tax debts in “exceptional circumstances”,

namely when the debtor has been uncooperative (by for example, failing to disclose material information) or when efforts to obtain payment of the tax debt would otherwise be unsuccessful. The report prepared by TSG's SUNAT auditor in support of the request for interim measures premised the request on TSG's "irregular behavior." The only behavior cited was SUNAT's determination that TSG's books had failed to accurately reflect the company's total sales volume. A second report was subsequently submitted by TSG's SUNAT auditor, which also premised the request on the failure to accurately reflect sales volumes and only modified the specific subsection of the Tax Code upon which the auditor based the request. Neither report provided specific support for the auditor's conclusions. Furthermore, SUNAT's executing division in charge of imposing interim measures (*la División de Control de la Deuda y Cobranza*) did not make any requests for additional information from the auditor before imposing the requested measures. (para. 108-124)

TSG challenged both SUNAT's audit determinations and its imposition of interim measures via administrative and judicial procedures available under Peruvian law. TSG commenced an administrative procedure requesting SUNAT to lift the interim measures on the basis that SUNAT had not adequately justified such measures. SUNAT rejected TSG's application, but reduced its calculation of back taxes. TSG also challenged SUNAT's decision before the Fiscal Tribunal, which affirmed the interim measures but further reduced the amount of back taxes to approximately S/. 3.1 million and ordered SUNAT to recalculate certain additional amounts. (para. 109-113).

Following the imposition of SUNAT's interim measures, TSG was unable to utilize Peruvian banks for its transactions. TSG's sales subsequently decreased dramatically and ultimately, TSG commenced a debt restructuring proceeding in March 2005, which had the effect of suspending the interim measures and permitted TSG to continue operating. (para. 83, 112, 164-170)

The Claimant Tza, the 90% shareholder of TSG, thereafter commenced an ICSID arbitration claiming that SUNAT's audit determinations and interim measures constituted an unjustified indirect expropriation of its investment, in violation of the BIT. Tza sought over S/. 57 million based on the projected cash flow of TSG, in addition to S/. 15 million for moral damages, plus interest (at a rate of 11%) and fees and costs. Total damages demanded therefore approximated US\$ 25 million. (para. 59-60, 85)

On 19 June 2009, the Arbitral Tribunal issued a Decision on Jurisdiction and Competence in which it determined that Tza's interest in TSG constituted an investment for purposes of the BIT and that the Tribunal was competent to determine Claimant's expropriation claims. (para. 28, 98)

In its Final Award on the Merits, the Tribunal found that SUNAT's imposition of interim measures constituted an arbitrary taking and thus an indirect expropriation of Tza's investment. However, the Tribunal declined to adopt Tza's measure of damages, instead basing its calculation of compensation on the adjusted book value of TSG and awarding US\$ 786,306.24, plus interest (at U.S. Treasury Bond rates). The Tribunal further ordered each party to split costs evenly. (para. 170, 218, 240, 252, 261-268, 279-280, 282-285, 292, 302)

2. *Legal Issues Discussed in the Decision*

(a) *Whether SUNAT's audit constituted an indirect expropriation of Tza's investment. (para. 95, 103, 113)*

The Tribunal found that the audit of TSG appeared to have been routine in light of TSG's request in prior years for large refunds on sales taxes. In light of the deference given to a State's regulatory and administrative powers, nothing in the conduct of SUNAT in conducting the audit constituted an expropriation. At the same time, the Tribunal also noted that TSG's challenges of SUNAT's determinations were not frivolous. (para. 95, 103, 113)

(b) *Whether SUNAT's imposition of interim measures constituted an indirect expropriation of Tza's investment. (para. 48-50)*

The Tribunal determined that the interim measures imposed by SUNAT were arbitrary in nature and constituted an expropriation for the following reasons:

(i) *The Interim measures significantly interfered with TSG's operations. (para. 152-170)*

The Tribunal found that the interim measures, which were legally binding on all affected banks, prevented TSG from continuing to transact with such banks. Given that TSG's business model used Peruvian banks to conduct its transactions, the interim measures presented a severe and substantial impact on TSG's business. The Tribunal found that, based on the information SUNAT obtained during its audit concerning how TSG was financed and operated, SUNAT should have known that interim measures were a "strike at the heart of the operative capacity of TSG." The Tribunal also noted that as a result of the interim measures, TSG's sales fell from an average of S/. 80 million for the 2005-2006 period to S/. 3.4 million for 2005-2006. Thus, the Tribunal distinguished the present case from the

circumstances in *LG&E Energy Corp. v. Republic of Argentina* (ICSID Case No. ARB/01/I), where it was held that the decrease in an investment's capacity and income generation, by itself, does not constitute expropriation.

The Tribunal dismissed Peru's argument that the interim measures could not constitute an expropriation because they were ultimately suspended by TSG's restructuring proceedings. The Tribunal noted that SUNAT's interim measures were imposed for a period of one year and subsequently extended to be in effect for an additional two years. While the restructuring proceeding had the effect, under Peruvian law of suspending SUNAT's interim measures and allowing TSG to continue to operate through Peruvian banks, the Tribunal noted that the TSG could only resume normal operations once the restructuring proceedings concluded in June 2006. The Tribunal further noted that the restructuring proceedings were commenced at TSG's own initiative and were a reasonable and necessary response by TSG under the circumstances to mitigate its damages. The Tribunal determined that Peru could not rely on TSG's own efforts to justify or minimize the impact of SUNAT's actions. (para. 152-170, 222).

(ii) *SUNAT's imposition of interim measures was arbitrary.* (para. 171-217)

The Tribunal recognized the deference given to a State's regulatory and administrative powers and noted the general rule that a State is not liable for any losses resulting from the good faith application of general taxes and regulations. However, the Tribunal also noted that this deference is bound by the principle of reasonableness and non-arbitrariness reflected in public international law, as well as Peruvian law and treaty practice.

Here, the Tribunal determined that SUNAT failed to comply with its own internal guidelines and procedures which required *inter alia* (i) a more precise identification of assets to be attached via interim measures, (ii) a reasoned basis for the "exceptional" remedy of interim measures accompanied by detailed evidentiary support, and (iii) efforts to avoid interfering with the debtor's business operations. The Tribunal also noted that SUNAT's executing division failed to make relevant inquiries or requests for additional information

from the auditor before imposing interim measures. As a result, the Tribunal found that SUNAT's actions were arbitrary in nature, resulting in unjustified losses on the part of TSG. (para. 117-217).

(iii) SUNAT's interim measures were ineffective. (para. 219-222)

The Tribunal determined that while SUNAT's interim measures had a severe impact on the continued operations of TSG, they ultimately failed to be effective. The Tribunal noted that due in large part to the lack of precise identification of assets, such interim measures secured assets worth only US\$ 172 out of the approximately US\$ 4 million tax debt that resulted from the audit. (para. 219-222).

(iv) TSG did not have recourse to effective due process. (para. 223-240)

The Tribunal recognized that TSG availed itself of administrative and judicial procedures to challenge the imposition of SUNAT's interim measures. However, the Tribunal held that such procedures did not amount to an adequate and effective legal recourse to SUNAT's decision. The administrative and judicial bodies that reviewed the interim measures failed to address and analyze sufficiently TSG's claims and, instead, adopted SUNAT's positions without a reasoned basis. The Tribunal found that TSG therefore had access only to formal, rather than substantive, legal recourse. (para. 223-240).

(v) TSG did not act in bad faith and did not fail to mitigate its damages. (para. 241-251)

Finally, the Tribunal rejected respondent's arguments that Tza had conducted himself in bad faith because of the manner in which he organized his investment in TSG and TSG's failure to use funds reimbursed by SUNAT to pay his tax debt rather than TSG's business loans. The Tribunal noted that neither the structure of Tza's investment (and his delegation of authority to others) nor TSG's decision to pay off its business debts (and thereby mitigate its damages) evidenced bad faith.

The Tribunal also rejected the argument that TSG failed to mitigate its damages by failing to request certain other

measures available to it under Peruvian law (e.g. requesting the executing division of SUNAT to substitute the interim measures or requesting waivers to make certain payments for the continued operation of TSG). The Tribunal found that it was doubtful that these additional measures would have been effective. It would therefore be unreasonable to expect TSG to exhaust these remedies. The Tribunal noted that TSG had mitigated its damages with the commencement of restructuring proceedings and that TSG's efforts to mitigate damages would be taken into account in the determination of damages. (para. 241-251)

- (c) *What is the appropriate compensation for expropriation? (para. 252-292)*

With respect to compensation, the Tribunal noted that standard that the measure of damages is the amount needed to place the Claimant in the same position he would have been without the expropriatory act. Both parties were in agreement that this amount should be based upon the value of TSG. However each party had different methods as to how to calculate the value of the company: Tza based his requested damages on the discounted cash flow of TSG, while Peru argued that the appropriate standard was the company's adjusted book value.

The Tribunal rejected Tza's requested damages, which were based on the discounted cash flow of TSG. The Tribunal noted that TSG had been in operation for only two years during which its cash flow was negative. TSG was highly leveraged, operated in the high risk fishing industry and had already begun to lose market share in the industry when SUNAT imposed its interim measures. In light of this, the Tribunal adopted Respondent's position that proper compensation should be based on TSG's adjusted book value, resulting in awarded compensation of US\$786,306.24. (para. 261-273).

The Tribunal rejected wholesale Claimant's request for moral damages. Relying on *Lemire v. Ukraine* (ICSID Case No. ARB/06/18), the Tribunal found that none of the conduct outlined in that case as justify moral damages (i.e. (i) physical harm or threat of harm to the investor, (ii) State action resulting in a deterioration of physical or mental health or

harm to reputation, and (iii) severe and substantial causes and effects of expropriation) existed here. (para. 274-285)

Finally, the Tribunal also rejected Claimant's requested interest rate of 11%. This rate was based on the rates used by TSG for its financing, and thus incorporated a risk factor that the Tribunal determined was no longer applicable post-expropriation. Instead, the Tribunal adopted respondent's position that the appropriate interest rate should approximate the rate of return had the damages awarded been re-invested for a favorable return. The Tribunal therefore ruled that the interest rate on damages would be tied to the average monthly rate on 10-year U.S. treasury bonds. At the date of the Award, the interest awarded was US\$227,201.30. (para. 286-292).

(d) *Which party should bare the costs of arbitration? (293-302)*

The Tribunal observed the different perspectives of certain arbitral tribunals with respect to awards on costs, including the principle that the losing party pays (citing *Methanex* and *EDF*) 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 during the arbitration (citing *Waste Management II*).

The Tribunal lauded the parties' conduct during the arbitration and concluded that it would not depart from the generally accepted practice of splitting costs equally between the parties. (para 296-301).

3. Decision

SUNAT's imposition of interim measures constituted an indirect expropriation of Tza's investment. With respect to damages, the adjusted future cash flow of TSG was an inappropriate basis for compensation. Instead compensation was based upon the adjusted book value of TSG. Thus Tza was awarded US\$ 786,306.24 in compensation, plus interest (at U.S. Treasury Bond rates). No moral damages were awarded and costs were to be paid equally by each party. (para. 170, 218, 240, 252, 261-268, 279-280, 282-285, 292, 302)