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Deutsche Bank AG v The Democratic Socialist Republic Of Sri Lanka

Judith Gill QC

6 November 2016

Introduction

- ICSID claim brought by Deutsche Bank AG (**DB**) against the Democratic Socialist Republic of Sri Lanka
- Case arose out of a hedging agreement entered into between DB and the Sri Lankan national oil company Ceylon Petroleum Company (**CPC**) on 8 July 2008
- First ever investment treaty case arising out of a derivatives transaction
- Backdrop of high and rising oil prices affecting Sri Lankan economy
- Heard by tribunal comprising:
  - Mr Makhdoom Ali Khan (Pakistan)
  - Prof. David Williams QC (New Zealand)
  - Prof. Dr. Bernard Hanotiau (Belgium) – President
- Award delivered 31 October 2012
- Dissenting Opinion

Background to the case

Sri Lanka imported around 30 million barrels of oil each year, of which around 27 million were imported by the state-owned CPC

For several years prior to the events in question, oil prices followed a strong upward trend rising from US$28 per barrel in January 2003 to a peak of US$140 in July 2008

Central Bank identified hedging as a means to help ease the financial burden of high and rising oil prices and advocated its adoption

Cabinet Study Group established by Parliament

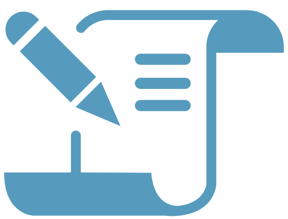
– Report noted, *inter alia*, that as a result of recent oil price rises "*the foreign exchange requirement is very high and could be unbearable if prices rise above US$80 per barrel*"

– Recommendations included granting authority to CPC to call for hedging quotations, decide on future prices and to purchase hedging instruments from reputed banks

Background to the case – implementation

- Minister submitted a Cabinet Memorandum containing the Study Group's recommendations, which the Cabinet approved
- President approved the Cabinet Memorandum, in his capacity as Minister of Finance
- Ministry issued instruction to CPC to commence the hedging programme
- CPC Board passed resolutions empowering its Chairman and DGM (Finance) "*to execute hedging transactions by using appropriate hedging instruments*" with DB, Standard Chartered Bank and Citibank
- By the time of the Hedging Agreement with DB, CPC had concluded 23 hedging transactions with Standard Chartered Bank and Citibank and received around US$20 million in payments
- Clear with hindsight that the Hedging Agreement was concluded at close to the market peak, though at the time further oil price rises were predicted

The Hedging Agreement



- Hedging Agreement was comprised of a term sheet, risk disclosure statement and confirmation which in turn incorporated the ISDA 1992 Master Agreement yet to be executed
- It was a zero cost hedging structure in respect of 100,000 barrels with a term of 12 months
- Payments calculated on a monthly basis
  - Basic put and call options both set at US$112.50 (strike price)
  - Upside caps of (i) US$10 per barrel a month (US$1m in total) and (ii) overall limit of US$2.5m
  - No downside limit but mitigation of physical deliveries
  - No premium payable for the instrument
- On 8 July 2008 the relevant oil price was US$137.52 so Hedging Agreement was ‘in the money’
- Unlike many other SCB/Citibank trades, Hedging Agreement had no leveraged downside
- Early termination provided for if ISDA Master Agreement not executed within 90 calendar days

The effect of oil price movements

- After reaching a peak of US$140.24 on 15 July 2008, oil prices began to fall, dropping to below US$50 by mid-November 2008
- Unexpected drop in oil price exposed CPC to substantial payment obligations in respect of the hedged quantity
- DB made a payment to CPC for US$35,523 in September 2008
- CPC made payments to DB of US$1,659,636 in October and US$4,507,857 in November
- A further payment appears to have been approved but not actually paid
- CPC responds to negative press coverage by explaining that overall it was benefiting from the reduction in oil prices and assured banks it would meet all obligations under existing hedging arrangements

Supreme court proceedings

- Fundamental rights petition alleging a breach of the Constitution filed before the Sri Lankan Supreme Court on 26 November 2008
  - challenged CPC's authority to enter into the derivative transactions
  - claimed the transactions were *"prima facie iniquitous since they are structured entirely for the benefit of the respective banks"*
  - sought interim order suspending payment by CPC to the banks
- Supreme Court granted the interim order 2 days later directing, among other things, that all payments by CPC to the banks be suspended and the Monetary Board of the Central Bank should carry out an investigation
- Banks were not made parties to and did not appear before the Supreme Court
- DB exercised its right to terminate the HA on 3 December 2008 for failure to execute ISDA Master Agreement
- The Supreme Court's interim orders remained in effect until vacated in a Final Order on 27 January 2009 at which time Petitioners not pursuing application

Central bank investigation

- Central Bank began an investigation in November 2008
- On request DB provided copies of documents and responded to questions received
- Central Bank sent DB its Assessment of Compliance on 5 December which contained five allegations, essentially that DB had not provided sufficient information or updates regarding risk to the CPC Board nor taken sufficient account of the risk of loss to CPC in the event of a fall in oil prices
- The Assessment of Compliance requested a response by 12 December 2008 and DB wrote rejecting the allegations on 11 December 2008

Central bank investigation

– On 13 December a final Investigation Report relating to each of the banks with whom CPC had hedging agreements was placed before the Monetary Board (but not sent to DB)

– The final Investigation Report repeated earlier findings in the Assessment of Compliance but was broader in scope and included several findings on new allegations such as:

  – DB had failed to obtain necessary undertakings from the CPC Board;

  – DB had violated best practices and *“prudential norms”* ;and

  – the Hedging Agreement was heavily weighted in DB’s favour

– DB first given notice of the final Investigation Report on 6 January 2009 and wrote rejecting the new allegations on 12 January 2009

The orders of the Monetary Board

- On 16 December 2008, based on the final Investigation Report, an Order of the Monetary Board was sent to each of the banks
- The Order notes that the hedging "*transactions are materially affected and are substantially tainted*" and ordered that the banks "*do not proceed with, or give effect to, these transactions*“
- Central Bank issued a press release on 27 January 2009 noting that whilst the Supreme Court had withdrawn its interim orders, the Orders issued by the Monetary Board "*will continue to be in force*"

Proceedings by the international banks – Citibank

- **Citibank** brought commercial arbitration proceedings based on a contractual claim before the LCIA in London
  - In August 2011 the LCIA tribunal dismissed Citibank's claim for US$195 million, finding that CPC did not have capacity to enter into the contracts which were inherently speculative
  - Arbitration subject to confidentiality restrictions but award admitted to the record in DB's ICSID claim

Proceedings by the international banks – SCB

SCB brought proceedings based on a contractual claim in the English High Court

- Claim for S$162M relating to two trades
- Shortly before the High Court proceedings began the Central Bank imposed a 27 billion LKR (approximately US$240M) fine on SCB, alleging that it had breached the provisions of the Sri Lankan Exchange Control Act
- Judgment at first instance handed down in July 2011 awarding SCB the full amount of its claim plus interest amounting to c.US$180M.
- CPC's appeal to the Court of Appeal was dismissed in July 2012:
  - acknowledged the LCIA tribunal's view in the Citibank case that the contracts were beyond the statutory powers of CPC as they were inherently speculative in nature
  - found no clear distinction between 'speculation' and 'hedging'
  - focussed on whether the contracts fell within CPC's ordinary powers
- Leave to appeal to the Supreme Court was pending when settlement reached
- Settlement reported by the Sri Lankan Sunday Times on 30 June 2013; terms believed to be recovery of c.US$60M, representing 1/3 of the amount of its judgment
- As part of the settlement, the Central Bank fine was annulled

Proceedings by the international banks – DB

- DB commenced treaty arbitration before ICSID alleging breaches of the Germany – Sri Lanka bilateral investment treaty
- Claims based on alleged breaches of treaty protections for:
  - Fair and equitable treatment
  - Expropriation
  - Umbrella clause
    - Claim reliant on attribution of CPC's actions to the State
    - Not necessary to decide given other findings of breach of the treaty
  - Full protection and security
- Tribunal only found it necessary to rule on the first two

Proceedings by the international banks – DB

- ICSID Award in October 2012 against SL for the principal amount claimed of c.US$60M plus interest and costs
- SL initiated proceedings to annul the ICSID Arbitration Award in February 2013.
- Annulment hearing originally scheduled for June 2014
- Settlement was agreed in principle and the parties agreed to stay the Annulment Proceedings in April 2014
- Settlement finally concluded in 2016 reported as being for US$26m

Procedural issues

- Request for bifurcation of jurisdiction and merits
- Disclosure issues
  - Dispute regarding requirement for an electronic search
    - Tribunal ruled agreement to produce “Documents” includes electronically stored information such as emails
  - Requests for documents denied but with warning of potential adverse inferences
- Admission of Citibank award
  - Exclusion from the record
  - Reconsideration by tribunal and subsequent admission
- Timing of the ICSID Hearing
  - Request for Arbitration submitted in February 2009
  - Substantive hearing originally scheduled for 26 July 2010
  - Rejoinder filed on 7 July 2010
  - First available date for adjourned hearing August 2011

General strategy and tactics

- Appointment of tribunal members
- Importance of disclosure
- Backdrop of global financial crisis
- Focus on inherently unattractive position of withdrawal once market turned
- Inference that steps taken with political motive
- Lack of due process
- Precursor of public proceedings in SCB case
- Lessons from the Citibank experience
  - Derivatives as a legitimate risk management tool
  - Explanation of product and the benefits of hedging
  - Focus on probability rather than absolute amounts

Key Issues – Jurisdiction

Was the Hedging Agreement an Investment?

- Double-barrel test under BIT and Art 25(1) ICSID Convention
- Definition of investment under BIT
- Application of Salini characteristics
- Validity of the Hedging Agreement and whether CPC had capacity to enter into it?

Key issue was how to persuade tribunal that a financial instrument like the Hedging Agreement should be protected given objections based on:

- Its origins in commercial banking
- Involvement of DB branches outside Sri Lanka
- Lack of physical investment
- Absence of payment or funds being advanced at time entered into
- Uncertainty of future obligations

Investment under the BIT

1

Familiar reference to investments including "*every kind of asset*" and "*in particular*" list of categories including "*claims to money which have been used to create an economic value or claims to any performance having an economic value and associated with an investment*"

2

Majority found Hedging Agreement fell within this description

- Hedging Agreement a legal property with an economic value for DB.
- No need to show an investment separate from the claim to money itself as this would be defining an investment by reference to an investment
- Even if there were requirement for a separate investment it relates only to claims to performance
- Territorial nexus satisfied as preliminary work and impact of the investment in Sri Lanka including DB payment, even if DB branches elsewhere involved in paperwork

Investment under Article 25(1)

Article 25(1)

– No strict application of the 5 *Salini* criteria which don't appear in the ICSID Convention

– Only contribution, risk and duration appropriate benchmarks as both contribution to host state's economic development and regularity of return too subjective

Investment under Article 25(1)

Article 25(1)

- DB made **substantial commitment**:
  - By immediately committing to pay US$2.5M if oil prices remained above strike price
  - At time of inception oil prices substantially above strike price so had immediate effect
  - Immediate reduction of exposure to price volatility and improved cash flow predictability
  - Initial payment to CPC
  - Two years of negotiations beforehand and resources invested subsequently on potential restructuring options
- **Risk** met by exposure to payment of US$2.5M
- Intended **duration** of 12 months sufficient; early termination irrelevant
- In any event Hedging Agreement neither an ordinary commercial transaction (due to its bespoke nature and approval at highest levels) nor a contingent liability (based on accounting treatment as financial assets) and the hedging programme was designed and implemented in the national interest

Capacity of CPC

Objects of CPC defined by statute and empowers Board to determine what it considers incidental and conducive to CPC's business; provided form honest view a transaction is within objects and powers, even if Board take the wrong view

- Tribunal went on to consider whether ultra vires because no capacity to enter into a transaction that amounted to speculation rather than a genuine hedge
  - Burden of proof on Sri Lanka as party alleging invalidity
  - Detailed expert evidence
    - Agreed hedge requires reduction of risk and exposure to physical market
    - Based on future predictions as at inception of prices remaining high there was a reduction of risk
    - Disagreed as to nature of reduction of risk and whether needs to be "meaningful"
    - Lack of precision as to what would be meaningful; would vary depending upon circumstances of the hedger and may vary from one day to the next
    - In any event evidence of a 6% cost reduction at inception would meet requirement

Noted English CA in SCB had decided distinction irrelevant if within objects but no need to decide if valid even if speculative given conclusion reached

Merits Issues: Key Challenges

- Appropriate dividing line between legitimate exercise of regulatory powers and breach of the treaty
- Voluntary termination by DB said to preclude any taking of the Hedging Agreement
- When did any expropriation occur given interim nature of Supreme Court action and subsequent termination of Hedging Agreement prior to Monetary Board Order?
- Establishing responsibility for combined acts of different organs of the state
- CPC's failure to pay gave rise to a debt claim which could be pursued through contractual mechanism:
  - Relationship between contractual remedy and treaty claim?
  - Ability to enforce contractual rights in practice?
  - Absence of a 'taking' of these contractual rights?
  - No loss caused by any breaches of the treaty

Merits Issues: Fair and Equitable Treatment

- **Relevant standard:**
  - An autonomous one, albeit the actual content not materially different from minimum standard of treatment in customary international law
  - Applied *Waste Management II* case as providing non-exhaustive components of the FET standard
- **Findings in relation to Supreme Court proceedings**
  - 5 page judgement rendered less than 48 hours after filing of petition
  - Granted claims based on extremely limited evidence and without hearing from the banks whose contractual rights affected
  - Conclusion reached (i.e. strong prima facie case established that transactions unlawful, not arms length and heavily weighted in banks' favour) and issuing of interim order in these circumstances a breach of FET standard
  - Reliance on subsequent public statements by Chief Justice who presided that decision made for political reasons
  - Subsequent discharge of interim order rendered irrelevant by Monetary Board Order

Merits Issues: Fair and Equitable Treatment cont'd

- **Central Bank investigation and Monetary Board Order**
  - Tribunal rejected concerns over foreign exchange liabilities and surprise at large payment obligations of CPC following fall in oil prices as not the true motivations
  - Purpose of investigation was implementation of decision already made to stop payments and outcome was a foregone conclusion
    - A paperless investigation
    - No-one from CPC or the Central Bank interviewed
    - Investigator reached own views of nature and purpose of hedging programme even though not involved at the time
    - Conclusion that not intended CPC would have to make large payments was in "total contradiction" of emphasis in Central Bank's own documents of downside risk
    - Identical conclusions reached
  - Lack of due process in DB not being informed of case against it before Monetary Board Order issued
  - Central Bank acted in excess of its powers under the Banking Act as provision relied on does not empower suspension of contract

Key Issues: Expropriation

- Contractual rights may be expropriated
- Coordinated actions of the Supreme Court and Central Bank prevented DB receiving payment
- This deprivation of the economic value of the Hedging Agreement amounted to expropriation
- Took place on date commenced i.e. date of Supreme Court interim order (prior to DB's termination)
- Legitimate exercise of regulatory powers is subject to proportionality requirement: prevents measures which substantially impact investor unless justified by substantial public interest
- No legitimate exercise of regulatory powers in this case in light of excess of powers, improper motive, breach of due process etc.
- DB had legitimate expectation contractual rights would not be interfered with

Key Issues: Causation

Sri Lanka alleged the existence of a debt claim and the possibility of pursuing it in the English courts meant there could be no damage caused by any action taken

- Existence of a contract does not preclude treaty claim as they are analytically distinct
- Claim not based simply on CPC's failure to pay but on state intervention to modify payment obligations in breach of its treaty obligations
- Fact that another means of recovery of the same loss caused by the treaty breaches does not prevent award of compensation by the tribunal
- No exhaustion of available remedies requirement
- Protection afforded by prohibition on double recovery
- CPC would likely be prevented from complying with any judgement and does not have operations outside Sri Lanka

Dissenting Opinion

- **No investment under the BIT**:
  - General reference to asset qualified by specific list
  - Specific requirements that claim to money both used to create economic value and is associated with an investment not met
- **No investment under Art 25(1) as**:
  - Contribution to economic development required and here none at time of inception as dependent on oil price movements
  - Almost all ordinary commercial transactions have some bespoke features
- **Expropriation**
  - The debt created by the failure to pay under the Hedging Agreement and the remedy for its recovery by action in the English courts survived any actions taken
  - It cannot therefore have been expropriated
- **FET**
  - On the facts disagreed that the Supreme Court acted in an improper manner
  - Central Bank investigation did not cause any loss
  - The Monetary Board Order did not cause loss because as English Court ruled in SCB case the debt owed was unaffected

Conclusions

- Investment arbitration is one of several possible alternatives none of which are inherently 'better' than the others
- Dynamic nature and evolution of treaty protection
- Importance of tribunal selection
- Delays continue to be an issue for investors
- Disclosure is a two-edged sword
- Coordinated measures by different state bodies/entities not viewed in isolation
- Vulnerability of state and its organs when perceived to be responding to political or popular pressures

Questions?

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