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Case summary

Southern Pacific Properties (Middle East) Ltd.
v
Arab Republic of Egypt

Year of the award: 1992
Forum: ICSID
Applicable law: Egyptian law, international law

Arbitrators	**Timeline of the dispute**
Dr. Eduardo Jiménez de Aréchaga – President Dr. Mohamed Admin El Mahdi Mr. Robert F. Pietrowski	24 August 1984 – notice of arbitration 18 December 1984 – arbitral tribunal constituted 20 May 1992 – arbitral award

Table of contents

I. Executive Summary

In 1974, SPP, a Hong Kong company, entered into agreements with Egypt to establish a joint venture (ETDC) with a view to develop an international tourist complex at the Pyramids Oasis in Egypt. SPP's Egyptian subsidiary, SPP(ME), held 60% of shares in ETDC, with the remaining 40% owned by the Egyptian partner.

The project went ahead until 1978 when, as a result of parliamentary opposition, the Government effectively cancelled the project placing ETDC in judicial trusteeship. By that time, SPP(ME) and SPP had invested approximately US$ 5 million in the project (capital contributions and loans to ETDC, expenses for infrastructure design and development) and sold 286 building lots for a total of more than US$ 10 million.

In 1978, pursuant to the contractual arbitration clause, SPP and SPP(ME) commenced an ICC arbitration, and obtained an award of US$ 12.5 million in damages. However, this award was later annulled by French courts on jurisdictional grounds.

In 1984, the Claimants decided to take the same matter before an ICSID Tribunal, pursuant to Egyptian Law which contained an ICSID arbitration provision. The Claimants maintained that Egypt's actions violated the agreements and amounted to expropriation of the investment, and thus claimed compensation for the value of their investment in ETDC plus interest.

In its 1992 award based on Egyptian and international law, the Tribunal held that Egypt's actions constituted a lawful expropriation of the Claimants' investment (their shareholding in ETDC) and that Egypt was therefore liable to pay "equitable compensation" for the value of the expropriated investment. In establishing this value, the Tribunal rejected the Claimants' DCF analysis, as well as the analysis based on past sales of SPP(ME)'s shares. The Tribunal awarded all out-of-pocket expenses incurred by the Claimants with interest at a 5% rate, prescribed by Egyptian law, and with an upward adjustment to account for post-1978 US dollar devaluation. In addition, the Tribunal compensated the Claimants for the loss of opportunity to make a commercial success of the project. In total, the Tribunal awarded US$ 27.6 million.

II. Factual Background and Claims of the Investor

In 1974 Southern Pacific Properties Limited ("SPP"), a Hong Kong company, and the Egyptian general Organization for Tourism and Hotels ("EGOTH"), an Egyptian public sector entity established by decree, concluded two agreements (framework and supplementary) for the development of two international tourist complexes in Egypt, one at the Pyramids Oasis one on the Mediterranean coast. Both agreements were also signed by the Egyptian Minister of Tourism.

As envisaged by the agreements, SPP and EGOTH created a joint venture company "ETDC" for the development of the complexes, SPP holding 60% interest and EGOTH 40%. SPP incorporated a wholly-owned subsidiary company, Southern Pacific Properties (Middle East) Limited ("SPP(ME)") to hold SPP's shares in ETDC.

Under the agreements, the Ministry of Tourism undertook to secure the title to property and the possession of land for EGOTH. The Ministry and EGOTH undertook to transfer the right of usufruct for such property to ETDC as EGOTH's capital contribution for its 40% share in ETDC. On its part, SPP agreed to obtain the necessary financing for the projects.

Implementation of the project went ahead until early 1978 when parliamentary opposition to the Pyramids Oasis project was raised, particularly in view of the antiquities discovered in the project area. The Government took a series of measures, including two Presidential Decrees, which had the effect of canceling the project and placing ETDC in judicial trusteeship. By that time, SPP(ME) and SPP had invested approximately US$ 5 million in the project. In addition, ETDC sold 286 lots on which villas and multi-family accommodations were to be built, for a total of more than US$ 10 million.

As the supplementary agreement contained an ICC arbitration clause, in 1978 SPP and SPP(ME) commenced an ICC arbitration, claiming the value of SPP(ME)'s shareholding in ETDC, (which allegedly had become worthless as a result of the cancellation of the project), as well as lost profits. In 1983 the ICC Tribunal awarded US$ 12.5 million in damages, but the award was subsequently annulled by the Paris *Cour d'Appel* on jurisdictional grounds.

In 1984, SPP(ME) filed a request for arbitration at ICSID, asking for relief in the same matter. That arbitration was initiated pursuant to the Egyptian Law No.43 which contained a provision enabling investors to refer certain disputes to ICSID. SPP was later joined as Claimant alongside SPP(ME) to the case.

The Claimants submitted that Egypt's actions had violated the agreements and amounted to expropriation of the investment. They sought compensation for the value of their investment in ETDC, the amount of loans made to ETDC, post-cancellation project costs and post-cancellation legal, audit and arbitration costs, together with compound and contractual interest. In the alternative, the Claimants claimed the value of their investment in ETDC on the basis of their out-of pocket expenses, plus compensation for loss of opportunity. As a further alternative, the claimants claimed for their out-of-pocket expenses only.

Egypt submitted a counterclaim arguing, *inter alia*, that its cancellation of the project had been required by both Egyptian and international law, in particular by the 1972 UNESCO Convention for the Protection of the World Cultural and Natural Heritage.

III. Findings on Merits[1]

A. Applicable law

The Tribunal held, pursuant to Article 42(1) of the ICSID Convention, that in the absence of any specific agreement between the parties, the applicable law was the law of Egypt. However, it also stated that where municipal law contained a *lacuna* or its application would violate international law, the Tribunal was bound to apply directly the relevant principles and rules of international law (supplementary and corrective function of international law). (para.84)

B. Expropriation

The Tribunal found that the decision to cancel the project was a lawful expropriation for public purpose (preservation and protection of the antiquities in the area). However, the rules of both Egyptian law and international law imposed an obligation to indemnify parties whose rights had been affected by expropriation. (paras.158-159)

The Tribunal defined, as an object of expropriation, not the land or the right of usufruct held by ETDC, but SPP(ME)'s rights as a shareholder of ETDC, derived from the right of usufruct. In the Tribunal's view, those rights and interests were entitled to the protection of international law despite their contractual nature, and thus compensation for the taking of those rights was due. (para.164)

The Tribunal also held that the UNESCO Convention did not exclude the Claimants' right to compensation, as the Convention became binding on Egypt only in 1979, and only from that date Claimants' activities on the Pyramids site became internationally wrongful. (para.154)

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

As discussed above, the Tribunal applied Egyptian law subject to the supplementary and corrective function of international law.

B. Standard of Compensation

The Tribunal applied the standard of fair compensation enshrined in Egyptian law and emphasized that the Claimants were entitled to receive fair compensation for the value

[1] The award was adopted by majority with one arbitrator (Egyptian appointee) issuing a dissenting opinion, in which he declined Egypt's liability. Prior to this award on merits, the Tribunal issued two decisions on jurisdiction (of 27 November 1985 and of 14 April 1988) which are not covered in this summary.

of the expropriated investment rather than damages for breach of contract. (paras.159, 183, 212, 214)

Importantly, the Tribunal also elucidated the general principle that "the measure of compensation should reflect the claimant's loss rather than the defendant's gain". (para.247)

C. Heads of Damages Claimed

The Claimants submitted three alternative claims for compensation:

1) The first claim included compensation for the value of the investment in ETDC at the time the project was cancelled (calculated on the basis of the DCF analysis and of past sales of shares), the amount of the loan to ETDC, post-cancellation project costs for 1978 and 1979 and post-cancellation legal, audit and arbitration costs from 1980 to 1990, together with compound and contractual interest.
2) The first alternative claim included the value of their investment in ETDC at the time the project was cancelled, calculated on the basis of Claimants' out-of pocket expenses plus compensation for loss of the chance or opportunity of making a commercial success of the project;
3) As a second alternative, the Claimants claimed for their out-of-pocket expenses only (without compensation for the loss of opportunity).

As summarized below, the Tribunal rejected both the DCF analysis and the shares-transactions approach. The Tribunal made its award on the basis of the first alternative claim.

D. Claims Rejected

1. DCF analysis

To calculate the value of the investment at the time of taking, the Claimants relied on the DCF method to determine the present value of the future earnings expected to be generated by ETDC. In applying the DCF method, the Claimants first estimated the net revenues that would have been earned over the initial 18-year period of development, and then discounted that revenue flow to the present value (value on the date the project was cancelled) and further reduced this figure to 60% (SPP(ME)'s share). To project revenues into the future, the Claimants used the actual lot sales made during the project's lifetime. (paras.184-185)

The Tribunal decided that the DFC method was not appropriate in this case because the project had not been in existence for a sufficient period of time to generate the data necessary for a meaningful DCF calculation. At the time of project cancellation only 6% of the lots had been sold; all other lot sales were hypothetical. The project was in its infancy and there was very little history on which to base projected revenues. (para.188)

The Tribunal concluded that the application of the DCF analysis would result in awarding "possible but contingent and indeterminate damage" and "speculative or uncertain damage", which would be contrary to the settled rules on international responsibility of States (with references to *Chorzow Factory* and *Amoco* cases). (para.189)

The Tribunal also rejected the DCF analysis on the grounds that from1979 onwards the Claimants' activities on the Pyramids Plateau would have been in conflict with the UNESCO Convention, and since then any profits that might have resulted from such activities would be non-compensable. Therefore, it would be inappropriate to base DCF analysis on the profits projected beyond 1979. (paras.190-191)

2. Shares transactions approach

To support their DCF calculations, the Claimants further relied on certain transactions of SPP(ME)'s shares, in particular the sale in 1976 of 25% of SPP(ME) to two members of the Saudi Arabian royal family, the offer from a third member of the Saudi Arabian royal family, and repurchase by SPP(ME) of some of its shares. On the basis of each of these transactions, the Claimants' expert calculated the overall value of SPP(ME) and determined how much of this value accounted for SPP(ME)'s 60% ownership in ETDC. (paras.192-193)

The Tribunal started off by saying that "the purchase and sale of an asset between a willing buyer and a willing seller should, in principle, be the best indication of the value of the asset. This is certainly true in the case of a perfectly competitive market having many buyers and sellers in which there are no external controls or internal monopolistic arrangements." (para.197)

However, the Tribunal decided that in the present case "there was a very limited number of transactions and there was no market as such for the shares that were sold. The price at which the shares were sold was privately negotiated." (para.197) For these reasons, the Tribunal concluded that the mentioned share transactions could not be used to accurately measure the value of SPP(ME)'s investment in ETDC.

E. Damages Awarded

The Tribunal decided that the first alternative claim – for out-of-pocket expenses and loss of opportunity – was justified and that an award on this basis would constitute fair compensation.

1. Out-of-pocket expenses

The Tribunal determined that the following should be reimbursed as part of out-of-pocket expenses:

a) SPP(ME)'s capital contributions and loans to ETDC (the total amount of approx. US$ 3.4 million, not disputed by the Respondent);

b) Pre- and post-cancellation "development costs", i.e. expenses associated with construction and marketing activity that was carried out in relation to the project;
c) Post-cancellation legal, audit and arbitration costs from 1980 to 1990.

The Tribunal held that development costs could be reimbursed only to the extent these expenses were proven. In particular, in the procedural order of 13 February 2001 the Tribunal requested the Claimants to provide evidence as to:

- nature, date and amount of the development costs;
- names of recipients of payments in excess of US$ 20,000;
- confirmation that these sums were legitimately and actually expended;
- confirmation that they were directly connected with the project;
- explanation of why these costs were not charged to or were not directly recovered from ETDC.

(para.200)

It is important to note that the Claimants demanded indemnification for *their* costs, not those incurred by ETDC. The items in question primarily involved the allocation of salaries and costs incurred by executives and employees of SPP such as overhead costs, travel and entertainment expenses, and costs incurred for recruiting and relocation of personnel, consultations concerning marketing and banking, and so forth. The Tribunal reasoned that because the project was cancelled, the Claimants could not recoup these expenses with future profits and the expenses thus became irrecoverable losses. (para.202) The Tribunal awarded US$ 1,719,000 in development costs but refused to award costs for which the Claimants were not able to identify the payee (US$ 1,545,000). (para.203)

As for the post-cancellation legal, audit and arbitration costs, these included *inter alia* costs resulting from the ICC arbitration and related court proceedings in France. The Claimants contended that a great deal of research and preparation involved in the ICC arbitration obviated the need to undertake the same work in the ICSID proceedings. The Respondent objected arguing that the awards and judgments in other cases had already decided the question of costs incurred in those proceedings.

The Tribunal considered that "in cases as the present one, where the measure of compensation is determined largely on the basis of out-of-pocket expenses incurred by the claimant, there is little doubt that the legal costs incurred in obtaining the indemnification must be considered as part and parcel of the compensation, in order to make whole the party who suffered the loss and had to litigate to obtain compensation. This is particularly so when, as in this case, the amount offered as compensation by the Respondent was manifestly insufficient." (para.207)

On the basis on the detailed list of all payments submitted by the Claimants, the Tribunal awarded in full those legal and accounting fees and expenses that were incurred solely in connection with the ICSID proceedings (US$ 4,242,000). The Tribunal also awarded half of the costs incurred in connection with the ICC proceedings and related courts proceedings as being relevant to the ICSID proceedings. The Tribunal determined that, in total, relevant costs amounted to US$ 5,092,000. (paras.210-211)

2. Loss of commercial opportunity

Without giving a specific figure, the Claimants requested the Tribunal to fix an "additional amount" to compensate "for the loss of the chance or opportunity to make a commercial success of the project".

The Tribunal was convinced that at the time of project cancellation the *value of the Claimants' investment* exceeded the out-of-pocket expenses; the indication of this was that the Claimants had already sold some of the sites, and construction of infrastructure was well under way. To compensate for this additional value of the investment, the Tribunal used the concept of "loss of commercial opportunity". (paras. 212-214)

The Tribunal admitted that a monetary assessment of the loss of opportunity "necessarily involves an element of subjectivism and, consequently, some uncertainty." However, in the Tribunal's view, it was well-settled that the fact that damages could not be assessed with certainty was no reason not to award damages when a loss had been incurred. (para.215)

The Tribunal determined the relevant amount on the basis of sales of villas and multi-family sites by ETDC before project cancellation (approx. US$ 10 million). The Tribunal noted that those sales represented a very small percentage of the possible future sales and that remaining lots were a "potential source of very substantial revenues". Therefore the Tribunal used those actual sales to determine the "minimum measure of the value of the loss of commercial opportunity". To arrive at this value, the Tribunal calculated the difference between the Claimants' expenditures and the portion of imputed revenues corresponding to SPP(ME)'s 60% shareholding in ETDC. The final figure was approx. US$ 3 million. (paras.216-218)

F. Interest

The Tribunal applied Egyptian law to the calculation of interest, as there was "no rule of international law that would fix the rate of interest or proscribe the limitations imposed by Egyptian law" (Egyptian law prohibited award of compound interest). (para.222) Therefore, the Tribunal awarded simple interest at the rate of 5% p.a., as prescribed by Egyptian law.

However, Egyptian law did not contain rules as to the **date** from which interest should run. Given this *lacuna*, the Tribunal thought it legitimate to apply the "logical and normal principle usually applied in cases of expropriation, namely, that the *dies a quo* is the date on which the dispossession effectively took place, since it is from that date that the deprivation has been suffered." This principle, the Tribunal stated, was supported by doctrine and the jurisprudence of international tribunals. (para.234) The Tribunal added that fixing the *dies a quo* from the date of filing the claim or the date of the award, as requested by the Respondent, would encourage parties who expropriated property to refuse to pay compensation and to delay the proceedings seeking compensation. (para.234)

As to the *dies ad quem* for the running of interest, the Tribunal noted that the prevailing jurisprudence in international arbitration was to the effect that interest run until the date of effective payment. (para.235)

G. Monetary Adjustment for Currency Devaluation

Since 1978 the US dollar had undergone significant devaluation. The Tribunal decided that for the compensation to be fair, the award of Claimants' out-of-pocket expenses should be adjusted upward to account for this devaluation, in order to give the Claimants the same purchasing power as they had in 1978. The Tribunal noted that if it applied a "commercial" rate for the award of interest, this adjustment would not be necessary, as commercial rates of interest included adjustment for inflation (and thus devaluation). (paras.237-239) In support of its devaluation adjustment, the Tribunal referred to the *Aminoil* arbitration (where the award was adjusted to account for inflation) and Egyptian law. (paras.240-242)

In making the adjustment, the Tribunal used a "deflating factor" derived from the data of the International Monetary Fund computed on the basis of the US Consumer Price Index (2.2 in December 1991). In other words, the purchasing power of US$ 100 in 1978 was equivalent to the purchasing power of US$ 220 in 1991. (para.243)

The Tribunal limited this adjustment to out-of-pocket expenses only and did not adjust its award for the loss of commercial opportunity "because of the nature of that particular cost and the method by which it was determined". (para.244)

V. Implications / Initial Analysis

- **Types of compensation.** The Tribunal seemed to contrast compensation for expropriation with damages for breach of contract. However, it did not explain what exactly the difference was.
- The Tribunal noted that the **measure of compensation** should reflect the claimant's loss rather than the defendant's gain. This implies that the amount of unjust enrichment of the defendant should not be used as a measure of compensation.
- The Tribunal elucidated rules on international responsibility of States whereby "no reparation for **speculative or uncertain damage** can be awarded".
- This case falls in line with other existing case-law where tribunals rejected the use of **DCF analysis** to assess the value of enterprises without a sufficient track-record of business operations and adequate data for projection of revenues into the future.
- In the course of **DCF analysis** (or the award of future profits), attention should be paid to the possible future business obstacles to deriving the profits. In this case, the Claimants' activities would have become contrary to international law from 1979 onwards (as a result of Egypt's international obligations under

the UNESCO Convention). Therefore no lost profits could be awarded beyond that date.

- The Tribunal's approach to the **share-transactions method** appears overly strict. The Tribunal declined the use of this method because (1) there was a very limited number of transactions (however, there were at least two transactions and one offer, representing, in total, more than 25% of shares); (2) there was no market as such for the shares that were sold (does it mean that this method can only be applied for publicly-traded shares?), and (3) the price at which the shares were sold was privately negotiated (does this mean that a privately-negotiated price never reflects what a willing buyer would pay to a willing seller?). This approach can be contrasted with the Tribunal's approach in the more recent *CME v. Czech Republic* case, where the Tribunal used the offer-approach to estimate the value of the company (in that case the offer was privately negotiated, there was no market, but the offer was for the whole company).
- This case offers guidance as to the **evidence** required to support out-of-pocket expenses.
- In this case the Tribunal took the fairly unusual decision to award **legal and arbitration costs** relevant to the ICSID proceedings as part of the compensation for expropriation and not under a separate heading. The Tribunal also awarded half of legal costs incurred during other proceedings relating to the same events.
- The Tribunal supported the view that the **value of investment** is in most cases higher than the actual expenditures incurred in relation to the investment project, as the investment also carries the prospect of future commercial benefits. The same reasoning will hold true in the context when tribunals award damages on the basis of the book value of assets.
- The Tribunal admitted that an assessment of certain heads of damages (in particular, loss of opportunity) involved a degree of **subjectivism and uncertainty**. However, the Tribunal refused to consider it an impediment when it was obvious that the damage had been incurred. This is an important finding, given that in many cases assessing the value of investment (especially in cases of projections into the future) a degree uncertainty is necessarily involved. At the same time, the Tribunal seems to contradict its earlier statement that "no reparation for speculative or uncertain damage can be awarded" (for this reason the Tribunal rejected the DCF analysis).
- Compensation of the **loss of commercial opportunity** was done on the basis of the same data that were considered insufficient for DCF analysis. This might suggest that the "loss of opportunity" concept may be used where the investment is in the initial stages of operation and where the data is insufficient for a more sophisticated economic analysis. This might also imply that compensation for the loss of opportunity would normally be less than that for lost profits or for the going concern value.
- To calculate the value of the **loss of opportunity**, the Tribunal estimated the revenue and deducted relevant expenditures. This technique is similar to the estimate of future profits, the difference being that the Tribunal did not use

projections for the future but used figures of sales already made at the time of project cancellation.

- **Interest**. According to the Tribunal, there is no rule of international law that would fix the rate of interest or prescribe whether interest should be simple or compound.
- **Date of interest.** The Tribunal noted that it was customary to calculate interest from the date of expropriation (not from the date of filing the claim or from the date of the award).
- **Adjustment for inflation/devaluation of currency.** Only for out-of-pocket expenses. The adjustment can be applied when the interest rate does not cover currency devaluation as a result of inflation. IMF data used to calculate the deflator factor. Although the gist of the Tribunal's reasoning on this issue is quite clear, there might be some confusion in terms. The term "currency devaluation" is refers to currencies with *fixed* exchange rates, whereas the term "depreciation" is appropriate for currencies with *floating* exchange rates (such as US dollar since 1973). In addition, currency depreciation is not a function of inflation only; there might be other important factors, such as trade deficit, that lead to depreciation.