

## Working Paper

### **Analyzing The Impact of the Clauses on Expropriation and Fair and Equitable Treatment contained in the Free Trade Agreement signed between Peru and United States in the Peruvian Administrative Law<sup>1</sup>**

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#### **Introduction.-**

According to Bremmer and Keat, political risk is important for an investor not only in an aggregate level (country or continent), but also in a micro level (municipal or regional)<sup>4</sup>. The political system influences the functioning of State bodies and, thus, it will determine how coercion will be applied in the society, what rules will govern the social and economic life, and under what rules the administration of the judicial system and the bureaucratic apparatus will work.

In that sense, the functioning of the political system and its expression in State decisions will influence the economy and, hence, in the perception that investors will have in deciding whether or not to invest in a particular country and what is the rate of return that they will have due to their investment. Countries with high levels of political instability, constant changes of rules, arbitrary administrative and judicial decisions could discourage private investment (foreign or domestic). This scenario would harm the competitiveness of private enterprises.

The perception of political risk is a reflection of the quality of the institutional framework governing a country. In that sense, high political risk might show a weak institutional framework where State measures are in function of the particular interests of the politicians who are in government or economic elites capable of influence them, or are measures which responded only to the authority's will without further technical support or any control without which it is impossible to know if a measure is based on the pursuit of public goals. In this kind of institutional framework, quite common in developing countries, the success or survival of a firm depends on if an investor can access or exert pressure on State authorities. The effort, merit or creativity is not enough to be competitive in the market.

Therefore, rules and organizations which control the arbitrariness and the lack of rationality of government action would improve the institutional framework and diminish the political risk of investing in a particular country or región. From our point of view, Investment Treaties (hereafter, IIA's), and arbitral jurisprudence which interpret such treaties could become a set of rules which serve to control whether government action is aimed to achieve public goals in a rational way.

Indeed, although the academic literature on investment, as noted Roberto Echandi, has focused on analyzing how IIA's attract foreign investment to the developing countries, this would not necessarily be the only function that these treaties have, and perhaps not even the most important<sup>5</sup>. For him, the IIA's can also drive or lock pro-market reforms in developing countries that prevent or, at least, hinder

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<sup>1</sup> We want to thank "SECO WTI Academic Cooperation Program" for its generous financial support. Likewise, we thank Professor and former Ambassador of Costa Rica Roberto Echandi, for his helpful supervision in the election of the topic and his suggestion in the elaboration of the paper. Also, we thank Victor Saco Chung for his valuable comments. Any mistakes are only responsibility of the authors.

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<sup>4</sup> BREMMER, Ian y Preston Keat. *The Fat Tail. The power of Political Knowledge for Strategic Investing*. Oxford University Press, 2009, pp. VIII – 3 y ss.

<sup>5</sup> ECHANDI, Roberto. What do Developing Countries Expect from the International Investment Regime? In: *The Evolving International Investment Regime: Expectations, Realities, Options*. Edited by Jose E. Alvarez, Karl P. Sauvant, Kamil Girard Ahmed, and Gabriela P. Vizcaino. New York: Oxford University Press, forthcoming 2010, pp. 3 y ss.

arbitrary or unilateral amendment by the host State, giving stability to its economic policies to benefit both foreign and domestic investors. Also, IIA's contain rules that promote greater transparency and consistency in policy making between national agencies<sup>6</sup>, in order to allow investors to foresee the risks of their investments and to avoid future damage of their rights.

In that sense, although the IIA are intended to protect foreign investors, those rules may also have positive effects for domestic investors. This paper aims to analyze the hypothesis as to whether the expropriation clause (direct and indirect) and the fair and equitable treatment (hereinafter, the FET) contained in the chapter on Investment Protection that is part of the Free Trade Agreements (hereinafter, FTA) signed by Peru and the United States influence in the creation of a productive investment climate, that is, an environment that encourages creativity and effort of economic agents in the market, allowing a sustainable development in the country. We have chosen Investment Chapter of the Free Trade Agreement with the U.S.A on expropriation and FET as this treaty has also served as inspiration to the following treaties concluded by Peru on investment issues.

For the purposes of exploring the our hypothesis, the chapter one defines the concepts of rules, agents, investment climate and institutional framework, as this will show how we utilize these concepts in our work which can be different classic authors as Douglas North. The chapter two defines the concepts of expropriation and FET and whether if both have an impact on the creation of an inclusive investment climate. Finally, chapter three discusses some applied cases where, an institutional framework that promotes inclusive and productive investment it applied<sup>7</sup>.

1. Conceptual framework
    - 1.1. Definitions of rules
      - 1.1. Types of rules
      - 1.2. The importance of Rules for the interaction of agents
    - 1.2. Agents
    - 1.3. Institutional Framework
    - 1.4. Investment Climate
  2. Analysis of the Clauses on Expropriation and FET contained in FTA signed between Peru and the United States in the Peruvian Administrative Law
    - 2.1. The importance of the institutional framework in developing countries
    - 2.2. The Treatment of Expropriation in the chapter on Investment in FTA with U.S.
      - 2.2.1. The purpose of protecting property rights
      - 2.2.2. What can be object of expropriation according to the FTA signed by the Peruvian State with the USA?
      - 2.2.3. How to protect the foregin investor from the State's expropriation power?
      - 2.2.4. Impact of the expropriation clauses in the Peruvian Law
    - 2.3. The limits of the State's actions in the FTA when it regulates a foregin investor's activity: the FET within the minimun standards of treatement
      - 2.3.1. What has been understood as "fair and equitable"?
      - 2.3.2. The FET clause and its incorporation to Peruvian law
    - 2.4. Incorporation of regulatory expropriation clauses and FET in the Peruvian law
  3. Case studies
    - 3.1. *Shougan Hierro Perú* vs. Municipality of Nazca
    - 3.2. Changes in the permits in the *Pizza Street*
    - 3.3. The restrictions to *Transportes Huaral*
- Final Remarks

<sup>6</sup> ECHANDI, Roberto. What do Developing Countries Expect from the International Investment Regime? In: The Evolving International Investment Regime: Expectations, Realities, Options. Edited by Jose E. Alvarez, Karl P. Sauvant, Kamil Girard Ahmed, and Gabriela P. Vizcaino. New York: Oxford University Press, forthcoming 2010, pp. 13 – 15.

<sup>7</sup> It should be noted that these rules are factors that help in creating a climate of inclusive and productive investments, but are not sufficient to create such an environment. There need to be, among others, a stable macroeconomic environment, an independent justice system, equal opportunities for all people and a meritocratic civil service.



## Chapter 1

### Conceptual Framework<sup>8</sup>

In this chapter, we will define the concepts to be used throughout this paper that, in some cases, may differ from the classical authors of Neo Institutionalism. In addition, we will try to give them greater accuracy in order to avoid ambiguity or obscurity in their use. Finally, it will also be shown how they relate to the various terms in the formation of a productive and inclusive Investment Climate.

#### 1. Definition of rule

It will be understood by Institutions the rules that govern human interaction in a particular place. For purposes of this paper, it will be used the term rules for institutions in order to avoid the ambiguity that may have in Civil Law the term “institutions” which, in many cases, is also used to identify organizations. The term *rules* get the idea to be conveyed by institutions.

According to North (1990), Rules are designed to restrict human interaction since its purpose is to define how people and organizations behave in a certain place and time<sup>9</sup>. Rules provide a structure to everyday life and let you know what to expect from other actors in a society, reducing uncertainty in human interactions.

Indeed, the rules of conduct set parameters from which you can expect a certain behavior from other agents. However, Rules do not only serve to limit or restrict human behavior, but they can also influence it in a particular direction. Indeed, if the agents discover what the consequences will be if they behave in a particular way, then they will try to plan strategies to avoid the negative consequences of a particular rule, but will try to devise other forms of behavior to achieve its objectives.

#### 1.1. Types of Rules.-

Rules can be formal or informal. They are formal when they are created and issued by an authority to establish the behavior that agents must take when interacting with other actors in society. On the other hand, Rules are informal when they are not created intentionally, but arise from the process of interaction between agents through negotiation or tradition.

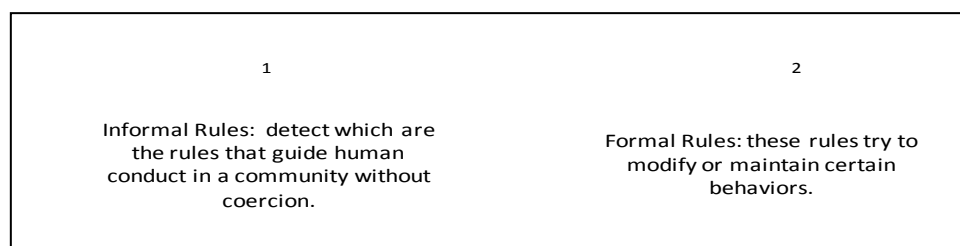
However, the rules that give more information about the behavior of people are the informal ones as these reflect their traditions and motivations in daily life. To discover which the informal rules are that guide the behavior of an specific community is key to analyze the feasibility of a strategy to reform the formal rules in a community. In that sense, for the development and implementation of formal rules is necessary, first, to study the informal rules that govern the behavior of a community. It is only when those are known that formal rules can be implemented, being accompanied by an implementation strategy and monitoring. Otherwise, the formal rules could prove to be ineffective or even counterproductive.

### Chart N° 1

#### Relationship between formal and informal rules

<sup>8</sup> This section is based on the first chapter of the document elaborated by CésarHiga y Jorge Tudela. Exploración de las condiciones y criterios necesarios en la elaboración y diseño de reglas formales que promuevan un clima de inversión inclusivo. Documento presentado en la Conferencia Anual de la Asociación la Asociación Latinoamericana y del Caribe de Derecho y Economía (ALACDE), available in <http://escholarship.org/uc/item/2rj0d5f7#page-1>

<sup>9</sup> NORTH, Douglass. Institutions, Institutional Change and Economic Performance. Cambridge University Press, 1990, p. 4.



It usually happens that formal rules are made without knowing the informal rules governing the community. This would probably raise their cost of compliance or even its total breach, affecting the credibility of formal rules as instruments to govern life in society.

## 1.2. The importance of Rules for the interaction of agents.-

Rules determine the structure of incentives - positive or negative - that surround the decision making of individuals. These incentives will determine the benefits or harms that an agent could get if he acts in a particular way, orienting their behavior according to what they expect. Therefore, Rules will have a major effect on the type of activities that individuals, in pursuit of their goals, will develop. If the rules in a given framework are designed to encourage that the success or survival of a company depend on its ability to influence public policy makers, then they will behave in order to accomplish this goal. By contrast, if the firm's success depends on its efficiency to develop its business activity, it will direct its behavior toward achieving that goal.

Rules can also guide the behavior of agents to reach productive activities or extractive activities<sup>10</sup>. To encourage them achieve productive activities is necessary that Rules are – in the terminology of Acemoglu and Robinson – inclusive, that is, Rules that allow all agents to have the opportunity to participate in economic activities where talents and skills are rewarded according to the merit and effort deployed to meet the needs of others<sup>11</sup>. This environment will encourage agents to invest in physical and human capital, technology, etc<sup>12</sup>.

However, Rules could also produce an extractive institutional framework, that is, that State entities only extract rents from one group and redirect them to other groups in the society without favoring any productive activity.

## 2. Agents.-

By agents we mean any type of entity, whether it is an individual or an organization. This paper assumes that individuals seek to maximize their own interests and, in the case of organizations, they seek to maximize the interests of those who lead them. This is important because we assume an environment where players are selfish and rational, even if they are political organizations or State entities<sup>13</sup>.

The main agent who interacts in the society is the State as it is the one that can set the Rules that, in first place, govern a particular relationship. One of its duties is to mediate in the conflicts that can arise between other agents different in society, determining who or what kind of interests are protected, and have the ability to impose its decisions. However, Government organizations respond to the interest of

<sup>10</sup> ACEMOGLU, Daron y James Robinson. Why Nations Fails. The origins of Power, Prosperity, and Poverty. Crown Business, New York, pp. 73 – 83.

<sup>11</sup> ACEMOGLU, Daron y James Robinson. Why Nations Fails. The origins of Power, Prosperity, and Poverty. Crown Business, New York, p. 74.

<sup>12</sup> ACEMOGLU, Daron y James Robinson. The role of institutions in Growth and Development. Working Paper Nº 10, Comission on Growth and Development, p. 6.

<sup>13</sup> As discussed below, this assumption will be important in the design of the process and the criteria that should be taken into account to rationalize government action in creating a productive Investment Climate.

those who lead it. These interests may be aligned with the interest of the community or with the interests of a particular group that wants to influence those who are at the top of the State agency. Therefore, the way an agency is going to be handled depends on the institutional framework in which the entity lives.

### 3. Institutional Framework

The rules and the behavior of agents will establish the institutional framework and environment under which they will interact in society. Agents will adapt their future behavior depending on how they perceive the rules that guide incentives in the society. Following Acemoglu and Robinson, societies can have two types of institutional frameworks: (i) the extractive, when State agencies are responsible only of extracting resources from one group in society to another, and (ii) the inclusive, where State agencies are responsible for ensuring an environment where actors success depends on their ability, merit, effort, etc, that is, when the opportunities and benefits of the individuals and firms is not determined by political power but on how well they satisfy the needs of other market players.

### 4. Investment Climate<sup>14</sup>.-

The investment climate is determined by the set of rules that establish the opportunities and incentives surrounding the decision of an economic agent on whether or not he invests on a given market. In deciding whether or not to invest, an investor will consider aspects such as costs, risks and barriers to competition, which will determine if the expected or future benefits justify the investment he will perform<sup>15</sup>. The main factors that affect the costs, risks and barriers to competition are: (i) the Rules (institutional framework), (ii) geography, (iii) market size, and (iv) the consumer tastes and preferences.

One aspect that influences the perception of risk or uncertainty of the future lies in whether the rules under which a firm invests will be stable and predictable. Another aspect is referred to the social climate that will exist after the investment. In fact, after the investment was done, a group of agents may perform actions that seek to block the development of the investment, which will raise the cost of the project undertaken.

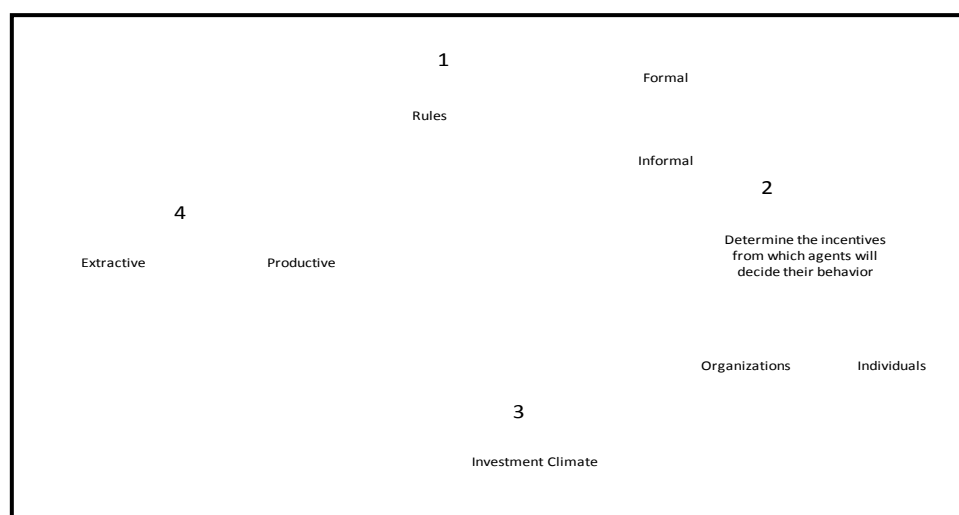
In both cases, State agencies can play an important role in the perception of risk that firms have about the future environment in which they will conduct their activities. Indeed, they have a role in the formation of the perception about whether the rules might be changed, if they will protect property rights, in how to resolve conflicts between agents, etc. Therefore, depending on the future perception of the investment climate, firms develop strategies to safeguard their future benefits which could fall in the category of extractive or inclusive.

#### Chart N° 2

Relationship between Rules, actors and the investment climate

<sup>14</sup> World Development Report 2005. A Better Investment Climate for Everyone. Copublication of the World Bank and Oxford University Press.

<sup>15</sup> World Bank. World Development Report 2005. A Better Investment Climate for Everyone. Copublication of the World Bank and Oxford University Press, pp.1 y 20.



This chart clearly shows the circular flow that will determine the type of investment climate in a society. As discussed, Rules will affect the incentives of economic agents to behave in a certain way. These, at the same time, define the type of investment climate that will result from their behavior, either extractive or productive. Following Acemoglu and Robinson (2010)<sup>16</sup>, the type of investment climate and of economic growth is what will determine the political power of the agents as it will also assign a particular distribution of resources. This power will then determine the rules in a subsequent period.

It is important to point that "bad rules" perpetuate in time as it is difficult to break with the mechanisms that ensure an extractive circular flow. New investors will only adapt to those already established in past periods because of an unequal balance of power when making new regulations.

<sup>16</sup> ACEMOGLU & ROBINSON. The Role of Institutions in Growth and Development. Review of Economics and Institutions, 2010.

## Chapter 2

### Analysis of the Clauses on Expropriation and FET contained in FTA signed between Peru and the United States in the Peruvian Administrative Law

#### 2.1. The importance of the institutional framework in developing countries

Acemoglu and Robinson (2010) attributed the differences in countries' economic growth to differences in the rules imposed in a society, which are the *fundamental causes of economic growth*<sup>17</sup>. These relate to differences in securing property rights for businesses and citizens, the ability to develop contracts to facilitate economic transactions, the entry barriers that new firms face to enter a market and compete in it; barriers and costs that individuals face in investing in human capital and the incentives that politicians have in providing public goods.<sup>18</sup>

In that sense, Rodrik<sup>19</sup> points out that all the examples of successful developments are, ultimately, the collective result of individual decisions made by entrepreneurs to risk in new ventures and tries to discover new products<sup>20</sup>. To achieve that entrepreneur's flourish and develop their full potential, there must be an environment or institutional framework that enables them to appropriate the fruits of their effort, merit and creativity. So, as Rodrik follows, the discussion is not whether institutions matter to explain the development of a country, especially since there is evidence in this regard, but which institutions are the ones who encourage these traits. Among the institutions that would encourage such traits are the following<sup>21</sup>: (i) well-defined property rights, (ii) regulatory institutions seeking markets to work efficiently, (iii) institutions to ensure macroeconomic stability, (iv) social security<sup>22</sup> and, (v) institutions that adequately manage conflicts that may occur within the society.

The existence and structure of economic rules that create incentives for effort, merit and creativity depends largely on the political system works. Therefore, it is important to distinguish between the economic rules and political rules. Economic rules, directly related to the investment climate, are important because they provide incentives within an economy, affecting investment decisions in physical and human capital and the organization of production. Nevertheless, these rules depend on political process. As economic agents know this, they will try to influence in politicians in order to get rules in their favor. There may also be cases where politicians want to obtain the economic resources for private purposes (campaign financing, bribes, etc.), which could be achieved as they control the State. In that sense, if an economic agent refuses to accept the requirement of a politician, that agent could suffer political reprisals in his economic activity. Therefore, the rules that control and rationalize the exercise of political power will be the key to creating an investment climate productive and inclusive (political rules).

<sup>17</sup> ACEMOGLU & ROBINSON. The Role of Institutions in Growth and Development. Review of Economics and Institutions, 2010.

<sup>18</sup> ACEMOGLU, Daron. Introduction to economic growth. Princeton University Press and copyrighted, 2008, chapter 22.

<sup>19</sup> RODRIK, Dani. Institutions for high-quality growth: what they are and how to acquire them. National Bureau of Economic Research, 2000, pp. 1 – 2 – 5, available in <http://www.nber.org/papers/w7540>

<sup>20</sup> RODRIK, Dani. Institutions for high-quality growth: what they are and how to acquire them. National Bureau of Economic Research, 2000, p. 1, available in <http://www.nber.org/papers/w7540>

<sup>21</sup> RODRIK, Dani. Institutions for high-quality growth: what they are and how to acquire them. National Bureau of Economic Research, 2000, p. 1, available in <http://www.nber.org/papers/w7540>

<sup>22</sup> See: The role of Institutions in Economic Development, available in. <http://www.palgrave.com/PDFs/9780230222298.pdf>, p. 120.



Thus, Acemoglu and Robinson<sup>23</sup> mention that the political process must be designed in order to avoid its control by only one group of society as it might attempt to appropriate the benefits of economic growth through the adoption of rules or State measures in its favor.

Following this line of thought, as has been pointed out at the beginning of this paper, the IIA can be seen not only as a means to attract foreign investment (economic objective), but can also serve to control and rationalize the behaviour of state bodies when these perform actions that harm investors (policy objective). This policy objective acquired greater importance in countries with weak institutional frameworks such as the case of developing countries. In these countries, it often happens that the State is a function of the particular interests of the ruling politicians or the interests of economic elites. These factors undermine the investment climate of a country because the State's action is not based on the achievement of public goals, but private ones.

In that sense, clauses that regulate expropriation (direct or indirect) or the FET become mechanisms that ensure that the State's measures are based on the well-being of the society, are rational and try to balance the interest of an investor and public goals, which would result in the improvement of the investment climate in the country.

As a basis for the analysis of the institution of expropriation and the FET, this paper has chosen the text of the investment chapter of the FTA with the U.S. because this treaty served as an inspiration to the following treaties negotiated by Peru on investment issues<sup>24</sup>.

## **2.2. The Treatment of Expropriation in the chapter on Investment in FTA with U.S.**

This section is going to analyze the regulation that has given the state the power to expropriate in the FTA signed with the U.S.

### **2.2.1. The purpose of the protection of property rights**

As it has been mentioned, the protection of the entitlements of an investment, its economic exploitation and the diminishing of political and social risks around of an investment are key factors for an investor when he decides to carry out his projects in a country, which would have positive effects on economic growth. For example, the World Bank notes that secure property rights are linked with rewardness of the effort made by an enterprise, securing that all firms - large or medium, informal or formal, rural or urban - will be able to appropriate the fruits of their investment. The more protected are these rights, the stronger the link between effort and reward, and the greater the incentive to open new businesses, invest more in existing and work harder<sup>25</sup>.

Notwithstanding the above, it is also recognized the expropriatory power of the State, which is one of the most severe forms of interference that can suffer a person in his property rights<sup>26</sup>. Since this power implies a serious intrusion on a person's property, the doctrine recognizes that the exercise of this power must be subject to certain requirements that justify its use. Thus, as pointed by Dolzer and Schreuer, although international law recognizes this power to the State, it also sets limits and conditions under which it can exert<sup>27</sup> which are incorporated in the investment agreements signed by Peru.

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<sup>23</sup> ACEMOGLU & ROBINSON. The Role of Institutions in Growth and Development. Review of Economics and Institutions, 2010, pp. 19 – 22.

<sup>24</sup> See, for instance, the article 812 of the Free Trade Agreement between Peru and Canadá and the Article 133 of the Free Trade Agreement between Peru and China.

<sup>25</sup> WORLD BANK. A better Investment Climate for Everyone. World development report 2005. A co-publication of the World Bank and Oxford University Press, 2005, p. 79.

<sup>26</sup> DOLZER, Rudolf y Christoph Schreuer. Principles of International Investment Law. Oxford University Press, 2008, p. 89.

<sup>27</sup> DOLZER, Rudolf y Christoph Schreuer. Principles of International Investment Law. Oxford University Press, 2008, p. 89.

### 2.2.2. What can be object of expropriation according to the FTA signed by the Peruvian State with the USA?

According to clause 10.28 of the FTA with the U.S., investment means the following:

“(…)

**Investment** means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:

- (a) an enterprise;
- (b) shares, stock, and other forms of equity participation in an enterprise;
- (c) bonds, debentures, other debt instruments, and loans;<sup>28 29</sup>
- (d) futures, options, and other derivatives;
- (e) Contracts in construction, management, production, concession, revenue-sharing, and other similar contracts;
- (f) intellectual property rights;
- (g) licenses, authorizations, permits, and similar rights conferred pursuant to domestic law;<sup>30 31</sup> and
- (h) other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges;”

As can be seen, the definition of property that can be expropriated is quite broad and can be both tangible and intangible<sup>32</sup>, which gives fairly wide coverage to the different investments that an investor can make in the country.

### 2.2.3. How to protect the foreign investor from the State's expropriation power?

The Clause 10.7 of the FTA establishes that neither Party may expropriate nor nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization, except<sup>33</sup>:

- (a) for a public purpose<sup>34</sup>. This requirement already provides a first requirement to State bodies when they want to expropriate an asset owned by a foreign investor protected by the Treaty. While it will be very difficult for a foreign Arbitral Tribunal to declare that a

<sup>28</sup> Some forms of debt, such as bonds, debentures, and long-term notes, are more likely to have the characteristics of an investment, while other forms of debt, such as claims to payment that are immediately due and result from the sale of goods or services, are less likely to have such characteristics.

<sup>29</sup> Loans issued by one Party to another Party are not investments.

<sup>30</sup> Whether a particular type of license, authorization, permit, or similar instrument (including a concession, to the extent that it has the nature of such an instrument) has the characteristics of an investment depends on such factors as the nature and extent of the rights that the holder has under the law of the Party. Among the licenses, authorizations, permits, and similar instruments that do not have the characteristics of an investment are those that do not create any rights protected under domestic law. For greater certainty, the foregoing is without prejudice to whether any asset associated with the license, authorization, permit, or similar instrument has the characteristics of an investment.

<sup>31</sup> The term “investment” does not include an order or judgment entered in a judicial or administrative action.

<sup>32</sup> In that sense, REINISCH, August. Expropriation. En: The Oxford Handbook of International Investment. Edited por Peter Muchlinski, Federico Ortino y Christopher Schreuer. Oxford University Press, 2008, p. 410.

<sup>33</sup> The text of this clause is repeated in several Free Trade Agreements and Investment Treaties celebrated by Peru and other countries. Even in cases where the text is not the same, the meaning of the wording is similar. It should be added that this clause is repeated in many investment treaties concluded at international level.

<sup>34</sup> For greater certainty, for purposes of this article, the term “public purpose” refers to a concept in customary international law. Domestic law may express this or a similar concept using different terms, such as “public necessity,” “public interest,” or “public use.”

particular measure does not fulfill a public purpose, the investor has the opportunity to challenge that requirement, but would have to demonstrate that the measure is either intended to benefit the particular interest of politicians or is influenced to benefit the economic interest of an economic group. This requirement would try to avoid the use of State power for private purposes.

- (b) in a non-discriminatory manner. This element ensures that all investors are treated equally and one investor is not treated differently from another.
- (c) on payment of prompt, adequate, and effective compensation. The importance of this requirement is that while the State may take the property to an investor, it must be prepared to compensate immediately, in the currency that the investor can use and the amount of compensation should be commensurate to the market value of the good.
- (d) in accordance with due process and Article 10.5. Under this requirement, the State before expropriating the investor must tell him that he will be expropriated, what are the causes of expropriation and that he will be paid compensation according to the market value of the property and in the currency that is easy to change for the investor. This means, in turn, that the investor can question, if necessary, the non fulfillment of any of the requirements the Treaty determines for the expropriation of property.

Furthermore, annex 10b of the Investment Chapter states that expropriation can be of two types: (i) direct, and, (ii) indirect, the difference revolves around whether the legal title of the owner is affected by the measure in question. Thus, direct expropriation occurs when an investment is nationalized or the property is formally transferred, while indirect expropriation occurs when an action or series of actions by a Party has an equivalent effect to direct expropriation without formal transfer of the, ie measures that, while not formally imply that the investor is deprived of the ownership of the property, the measurements have a practical or economic effect similar to an expropriation.

#### **2.2.4. Impact of the expropriation clauses in the Peruvian Law**

It should be noted that neither the regulation of the expropriation contained in paragraphs c) and d) nor the indirect expropriation are expressly written in the Peruvian Constitution<sup>35</sup>. This is why these provisions give a higher level of protection to the property rights of investors. This does not mean that these clauses are only designed to protect the interest of investors regardless of the public interest. Indeed, Annex 10 - B of the investment chapter of FTA establishes which cases do not constitute indirect expropriations.

These provisions allow that the State can expropriate the property rights of an investor but, in order to do so, it must comply with a number of requirements in order to guarantee that Government action is based on the welfare of the society; be rational (a relationship ends - means) and necessary (the measure is least burdensome possible), and finally, the investor is compensated on without delay, in an adequate and effective way.

As has been pointed out, if the authorities know they have to publicly justify any action or measure which would hurt the right of ownership of an investor and will have to compensate immediately, it will be more difficult that the State's action will work in favor of a private interest. Indeed, if the government can not justify such action, it will be invalid and, therefore, declare that such action has no effect, which would cause the Government is shown as arbitrary.

<sup>35</sup> Constitution of Peru; Article 70. - The right to property is inviolable. The State guarantees it. It is exercised in harmony with the common good and within the limits of law. Nobody can be deprived of his possessions except by national security or public necessity, declared by law and previous payment in cash of a compensation which include any eventual damage. The compensation must be determined previously by an appraiser. There exists an action before the Courts in case the affected person does not agree with the value of the property that the State has indicated in the expropriation proceedings.

Thus, regulation of the expropriation not only protects the property of foreign investors, but also creates incentives to control and rationalize government's action. This will have effects on the creation of a productive investment climate because the rules governing the market will target, technically, to seek social welfare, which would be an improvement of the country's administrative law.

### 2.3. The limits of the State's actions in the FTA when it regulates a foreign investor's activity

The investment chapter of the Free Trade Agreements signed by Peru also establishes that the State shall treat all investors in accordance with customary international law, including "fair and equitable treatment" and full protection and security. This clause sets a minimum standard of treatment that should be granted to a foreign investor and not discriminatory with national investors<sup>36</sup>, which must be in accordance with customary international law. For the analysis of the regulation of expropriating authority will be in comparison with the regulation contained in the FTA signed with the U.S.<sup>37</sup>

As noted by the doctrine, it is perhaps the most important clause on the protection of investments, due to its closure clause for the protection of foreign investment in a country. For example, Dolzer and Schreuer note that *"the purpose of the clause - in Investment Treaty - is to fill the gaps that may be left by specific standards, in order to obtain the desired level of protection by treaties"*<sup>38</sup>. There is considerable discussion in the literature if the minimum standard of treatment is different from the FET, however, it is agreed that, in the end, both clauses overlap because many of the principles guaranteed by one can be derived from the other<sup>39</sup>.

As you can see, this clause is intended to evaluate the treatment that the State has granted a foreign investor in a country. So, according to Van Harten, arbitrations in investment treaties are mechanisms for awarding public law matters for the following reasons: (i) the system is established by the act of State sovereignty, and (ii) is predominantly used to resolve disputes arising from the exercise of State's sovereignty. As a system of public law, it analyses the relationship between the State and an investor from a specific regulation that has been imposed on the latter<sup>40</sup>.

#### 2.3.1. What has been understood as "fair and equitable" with respect to the treatment of the State against IE?

Paragraph 1 of Article 10.5 establishes that each party shall give investor a treatment in accordance with customary international law, including fair and equitable treatment and full protection and security. According to Annex 10 - A, customary international law will result from a general and consistent practice of states followed by them in the sense of legal obligation. With respect to Article 10.5, the minimum treatment given to foreigners by customary international law refers to the principles of international law that protect their economic rights and their interests.

According to clause 10.5 of the FTA with the U.S., the "fair and equitable treatment" clause includes the obligation of non denial of justice in criminal, civil, or administrative procedures, in accordance with the principle of due process embodied in the principal legal systems of world. In the FTA, the FET is incorporated within the minimum standard of treatment that an investor must receive consistent with customary international law. From the review of arbitral jurisprudence in the application of FET, this clause would cover the following aspects<sup>41</sup>:

<sup>36</sup> OECD. Fair and Equitable Treatment. International Investment Law: a changing landscape, 2005, p. 100.

<sup>37</sup> See, for instance, the article 812 of the Free Trade Agreement between Peru and Canada and the Article 133 of the Free Trade Agreement between Peru and China.

<sup>38</sup> DOLZER, Rudolf y Christoph Schreuer. Principles of International Investment Law. Oxford University Press, 2008, p. 122.

<sup>39</sup> UNCTAD. Fair and Equitable Treatment. UNCTAD series on Issues in International Investment Agreement. New York – Geneva, 1999, p. 1.

<sup>40</sup> VAN HARTEN, Gus. Investment Treaty Arbitration and Public Law. Oxford University Press, 2007, p. 45.

<sup>41</sup> See, among other, the following cases: CMS v. Argentina; OEPC v. Ecuador; Metalclad v. Mexico; Tecmed v. Mexico; Lauder v. Czech Republic. Pope & Talbot v. Canada; GAMI Investment, Inc. v. Mexico; Saluka v. Czech Republic.

- a. Transparency in the decision making process
- b. Predictability
- c. Formal and substantive due process
- d. Stability
- e. Protection of the legitimate expectations of the investor
- f. Free from coercion and harassment
- g. Not subject to arbitrary and discriminatory treatment.
- h. Proportionality or balance between the right of investors and the public interest.

As can be seen, all these obligations seek to rationalize government action against the rights of investors and, thus, avoid arbitrariness. To do this, it create the following obligations:

- (i) Procedures that the State must follow before a given action;
- (ii) Criteria that the State should consider before doing something that could affect the rights of an investor; and,
- (iii) Proportionality or balance between the State's measure and investor rights.

According to Stephan Schill, the FET should be understood as reflecting the principle of Rule of Law<sup>42</sup>, which is that the government is limited by previous and present laws that will allow individuals, with relative certainty, to predict how the authority will use its coercive power in certain circumstances and, thus, plan their own actions on the basis of this knowledge<sup>43n</sup>.

According to Stephan Schill, the FET should be understood as the reflection of the principle of Rule of Law, which is that the government is limited by rules announced previously that will allow individuals, with relative certainty, to predict how the authority uses its coercive power in certain circumstances and, thus, plan their own affairs on the basis of this knowledge<sup>44</sup>. The concept of the Rule of Law also means that affected individuals are recognized as individuals with rights to be taken into account in the process of public decision-making, in the search for a proper balance between individual interests and the public interest; and in the institutional design of the Government, that is, there must be a separation of powers and a review of state actions by an independent judiciary<sup>45</sup>. In this way, they ensure a scheme that allows the foreign investor to know under what context is investing, your investment plan, defend your investment to an extent that may impair your investment, all of which will allow you to assess the risks they would be taking to invest in the country.

For Schill, the method for how these rules will allow them to previous investors know how the State will act in a given circumstance is obtained from the comparative analysis of the principles adopted by the legal systems of the Western States<sup>46</sup>. Thus, to discover and systematize those minimum rules that states must ensure to investors to create an investment climate that allows the economic development of their societies, which is the ultimate goal sought by countries to conclude investment treaties.

### 2.3.2. The FET clause and its incorporation to Peruvian law

<sup>42</sup> SCHILL, Stephan. Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law. IILJ Working Paper 2006/6, p. 9.

<sup>43</sup> HAYEK, Frederich. The Road of Serfdom, p. 54 (1944) citado por Schill, Stephan. Op. cit, p. 9.

<sup>44</sup> HAYEK, Frederich. The Road of Serfdom, p. 54 (1944) citado por Schill, Stephan. Op. cit, p. 9.

<sup>45</sup> SCHILL, Stephan. General Public International Law and International Investment Law – A Research Sketch on Selected Issues, December 2009, p. 15. According to Waldron, The Rule of Law is not the only political value in a society, but at the same time there exist other values such as Human Rights, Democracy and the market economy, which try to guarantee the social cooperation, justice and the dignity of their members. See WALDRON, Jeremy. The Rule of Law and the Measure of Property. The Hamlyn Lectures, 2011, July 2011, pp.6 – 10.

<sup>46</sup> SCHILL, Stephan. Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law. IILJ Working Paper 2006/6, p. 29 y ss.

While many of the principles and rules that are derived from the provision of "fair and equitable treatment" could be derived from several principles contained in the Constitution of Peru, it has not often been the case and, above all, those rules do not have been taken as required by the State. The reason is, perhaps, the institutional weakness of the State that responds to the interests of private interests that influence government or the rush of politicians to respond to certain demands of the public. If the dispute is to be resolved outside the country, the analysis could be done in a more objective and neutral scenario since the judges would not be pressured or biased by the interests of certain parties, which could occur in weak institutional environments such as in developing countries.

Since the Peruvian State has agreed to follow these rules of minimum treatment, the State must also apply this statement to domestic investors. It also will result in the reduction of risk perception on the country.

We shall see how a national investor may require that such minimum standards of treatment to be accorded to foreign investors also apply to them.

#### **2.4. Incorporation of regulatory expropriation clauses and FET in the Peruvian law**

As has been pointed out, some of the free trade agreements signed by Peru established a number of safeguards and protections to foreign investors that give greater protection to their investments in the country, limiting their exposure to the arbitrariness of State. Several of these guarantees are not explicitly listed in Peruvian legal system. In that sense, it is worth to wonder whether such clauses, which are contained in the FTA, can also be invoked by domestic investors when the state performs an act that could put in risk the value of their investments. From our point of view, the answer is positive, what we try to demonstrate in the following lines.

Article 63 of the Peruvian Political Constitution establishes that domestic and foreign investments are subject to the same treatment<sup>47</sup>. While this provision was intended to ensure foreign investor's minimum treatment, that provision may be invoked by a national investor if it considers that a foreign is receiving a different treatment. The goal is that all investors (domestic or foreign) have the chances to participate in the market with the same rules, unless there are reasons to justify their difference.

Furthermore, article 2 of the Political Constitution of Peru establishes that every person has the right of legal equality<sup>48</sup>. This rule has been interpreted to mean that the State should give the same treatment to all individuals, unless there are differences that justify a different treatment, but whose burden of proof is, again, in the State. In that sense, if the Peruvian government is committed to give a treatment to foreigners because it believes that it is necessary to create the right climate for investment, then the same treatment should be given to domestic investors.

This is very important to domestic investors due to the historical institutional weakness of the Peruvian State that often depends on the particular interests of politicians who are in Government or economic elite with influence over politicians. Under this situation, economic agents know that their success depend less in their effort to sell at lower prices, to produce at lower costs or innovate constantly, but more in their influence on politicians.

Therefore, the clause governing the "fair and equitable", and the case law that has been interpreted, would allow domestic investors to require such treatment that is given to a foreigner is also provide to it. This requirement may be claimed before the Constitutional Court for violating the principle of equal treatment.

<sup>47</sup> Constitution of Peru; Article 63.- The foreign and domestic investment are treated under the same conditions.

<sup>48</sup> Constitution of Peru; Article 2; Fundamental Rights.- Every person has the right:  
(...)  
2. to equality before the Law. Nobody must be discriminated based on grounds of origins, race, sex, language, religión, opinión, economic condition or any other condition.

**A note: the clauses on expropriation and FET will follow the same route which has had the Human Right Treaties in the Peruvian Legal System.**

Since the last years of the decade of 1990, the instruments recognized in human rights treaties began to be invoked and used by individuals who felt that their rights were being violated by the government. In particular, we tried to discuss the cases of violation of human rights at the Human Rights Commission and Court of Human Rights, because the domestic courts were controlled or intimidated by the Executive.

At that time, there were several statements condemning the Peruvian State for violations of human rights, which were slowly complied internally. Furthermore, the judgments of the Inter-American Court of Human Rights serve as a benchmark when interpreting the rights recognized in the Constitution by national courts. Even in a case where a judgment was contrary to a previous decision of the Commission on a case of Peru, the judgement is nullified in order not to incur international responsibility and respect the decisions of international courts to which is under Peru<sup>49</sup>.

The same route will occur when citizens know the utility of the investment protection clauses to require state agencies that their performance is always in the public interest, be rational, balanced and measures compensation if they leave their investments worthless.<sup>50</sup>

The next chapter will show, through various cases, clauses on expropriation and fair and equitable treatment would have some impact on state bodies when they exercise their public powers.

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<sup>49</sup> See R.N. N° 4104-2010 dated on September 27<sup>th</sup>, 2012.

<sup>50</sup> DOLZER, Rudolf. The impact of International Investment Treaties on Domestic Administrative Law. International Law and Politics, pp. 953 – 954.

### Chapter 3

#### Case Studies

This chapter will show several cases where State agencies behaved arbitrarily, harming the value of investments done by domestic investors. In some cases, the State measure would constitute an indirect expropriation because the value of the investment becomes zero, while in other cases the measure isn't so serious but it shows the lack of rationality with which the State agency acted.

The aim of this chapter is to show how the rules on expropriation and FET would oblige the state agencies to act rationally in the public interest, for which it is necessary to evaluate the relationship between the measure and the public objective; if the possible affected have been called to express their position over the measure; and, in case of the measure hurts seriously the right of investors, establish compensation measures for them. In case where the State does not behave in this way, an affected investor could sue it asking the annulment of the measure or the payment of compensation.

#### 3.1. *Shougan Hierro Perú vs. Municipality of Nazca*<sup>51</sup>

Shougan Hierro Perú S.A.A. (hereinafter, Shougan) is a mining company that operates, processes and sells iron. Its reservoirs are located on the southern coast of Peru in the district of Marcona, the province of Nasca, in Ica, approximately 530 kilometers from the Capital – Lima, from where the company gets all its raw materials to elaborate their products. These mineral deposits are the result of a mining concession granted by the Central Government<sup>52</sup>.

By Ordinance N° 006-2007-A/MPN<sup>53</sup>, the Municipality of Nazca (hereinafter, the Municipality) approved an update of the *"Urban Development Plan of the City of San Juan de Marcona 2006-2016"*, where cancels all mining concessions that were within the urban area of the city. The Municipality said that these concessions infringed the rules on environmental protection. In numeral 2.2.3.2. of this Plan, the Municipality indicated the following:

"The closeness and, in any cases, the overlapping between mining concessions and urban areas or similar is taking place in reality despite the apparent incompatibility between both, because of the mining areas given in concessions are not being exploited by their holders while the population of the city of Marcona are occupying those areas.

(...) The law allows cancellation of requests or concessions when they overlap with rights considered more important; in accordance with Article 64 of the General Mining Law (...)

(...) The exercise by the holders of the attributes of concessions such as the possible exploitation of metallic resources will be restricted, if not prohibited, by the inevitable breach of the rules of Environment and Protection environmental aforesaid, which give support to further the process of cancellation of mining concessions. "

Before this situation, Shougan made a claim against the Municipality by the approval contained in numeral 2.2.3 and 2.2.3.1 of the Ordinance N° 006-2007-A/MPN, because these clauses would violate its rights of free enterprise and industry, labor and property by denying them to exploit the concession that had been granted by the Government.

<sup>51</sup> The information of this case is based on the Judgment N° 007-2006-PI/TC, emitted the 22nd of June, 2007EXP No 01735-2008-PA/TC.

<sup>52</sup> See <http://www.shougang.com.pe/empresa.htm>

<sup>53</sup> Ordinances are general laws emitted by Regions and Municipalities in Peru to regulate matters that affect their jurisdictions, such as local transport, etc.



From the point of view of the majority of Judges of the Constitutional Tribunal (hereinafter, the TC), the Ordinance violated the freedom of contract of Shoughan, as this disposition changed the zoning of the area granted in concession from mining to urban area, which implied a serious modification the contract signed by Shoughan and Peruvian Government. However, the majority said not always a change in the rules imply a breach of contractual freedom because no right is absolute. In order to determine whether there was an infringement on freedom of contract it was necessary to analyze the restriction in light of the proportionality test.

In their analysis, the majority said the Municipality did not comply with the procedural established in the Ley 27015, modified by the Ley 27560, to change the zoning of an area where there are mining concessions as it were the City of Marcona. The Ley 27015 established that the authority local had to take in account the affected rights by any changes in zoning, which had not occurred in this case. The Municipality did not show any study which supported the change done; therefore, these changes were unreasonable.

On the other hand, there was a singular vote of the Judge Cesar Landa where he indicated that the prohibition of making mining activities in the area where Shoughan had its concessions implied the indirect revocation of them. This affected the rules and limits under which Shoughan got its concessions. The Municipality did not complied with the procedural established in the Law numbered 27015, modified by the Law numbered 27560, to change the zoning of a certain area.

Finally, the interesting idea about this vote for the purpose of this work is that the performance of the Municipality could be considered an indirect expropriation for the following reasons:

- (i) the action taken by the Municipality seriously impacts Shoughan's interest and prevent him from exercising his right to exploit the area has a mining lease;
- (ii) the duration of the Ordinance adopted was indeterminate;
- (iii) the relationship between the measure and the public objective that was meant to be achieved was clearly disproportionate.
- (iv) although there was no evidence to prove that the objective of the Municipality was directly affecting the property rights of Shoughan, in practice there was an indirect impact in the property rights.

From our point of view, the issue in dispute in this case was whether the clause prohibiting the exploitation of minerals in the city of Marcona violated the mining concession that Shoughan had to exploit minerals in that area.

Clearly, the ordinance violated the right of Shoughan to exploit the area where they had the mining concession. In that sense, if it prohibited the extraction of iron ores from that area, the land had little value, so this provision would have the effect of an expropriation.

This does not mean that the municipality could not change the zoning of their constituency, and even prohibit the performance of certain economic activities. However, the State institution must be aware of the rights that could be affected and whether the new regulation could have inappropriate effects. If it does, it should follow the procedure relating an expropriation in order to compensate the investor for their loss.

Currently, in an event like this, an investor can sue the Municipality and state that there has been a expropriation without having followed the adequate procedure, which is why the action of that agency should be declared invalid. If the Municipality wishes to modify the zoning in its influence area without having any responsibility, it should call a reunion to the agents who could be affected by this modification and try to quantify by how much each of them would be affected, having the willingness to compensate if the impact is too large. In this way, State measures could respond to a more participatory, transparent, rational and balanced procedure, giving a signal that State agencies won't act in an arbitrary way but in favor of public interest. This would have positive effects in the perception of agents about the quality of institutions in the country.

### 3.2. Changes in the permits in the *Pizza Street* <sup>54</sup>

The "*Pizza Street*" is one of the most concurred places in the city of Lima to eat and dance due to its location and its variety of bars, discotheques and restaurants. Nevertheless, this situation severely affected the health and safety of the citizens that lived in the neighborhood. Because of this, the Municipality of Miraflores approved an Ordinance numbered 212-2005<sup>55</sup> that restricted, in summary, the time in which the bars, discotheques and restaurants could receive clients to 01.00 am from Sunday to Thursday and 02.00 am from Friday to Saturday.

According to the Municipality, the Ordinance had the objective to protect the safety of the citizens in the area as many of the bars, discotheques and restaurants weren't prepared to receive clients due to their inadequate safety procedures. As well, it had the objective to protect the peace and health of the residents living in the vicinity of the so-called "Pizza Street". In the restricted area the noise disturbed the sleep of the neighbors. Nevertheless, although the local traffic and movement of people would create noise and safety problems that would harm the residents, the restriction imposed by the municipality would also have harmful effects on the bars, discotheques and restaurants, karaoke, etc.

As can be seen, the ordinances favored the neighbors living around the "*Pizza Street*" over the group of business man who had licenses to operate in the area. It is reasonable to assume that the behavior of the local authority responded to pressure from local residents because those businesses would not let them rest or sleep. However, they weren't able to present their position against the authority or raise a measure to reconcile their position with the one of the neighbors. In this case, the Municipality acted on behalf of a group without taking into account that their decision affected others.

The problem it's like a zero – sum game: a right given to one of the sides would mean an obligation to the other. And if compensations were to be established, the resources to pay if would come from public funding, affecting all of the citizens. Because of this, before making the decision of changing a regulation, a more open, participatory, and transparent procedure must happen to be able to which agents benefit and which one lose in the process. This would also allow finding ways to reach agreements and find ways to compensate if one party loses too much.

This type of procedure and criteria would ensure that rights are not affected by the State arbitrarily, but would ensure that the measures taken would be the product of an open, transparent, rational and based on the public interest process, which will help to the formation of an productive.

On the contrary, the fact that a regulation is issued without a discussion process could cause that other types of conflict arise, such as legal or political. In this case, for example, the businessman sues the Municipality in the TC. It is very likely that they had also thought about how to change the balance of power in the Municipal Council in order to, in the best case, eliminate the rule or, at worst, seek for compensation. This would make those resources to be used in an inefficient way.

Therefore, the rules developed from the interpretation of the clause on "fair and equitable treatment" requiring the state to be transparent in the decision making process, will ensure a formal and substantive due process to those affected by its decision, not arbitrary or discriminatory, and protecting the legitimate expectations of the investor. This would lead to the creation of a productive and inclusive institutional framework, avoiding the arbitrariness of the State.

In this case, although the ordinances issued by the Municipality had a public purpose, this entity didn't provided an adequate due process to investors operating in the "*Pizza Street*", since they were not allowed to show their opinion of the future regulation that would have direct impact on their business. In the same way, an assessment wasn't made to check whether the measure was the most suitable to achieve the desired purposes and what kind of compensation measures could have been taken.

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<sup>54</sup> This case is based on the information contained in Judgment N° 007-2006-PI/TC issued on June 22nd, 2007.

This was important not only the local businessman in the *Pizza Street*, but for the purposes of sending the message that the Municipality cannot take unilateral or arbitrary decisions that will affect the investment made in their constituency.

### **3.3. The restrictions to *Transportes Huaral***<sup>56</sup>

The Huaral Tourism Transport Company (hereinafter Huaral Transport) is a company that provides transportation services in the province of Huaral. The main site of this company was in the historic center of the city, and because of this it contributed to traffic chaos in that area which harmed both the neighbors and the landscape. In this situation, by Ordinance 009 - 2009 – MPH called the Plan of Urban Development; the Municipality of Huaral prohibited all transport companies to operate in the historic center of the city.

Subsequently, by Ordinance No. 016-2009-MPH, the Municipality states that transport companies authorized to July 31, 2008 that could occupy land terminals that had appropriate and sufficient areas for vehicles will be allowed to turn and maneuver internally and not impair the free flow of traffic and people, meeting the demanding requirements in the existing rules, until adoption of the Plan of Urban Development.

Transport Huaral sued the Municipality of Huaral for imposing illegal bureaucratic barriers and lack of reasonableness in the ordinance<sup>57</sup>. The company stated that this municipality authorized it to operate a bus terminal within the area defined by an operating license in 2000, but the new Ordinance did not recognize this and prohibited the activities the past license gave them. It was also noted that the Municipality did not present a technical study that supports that traffic congestion was a serious problem into the historic center and, therefore, it was necessary that restriction.

By Resolution 1535-2010/SC1-INDECOPI, The Competition Tribunal of Indecopi noted that while the municipality had jurisdiction to regulate the entry and exit of land transport vehicles into the historic center of the town, this is to be done respecting the rights of the companies that operate in that area. In this case, while maintaining the existing license of Transport Huaral to operate, the fact that their buses were prevented from driving in the historical implied revocation of the operating license. As can be seen, this case can also be described as an indirect expropriation because the prohibition to drive through the Historic Center of Huaral prevented that this company can store its buses in their main site. Although the license has not been revoked, the fact that no vehicle could enter this area would prevent that the business could operate.

If the Municipality considered that the restriction was a necessary measure to rearrange the traffic in the historic center of Huaral, this authority should have, first, assessed all the possible actions to take, who might be harmed by them and how it can compensate if someone receives a negative impact. This procedure should be as open and participatory as possible in order that the whole community can participate in the development of the new regulation and to seek solutions that reconcile the public interest with the private interest.

This procedure must be met not only because the Peruvian State has signed a number of investment treaties in where it compromises to give a fair and equitable treatment to investors and compensation in case of expropriation, but for all the implications of these rules in creating a productive and inclusive investment climate which will have effects on the country's sustainable development.

#### **Final remarks.-**

Throughout this work, we have seen that Rules will determine the structure of incentives - positive or negative – which surround the decision making of agents in a given country, whether they are investors, politicians or citizens. In fact, agents will act towards a productive or extractive activity according to the

<sup>56</sup> This case is based on the information contained in Resolution 1535-2010/SC1-INDECOPI.

<sup>57</sup> The Ordinance 009-2009-MPH was emitted on March 17<sup>th</sup>, 2009.

incentives that exist in their environment. To encourage agents into a productive activity, it is necessary that the rules which make up the country's institutional framework reward effort, merit and to satisfy the needs of other market players.

In this line of thought, the rules developed from the clauses on expropriation and FET guarantee an environment where the state bodies act in function of public interest, in a rational way and balancing the private interest with the public interest. Indeed, Rules like due process, non-discrimination, transparency, protection of legitimate expectations, proportionality and compensation measures, among others, become keys to ensure an institutional framework which guarantee that the state bodies behave in a rational way in favor of the public interest. If the government or other State bodies act arbitrarily or unilaterally, investors may sue them in the courts asking to cancel all measures which jeopardize their rights. If the State could behave in this way, the institutional framework of the country would be leading towards a productive and inclusive one, which would ensure the country's sustainable development.