Precedent in Investment Arbitration: The Case of Compound Interest

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Investment arbitration is a process through which foreign investors initiate proceedings against States in connection with governmental conducts that would have harmed their investment. Investment arbitration has grown rapidly in the past 10 to 15 years. For instance, the International Centre for Settlement of Investment Disputes, or ICSID, has seen its caseload rapidly increase during that time period: ICSID was created in 1966 but approximately 85% of its cases were registered after year 2000. ICSID is now the main recourse for foreign investors against States. In 2009, in the case of Sadio Diallo v. DRC, the International Court of Justice pointed out that ICSID had replaced diplomatic protection as the main legal recourse for foreign investors.1

The recourse to investment arbitration is therefore expanding and investment tribunals adjudicate an increasing number of claims involving various kinds of investors in many geographic places all around the world. The claims that went to investment arbitration in the past include claims brought by the former shareholders of Yukos against Russia for the expropriation of their assets through taxation,2 claims brought under the North

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American Free Trade Agreement against the United States in connection with environmental regulations,\(^3\) or claims brought by a class of 180,000 bondholders from Italy against Argentina in connection with Argentina’s default on its sovereign bonds.\(^4\) As you can see, investment tribunals settle a wide variety of claims which may nonetheless raise similar legal issues because of the similarity of the legal instruments under which investment claims are brought. Because of these similarities, investment tribunals increasingly refer to the decisions of other investment tribunals in their own decisions and awards.

When a coherent line of reasoning appears on a given legal issue, the question has emerged of whether arbitrators should follow this line of reasoning, or whether they retain discretion to give a distinct legal solution to the legal issue at stake.

In this context, two main positions have emerged in the academic debate on investment arbitration: the proponents of a first position, which I call the “majority position”, argue that there is no rule of precedent in investment arbitration. Arbitrators would act on an \textit{ad hoc} basis and retain their discretion to decide cases as they see fit. Conversely, the proponents of a second position, which I call the “minority position”, argue that arbitrators consistently refer to prior decisions and even feel compelled to follow these decisions when resolving a case.

The debate is omnipresent today in the world of investment arbitration. In fact, it divides investment tribunals themselves. For instance, in the decision on liability rendered on 14 December 2012 in the case of \textit{Burlington v. Ecuador}, a dissenting arbitrator disagreed with the majority of the arbitral tribunal as to the weight to be given to prior awards of other tribunals. Let me go through the relevant extract of this decision: “[…] the Tribunal considers that it is not bound by previous decisions. Nevertheless, the majority considers that it must pay due regard to earlier decisions of international courts and tribunals. It believes that, subject to compelling contrary grounds, it has a duty to adopt solutions


established in a series of consistent cases. […] Arbitrator Stern does not analyze the arbitrator’s role in the same manner, as she considers it her duty to decide each case on its own merits, independently of any apparent jurisprudential trend.”

This extract of Burlington v. Ecuador illustrates the importance of the debate on the weight given to prior cases in investment arbitration. While the majority of the tribunal held that it should follow solutions established in a series of consistent cases; Arbitrator Stern dissented and held that she had a duty to decide each case on its own merits.

My lecture today will test these conflicting positions through a concrete example: that of compound interest in investment arbitration. I chose this example for two main reasons. First, the award of interest is a subject over which investment tribunals have limited options. In fact, I have identified three issues that investment tribunals may decide with respect to interest: the dates from which interest should start running, the rate of interest, and whether interest should be calculated at simple or compound rates. What is the difference between simple and compound interest? Let me give you a concrete example. Assume that you made an investment of 100 at a simple rate of 10%: your investment will bring 10 the first year, 10 the second year, and so on. In other words, the rate of return is constant with simple interest. Let’s now assume that you made the same investment, but at compound rate. You investment will bring 10 the first year. But the second year, the 10 of interest incurred during the first year will be compounded to the principal of 100, and the interest for the second year will be calculated on this basis. As a consequence, the interest for the second year will be 10% of 100 + 10, or 10% of 110, or 11. In other words, the rate of return is exponentially growing with compound interest. This method of calculation may have an enormous impact on the amount of damages granted by arbitrators: for instance, in the seminal case of Aminoil v. Kuwait, the arbitrators granted approximately 100 million dollars of compound interest out of a total of 180 million dollars of damages. 


6 Award in the Matter of an Arbitration between Kuwait and the American Independent Oil Company (AMINOIL), 21 INT’L LEGAL MATERIALS 976 (1982).
will concentrate on this issue of simple vs. compound interest in this lecture. Second, the issue of simple vs. compound rates is particularly relevant because the practice of investment tribunals dramatically changed in this regard around 2000. Before year 2000, investment tribunals exclusively granted simple interest, except in two cases. This was justified to the extent that international law clearly favored simple interest over compound interest. For instance, the International Law Commission pointed out in 2001 in its Draft Articles on State Responsibility that “given the present state of international law, it cannot be said that an injured State has any entitlement to compound interest, in the absence of special circumstances which justify some element of compounding as an aspect of full reparation”.

As a consequence of this state of international law, the two tribunals that had granted compound interest on damages before 2000 had done so on the sole basis of domestic law, not on the basis of international law. These two cases are Atlantic Triton v. Guinea and SPP v. Egypt.

In the case of Atlantic Triton v. Guinea, the plaintiff claimed for the repayment of a debt owed by Guinea pursuant to a management contract for the operation of fishing vessels in order to establish a fishing industry in Guinea. The arbitral tribunal upheld Atlantic Triton’s claim for payment of damages as well as interest. In particular, the arbitral tribunal applied the article of the French Civil Code (which was still in force at the time in Guinea) according to which interest can be compounded if it has been judicially claimed and is owing for at least an entire year.

In the case of Southern Pacific Properties (SPP) v. Egypt, the claimant sought compensation for the value of its investment in a joint venture company that it had set up with the Egyptian General Organization for Tourism and Hotels for the development of tourist complexes in Egypt. The tribunal ordered Egypt to compensate SPP for the expropriation of the project, as well as compound interest on this amount of compensation. The tribunal

held that the loan agreement that had been concluded between SPP and the joint venture provided for compound interest, and further held that English law, which was applicable to the loan agreement, also allowed for compound interest.9

In these two cases, the tribunals had therefore granted compound interest on the basis of a domestic law. But the principle remained that investment tribunals could not grant compound interest on the basis of international law.

Twelve years later, in 2013, the opposite holds true: under the current practice of investment tribunals, injured parties seem entitled to compound interest under international law. This change in the general practice of investment tribunals can be traced back to 2000, after which investment tribunals started granting compound interest, as opposed to simple interest, on damages.

What happened in 2000? The tribunal in the case of CDSE v. Costa Rica reversed the general practice with respect to compound interest. In that case, U.S. investors claimed that the Government of Costa Rica had expropriated their property, purchased in 1970 and known as “Santa Elena”. Santa Elena was a real estate located in the northwest corner of Costa Rica and consisted in 30 kilometers of Pacific Coastlines. The expropriation decree was passed in 1978 for the purpose of preserving the populations of pumas and jaguars that were present on the property. The U.S. investors did not initiate arbitral proceedings before ICSID until 1995, and the tribunal rendered a final award in 2000. Therefore, twenty-two years had passed between the expropriation of the U.S. assets in 1978 and the condemnation of Costa Rica to pay damages in 2000.

In these circumstances, the ICSID tribunal decided that simple interest would not fully compensate the lost income that would have been generated if the foreign investors had reinvested the amounts due in 1978. Let me go through the relevant extract of the final award rendered on 17 February 2000 in CDSE v. Costa Rica: “[…] while simple interest tends to be awarded more frequently than compound interest, compound interest certainly is not unknown or excluded in international law. No uniform rule of

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law has emerged from the practice in international arbitration as regards the determination of whether compound interest or simple interest is appropriate in any given case. Rather, the determination of interest is a product of the exercise of judgment, taking into account all of the circumstances of the case at hand and especially considerations of fairness which must form part of the law to be applied by this Tribunal.\textsuperscript{10}

The tribunal accordingly applied compound interest on the damages granted to CDSE without relying on any domestic law. In support of its decision, the tribunal referred to two main reasons. The tribunal first pointed out that there was no uniform rule regarding the award of interest (which was not entirely true as made clear by the ILC draft articles of 2001. The tribunal also referred to general considerations of equity in order to justify the additional financial burden – in that case close to 12 million dollars – that it placed upon the State of Costa Rica. After \textit{CDSE v. Costa Rica}, investment tribunals progressively started granting compound interest on damages. Before I further describe this new trend in investment arbitration, I would like to go back to the terms of the debate on precedent that I presented earlier.

If we follow the “majority position”, the change that occurred after 2000 should be purely circumstantial and was not based on any “jurisprudential trend”, to borrow Arbitrator Stern’s words. Conversely, if we follow the “minority position,” investment tribunals should have relied on prior awards when granting compound interest since 2000.

In order to find out which position is correct, I gathered all the publicly available awards where investment tribunals granted interest between 2000 and 2012, or a total of 50 awards. In order to identify any evolution in the practice of investment tribunals, I divided these 50 awards into two equal batches of 25 awards each. Each batch was in turn divided into two categories of awards: awards that granted simple interest, and awards that granted compound interest. Within the second category of awards granting compound interest, I made a third distinction between tribunals that relied on prior awards and tribunals that did not rely on

prior awards when granting compound interest. In order to do so, I looked at the citations of prior awards in the dispositive part of each award. If the tribunal cited a prior award, I considered that it had relied, at least to a certain extent, on this prior award.

If the majority position were correct, the proportion of awards where arbitrators relied on prior decisions when granting compound interest should remain stable on average: indeed, if arbitrators did not feel bound in any way by prior awards, they would not rely on these awards, but for the sake of mere reference. The citation rate should therefore remain more or less the same across time. If the minority position were correct, on the contrary, the proportion of awards where arbitrators cite prior awards should increase: indeed, an increasing number of investment tribunals should rely on prior awards as these tribunals feel bound by an increasingly uniform practice. It is indeed reasonable to assume that tribunals increasingly refer to prior awards or decisions in a system where there are precedential mechanisms.

In reality, neither position appears to be correct: the proportion of awards where investment tribunals rely on prior decisions when granting compound interest does not remain stable or increase: in fact, this proportion has decreased between 2000 and 2012.

Between 2000 and 2012, indeed, investment tribunals granted compound interest much more often (in 39 cases) than simple interest (only in 11 cases). In addition, investment tribunals have granted compound interest more and more often since 2000: in the first batch of 25 awards, 17 tribunals granted compound interest; whereas in the second batch of 25 awards, 22 tribunals granted compound interest.

In addition, investment tribunals have relied on prior decisions when granting compound interest after 2000, but they have been doing so less and less often in the recent period. The proportion of tribunals that granted compound interest without referring to prior awards is indeed smaller in the first batch of awards than it is in the second batch. If we concentrate for instance on the last three years of the study (2010 until 2012), 8 investment tribunals granted compound interest without relying on any prior award, whereas all the investment tribunals that granted compound interest between 2001 and 2003 did refer to prior awards.
Therefore, the test does not validate either the minority or the majority position. Investment tribunals do not seem to increasingly cite prior awards, even though they adopt increasingly similar solutions over time.

In order to understand this apparent paradox, my hypothesis is that the issue of precedent should not be analyzed from the angle of the arbitrators’ duty to follow or not follow precedent. In my opinion, the analysis should focus on the reasons why arbitrators choose, in their own discretion, to refer to prior decisions and may feel compelled to follow these decisions. My proposition today is to analyze this question from the angle of the arbitrators’ authority, rather than the arbitrators’ duty.

On this question, Joseph Raz’ *Morality of Freedom* provides an interesting analysis of the arbitrators’ authority. Raz argues that the authority of arbitrators is “dual” and depends on their ability to provide “reasons for action.” According to Raz, arbitral awards would both contain what he calls “dependent” reasons and what he calls “pre-emptive” reasons. Arbitrators would decide cases in two different ways: they would use the arguments relied upon by the disputing parties (what Raz calls the “dependent reasons”), but they would also seek to substitute their own reasoning to the parties’ arguments when necessary (what Raz calls the “pre-emptive reasons”). Allow me to go through a rather long extract of Joseph Raz’ *Morality of Freedom*: “Consider the case of two people who refer a dispute to an arbitrator. He has authority to settle the dispute, for they agreed to abide by his decision. Two features stand out. First, the arbitrator’s decision is for the disputants a reason for action. They ought to do as he says because he says so. But this reason is related to the other reasons which apply to the case. [...] The arbitrator’s decision is meant to be based on the other reasons, to sum them up and to reflect their outcome. For ease of reference I shall call both reasons of this character and the reasons they are meant to reflect dependent reasons. [...] This leads directly to the second distinguishing feature of the example. The arbitrator’s decision is also meant to replace the reasons on which it depends. In agreeing to obey his decisions they agreed to follow his judgment of the balance of
reasons rather than their own. [...] I shall call a reason which displaces others a pre-emptive reason.”

I represented Raz’ argument on the following graph:

You can see on the horizontal line the level of discretion exercised by the arbitrators. On the left side of the graph, you are in the world of preemptive reasons. On the right side of the graph, you are in the world of dependent reasons. We can trace on this graph the practice of investment tribunals regarding compound interest. In fact, this example illustrates perfectly the dual nature of arbitral authority. As a first step, arbitrators cited investment awards to give themselves discretion to award compound interest, they pushed the boundaries of their authority and their decisions were “pre-emptive” in nature. We are on the left side of the graph and are getting closer to the center. Once compound interest became generally accepted by foreign investors and States, as a second step, investment tribunals no longer needed to rely on prior awards and progressively ceased to do so. Foreign investors and States indeed cited investment awards in their briefs and these citations operated as constraints for the arbitrators. As a consequence, the arbitrators’ discretion decreased and their decisions became dependent reasons. This evolution can be seen on the right side of the graph.

In this context, the citation of awards seems to be used by arbitrators for authority purposes: by relying on prior decisions, arbitrators have been able to assert their authority and introduce

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the award of compound interest. Although these awards have no binding effect, the discretion of arbitrators has progressively decreased as parties progressively started to rely on decisions granting compound interest.

As a further illustration of this dynamic, I would like to draw your attention to the award recently rendered on 5 October 2012 in the case of Occidental v. Ecuador. In that case, the arbitral tribunal granted the largest award in the history of investment arbitration against Ecuador, namely 1.7 billion dollars of principal and approximately 500 millions dollars of compound interest. The reasoning of the Occidental v. Ecuador tribunal regarding interest is worth noting: “The traditional norm is to award simple interest. However, this practice has changed and, in fact, most recent awards provide for compound interest. [...] An analysis of recent interest awards demonstrates that in 2007, all tribunals, except one, awarded compound interest. In the 2008-2009 period, six out of ten tribunals awarded compound interest. Several more recent cases have also awarded compound interest. [...] In summary, it may be seen that compound interest is the norm in recent expropriation cases under ICSID. The Tribunal sees no reason to depart from the norm and from the basis pleaded by both parties.”

The decision in Occidental v. Ecuador is a good illustration of how precedent works in investment arbitration: tribunals do not consider themselves bound by prior decisions but nonetheless rely on these decisions in order to sustain their authority when their decision would appear controversial. In this case, the arbitral tribunal accordingly granted compound interest despite the prohibition of compound interest under Ecuadorian law. As you may remember, an allowance for compound interest under the applicable domestic law was precisely the ground upon which investment tribunals occasionally granted compound interest prior to 2000. The Occidental v. Ecuador award confirms that the practice is now reversed: investment tribunals do not hesitate to bypass or ignore the prohibition of compound interest under an applicable domestic law and grant compound interest. Interestingly, the tribunal in Occidental v. Ecuador went as far as referring

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to the “norm” and the “basis pleaded by both parties” in its decision to grant compound interest: it clearly situated itself in the world of dependent reasons, where its decision was constrained and indeed summarized the reasons provided by the parties, in other words, the “norms”.

In sum, arbitrators do not seem to think of precedent in terms of duty; they use prior decisions depending on their needs, notably when they need to assert their own authority towards the parties. In the case of Occidental v. Ecuador, for instance, precedent was a useful tool for the arbitrators to ground their decision to grant compound interest despite the prohibition thereof under Ecuadorian law.

As a conclusion, I would like to go back to the original debate between what I called the majority position and the minority position. I tried to refute the majority position according to which there is no precedent in investment arbitration but I also suggested that the minority position may be too simplistic. Investment tribunals do act on an ad hoc basis and there is no rule of precedent in the traditional sense in investment arbitration. Therefore, precedent cannot be analyzed as a duty from the arbitrators’ perspective. However, the nature of the arbitrators’ authority may explain why arbitrators consistently refer to prior decisions when deciding cases and why precedent may over time operate as a constraint in their decision-making process.