

Case summary

Petrobart Limited v The Kyrgyz Republic

Year of the award: 2005

Forum: Arbitration Institute of the Stockholm Chamber of Commerce

Applicable investment treaty: Energy Charter Treaty (1994)

Arbitrators

Justice Hans Danelius, President
Prof. Ove Bring
Mr. Jeroen Smets

Timeline of the dispute

1 September 2003 - notice of arbitration
29 March 2005 - arbitral award

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I. Executive Summary

Petrobart Ltd, registered in Gibraltar, contracted with KGM, the Kyrgyz state gas company, to supply and deliver 200,000 tons of gas condensate. Petrobart made five deliveries but was only paid for the first two as KGM was in severe financial difficulties. Petrobart sued KGM in the domestic Bishkek Court and obtained a debt judgment of the outstanding amount of US\$ 1.5 million. Following the request of the Vice Prime Minister of the Kyrgyz Republic, the Bishkek Court stayed the execution of that judgement for three months. During this period, pursuant to a Presidential decree, KGM was restructured, with the majority of its assets being transferred to other state-owned firms. KGM was subsequently declared bankrupt, and Petrobart could not satisfy its debt judgment nor obtain any proceeds from the sale of assets.

Petrobart initiated arbitral proceedings against the Kyrgyz Republic under the Energy Charter Treaty, claiming that the Republic, by means of its interventions in the judicial proceedings and the Presidential decree ordering KGM's reorganization, failed to provide it with stable, equitable, favorable and transparent conditions, as prescribed by Article 10(1) of the Treaty, and breached other articles of the Treaty. The parties agreed to an arbitration procedure on written submissions only.

After dismissing jurisdictional challenges, the Tribunal found that the Kyrgyz Republic was under an obligation to carry out the KGM's reorganization in a way which would "respect" and protect the rights of Petrobart under the Treaty. The Tribunal held that the Vice Prime Minister's request to stay the execution of the judgment against KGM was an attempt to influence a judicial decision to Petrobart's detriment. The Tribunal concluded that the Kyrgyz Republic violated Article 10(1) and Article 10(12) of the Treaty.

The Tribunal concluded that the removal of assets from KGM had substantially affected Petrobart and that there was a "strong likelihood" relationship between the Treaty breach and the damage to the investor. Since the submissions to the Tribunal did not contain information sufficient for an accurate calculation, the Tribunal estimated damages caused by the removal of the assets from KGM at 75% of the value of the original debt judgment (US\$ 1.1million) plus simple interest – in accordance with UNIDROIT Principles – from the date of the debt judgement. The Tribunal rejected the claim for lost profits as not sufficiently established, as well as the claim for legal expenses incurred by Petrobart in the course of domestic legal proceedings.

II. Factual Background and Claims of the Investor

In February 1998, Petrobart Limited ("Petrobart"), a company registered in Gibraltar, entered into a contract ("the Contract") with Kyrgyzgazmuniazat ("KGM") for the supply and delivery of 200,000 tons of gas condensate. By March 1998, Petrobart had supplied five gas deliveries to KGM and invoiced US\$ 2,457,620. KGM paid only the first two invoices of US\$ 951,976, and claimed that financial difficulties prevented further payment. KGM suspended further deliveries.

To deal with KGM's mounting debt, the President of the Kyrgyz Republic decided to restructure the company. In September 1998, he issued a Presidential Decree ordering the transfer or lease (at undervalue) of some of KGM's valuable assets to two newly formed State companies but the liabilities were to remain with KGM.

Petrobart initiated proceedings before the domestic Bishkek Court in order to recover its outstanding debt from KGM, and obtained a debt judgment of US\$ 1,507,812. No payment was made, a writ of execution was issued and the Court Bailiff seized a portion of KGM's assets and scheduled these for auction to raise proceeds to satisfy Petrobart's debt. However, in February 1999 the Court received a letter from the Vice Prime Minister of the Republic requesting the Court to grant a stay of execution for three months, which the Court granted until May 1999.

In March 1999 an extraordinary meeting of KGM shareholders gave effect to a January 1999 Government Decree (which had called for the implementation of the September 1998 Presidential Decree), and transferred some of KGM's assets to Kyrgyzgaz. In April 1999, KGM was recognized as bankrupt by the Court, and Petrobart was included in the list of creditors to be satisfied in third priority.

Petrobart initiated international arbitration proceedings in March 2000 (the "UNCITRAL Arbitration") against the Kyrgyz Republic, under the Kyrgyz Foreign Investment Law that provides a mechanism for investor-State arbitration under the UNCITRAL rules. The UNCITRAL Tribunal decided that the Contract did not fall under the definition of "investment" in the Foreign Investment Law, and hence it did not have jurisdiction to try Petrobart's claims.

In 2003, Petrobart submitted a request for arbitration against the Kyrgyz Republic to the Arbitration Institute of the Stockholm Chamber of Commerce ("the SCC Institute"), under the Energy Charter Treaty (signed 1994, entered into force 1998), as ratified by the Kyrgyz Republic and the United Kingdom. Petrobart claimed that the acts of the Kyrgyz Republic breached the following obligations of the Treaty:

- Creation of stable, equitable, favourable and transparent conditions for the investment; fair and equitable treatment of the investment; no unreasonable impairment of use and enjoyment of the investment; observation of the contractual obligations entered into; according the investment treatment no less favourable than that required under international law (all under Article 10(1) of the Treaty);
- Ensuring that domestic law provides effective means for assertion of claims and enforcement of rights with respect to investments (Article 10(12));
- No expropriation or measures equivalent to expropriation (Article 13(1));
- Ensuring that a state enterprise conducts its activities in a manner consistent with the Republic's obligations under Part III (Article 22(1)).

Petrobart requested compensatory damages to the value of the debt judgment (US\$ 1,507,812 plus interest), compensation for further loss of profits (US\$ 2,376,339 plus interest), and outlays and related expenses (US\$ 200,500 plus interest), and any other such relief as the Tribunal thinks appropriate. The Kyrgyz Republic contested these

claims. To speed up the process, the parties agreed to provide written submissions and evidence only, with no oral proceedings.

III. Findings on Merits¹

A. Applicable law

The Tribunal determined that the Energy Charter Treaty (“the Treaty”) was applicable despite the fact that the Claimant was a company registered in Gibraltar, on the grounds that in the UK ratification procedure Gibraltar had not been expressly excluded by the UK.

B. Fair and Equitable Treatment Claim - Article 10(1)

On the facts, the Tribunal found firstly that Kyrgyz the Republic failed to comply with its duty under the Treaty to conduct acts in such a way as to “respect Petrobart’s rights as an investor” (p76). Although the actions to restructure KGM may have been necessary as part of a re-organisation programme for a State-owned enterprise in financial difficulty, only the assets of KGM, but not its liabilities, were transferred - to the disadvantage of KGM’s creditors, including Petrobart (p75). The Tribunal attached “particular weight” to this act by the Respondent (p76).

Secondly, the Tribunal found that the Vice Prime Minister’s request to stay the execution of the Bishkek Court’s debt judgement was “an attempt by the Government to influence a judicial decision” in favour of the Respondent. Such acts once again showed a “lack of respect” for Petrobart’s rights as an investor (p75). This act was seen as an “additional element” which contributed to the finding.

Hence the Tribunal found that the Kyrgyz Republic failed to accord Petrobart fair and equitable treatment of its investment in violation of Article 10(1) of the Treaty.

C. Article 10(12) of the Treaty

The Tribunal also found that the Vice Prime Minister’s letter requesting the stay of execution violated the Republic’s obligation to “ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to Investments, investment agreements, and investment authorizations”. (Article 10(12))(p77).

¹ Before proceeding to the merits, the Tribunal found that Petrobart was an “investor” under Article 1(7) of the Treaty, and Petrobart’s right to receive payment under the Contract was an “investment” for the purposes of Article 1(6). The Tribunal also rejected the Republic’s argument that under the doctrine of *res judicata* previous tribunals’ rulings prevented Petrobart from bringing a claim in this forum. Hence the Tribunal had jurisdiction over the claims.

D. Other Claims under Articles 13(1) and 22(1) - Rejected

The Tribunal rejected the claim under Article 13(1) that the measures taken by the Republic attained the level of *de facto* expropriation, as it was not clear that the measures taken were directed specifically against the investment or had the aim of transferring economic value from the Claimant to the Republic (p77).

Further, the Tribunal rejected the claim under Article 22(1) that the Republic failed in its obligation to ensure that the state enterprise KGM conducted its business in a manner consistent with Part III of the Treaty (p77).

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

In its award of damages, the Tribunal applied the Treaty and international law.

B. Standard of Compensation

The measure of damages was calculated so that Petrobart be placed, so far as possible, in the financial position it would have found itself had the breaches not occurred (p78).

C. Damages Claimed

Petrobart claimed it would have received full compensation under the debt judgment if the Republic had not requested the stay of execution. Petrobart contended that before the Republic's interference KGM had sufficient assets to satisfy the judgment and denied that KGM had been insolvent when the Contract was entered into. Further, Petrobart argued that the Republic frustrated the performance of the Contract and deprived Petrobart of its future profits had the Contract been fully performed. While specific performance would be the usual remedy for this type of claim, Petrobart requested that compensation in lieu be paid as specific performance was impossible in the circumstances.

Petrobart claimed:

- i) The full value of the debt judgment of US\$1,507,812;
- ii) Future profits on the remaining amount of undelivered gas condensate of US\$2,376,339;
- iii) Outlays and expenses related to pursuing the performance of the Contract of US\$200,500;
- iv) All costs related to the arbitration;
- v) Any other such relief as the Tribunal may deem appropriate.

The Republic denied Petrobart's claims, stating that Petrobart was in no worse a position than it would have been in had the Republic not committed the "interference" claimed, since KGM was insolvent at the time of the Contract and did not have sufficient assets to satisfy its debts. The Republic stated that Petrobart's claim for future profits was unfounded as KGM could have ceased to order gas condensate at any time and was not bound under the Contract to purchase from Petrobart.

D. Effects of the Transfer of Assets

The crucial question for the Tribunal concerning the transfer of assets by the Republic was whether KGM was insolvent before the asset transfer. To determine this, the Tribunal requested written answers to its questions, but the replies and comments received were not of sufficient detail for accurate calculations. The Tribunal decided to proceed by an "estimated assessment" based on the information provided, because the parties had agreed to only one round of written questions and answers with no oral submissions.

On the facts, the Tribunal decided that KGM was in a vulnerable financial position before the transfer of property, although this did not mean that its creditors could not be satisfied from the assets available at the time. Hence the transfer of the assets "aggravated, rather than created, the company's troublesome economic situation".

1. Causation

The Tribunal found it clear on the facts that assets of a high value were transferred from KGM. However, if KGM was insolvent at the time, as the Republic contended, the Tribunal noted that the asset transfer may not have been in conformity with the Republic's own bankruptcy laws. From these observations, the Tribunal concluded that the transfer of assets but not liabilities "must have caused considerable damage to KGM's creditors as a group", and therefore there was a "strong likelihood that Petrobart, as a creditor, suffered considerable damage as a result of this massive asset transfer" (p82).

Taking into account that the assets transferred were of a high value; that the transfer caused considerable damage to the creditors; that KGM was weak and unstable; and that it was unlikely that the assets would have satisfied the full amount owing to the creditors even if they had not been transferred, the Tribunal found it "clear that KGM's economic problems were drastically aggravated by the [transfers] to the detriment of Petrobart."

2. Calculation of Damages

The Tribunal could not establish the precise value of the assets transferred from KGM. It concluded on the facts presented that the value of the transferred assets "must have been very substantial". (p.82) Similarly, the Tribunal admitted that it

could not establish the total amount of legitimate claims against KGM by all its creditors.

The Tribunal decided to make a “more general assessment of these matters based on probabilities and reasonable appreciations” because the figures presented were too uncertain to produce accurate calculations of the damage caused by the asset transfers (p83).

The Tribunal decided that, if not for the asset stripping, Petrobart would have been able to obtain payment for a substantial part of its claim for delivered gas, which it estimated ('based on its general appreciation of the situation as a whole') at 75% of the value of the justified debt claim against KGM – as calculated by the Bishkek Court debt judgment.

E. Effects of the Stay of Execution

Petrobart argued that it would have been able to execute the debt judgment but for the Court’s decision to stay the execution, while the Republic replied that Petrobart could not have benefited from the judgment and execution order since, even if execution had taken place, Petrobart was under an obligation to return the property to KGM under Article 21 of the domestic Bankruptcy Law. The Tribunal did not take a position on the interpretation of the Bankruptcy Law, as the correct forum for this was the domestic Courts.

However, concerning the letter from the Vice Prime Minister to the Bishkek Court, the Tribunal had to decide whether Petrobart would have been able to enforce the debt judgement if the stay had not been granted.

1. Causation

It could not be established with any degree of certainty what effect the Minister’s letter had on the Court’s decision to stay the execution, but the Tribunal found it “likely that the Court attached some weight to it and that it was an element which the Court considered relevant”, because the letter was expressly mentioned in the Court’s decision. (pp.84-85)

However, the Tribunal could not establish with “a sufficient degree of likelihood that Petrobart, even if there had been no decision to stay the execution, would have been able to execute the judgment … or, if the execution had taken place, to resist a claim from the administrator of KGM’s bankruptcy procedure for the recovery of the proceeds of such an execution.” (p85)

F. Claim for Lost Profits

Firstly, the Tribunal noted that Petrobart did not claim for lost profits in the previous proceedings before the Bishkek Court nor before the UNCITRAL Tribunal.

The Tribunal examined the Contract and accepted that Petrobart was obliged to deliver and receive payment for the full amount of 200,000 tons of gas condensate, but made only five deliveries of approx. 17,000 tons. Although it was understandable that Petrobart did not wish to continue deliveries so long as KGM did not pay its debt owing, Petrobart did not notify KGM of its wish to terminate the Contract on account of the non-payment but instead stopped fulfilling its own contractual obligations to deliver gas. As a consequence, the legal relations between the parties became “ambiguous”. There also remained “a great deal of uncertainty” as to whether Petrobart was able to sell the gas elsewhere, or if they could limit the damage in another way.

As a result, the Tribunal decided that the lost profit claim was not sufficiently established, and Petrobart was not entitled to this claim.

G. Claim for Outlays and Expenses

Petrobart claimed US\$200,500 for outlays and expenses “in pursuing the performance of the Contract,” which include travel and accommodation costs, court fees, solicitor’s expenses and overheads for the Bishkek Court action in 1998 and the UNCITRAL Tribunal in 2002.

The Tribunal noted that these expenses were associated with the previous claims, and were – or should have been – finally settled in these proceedings. Thus there was no basis for granting compensation under this head of claim in the present proceedings.

H. Claim for Other Relief

Petrobart also requested such other relief as the Tribunal may deem appropriate, noting that this may have been of importance if subsequent precise losses had been identified by the Tribunal.

The Tribunal found it doubtful whether a claim of this general and imprecise nature could be accepted, since this would make it difficult for the Respondent to present an effective defence. In any event the claim was rejected as no subsequent losses were identified.

I. Interest

The Tribunal found that Petrobart was entitled to interest on that part of its claim which was ruled to be well-founded. As the claim was based on the Treaty, the interest was applied in accordance with international rules, even though the original value of the claim was based on a domestic Court’s decision.

The Tribunal found that (simple) interest would be applied in accordance with Petrobart’s claim, under Article 7.4.9 of the UNIDROIT Principles of International

Commercial Contracts,² from the date of the original judgement 25 December 1998 until the payment was made.

V. Implications/ Initial Analysis

- The Tribunal found a “**strong likelihood**” of a **causal link** between the Treaty breach and the damage suffered by the private investor. The Tribunal reasoned that if there was no illegal act by the State, the damage suffered by the Claimant would have been considerably less even though the insolvency would have occurred anyway (it is likely that the Claimant as creditor would have recovered a significant amount of the debt owing). By contrast, the Tribunal rejected the plea for damages on the basis of the second breach (‘stay of execution’ episode), because it could not establish a causal link with a ‘**sufficient degree of likelihood**’.
- The Tribunal dismissed the **loss of profit** claim on the basis that the Contract was reciprocally breached by the Claimant once it suspended deliveries after non-payment by the Respondent for previous invoices, without formally terminating the contract. The contractual nature of the relevant legal relationship thus affected the claim for lost profits.
- The Tribunal decided to adhere to the pre-agreed procedural rules, after acknowledging the insufficiency of the information provided. The fact that the Tribunal could not determine the amount of damages with certainty did not prevent it from awarding them. The Tribunal resorted to **approximation** ‘based on probabilities and general appreciations’.
- The Tribunal awarded **interest according to the UNIDROIT Principles**, which is the first instance of application of these Principles in investment treaty arbitration. The reason for this was that the case arose from a breach of the commercial contract between the parties but the Contract did not state the level of interest payable in case of a dispute. The Claimant proposed the UNIDROIT Principles and the Tribunal agreed.
- According to the tribunals, parties may not claim, as damages, **legal expenses** incurred in domestic proceedings or in previous arbitrations related to the matter at issue. This is because the issue of relevant costs is supposed to be settled in the relevant proceedings themselves.

² **UNIDROIT Article 7.4.9 (Interest for failure to pay money)**

(1) If a party does not pay a sum of money when it falls due the aggrieved party is entitled to interest upon that sum from the time when payment is due to the time of payment whether or not the non-payment is excused.

(2) The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment.

(3) The aggrieved party is entitled to additional damages if the non-payment caused it a greater harm.