*AD HOC* ARBITRATION

HEIRS AND SUCCESSORS-IN-INTEREST TO
SULTAN JAMALUL ALAM KIRAM, SULTAN OF SULU AND SABAH

*CLAIMANTS*

V.

MALAYSIA

*RESPONDENT*

# STATEMENT OF CLAIM

20 JUNE 2020

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1. This statement of claim (the "**Statement of Claim**") is submitted by Nurhima Kiram Fornan, Fuad A. Kiram, Sheramar T. Kiram, Permaisuli Kiram-Guerzon, Taj-Mahal Kiram-Tarsum Nuqui, Ahmad Narzad Kiram Sampang, Jenny K.A. Sampang, and Widz-Raunda Kiram Sampang (the "**Claimants**"), heirs to the Sultanate of Sulu and Sabah and successors-in-interest to Sultan Jamalul Alam Kiram, against Malaysia (the "**Respondent**"). Claimants and Respondent will hereinafter be jointly referred as the "**Parties**" and individually as a "**Party**".[1]

2. For the sake of convenience, attached as ***Appendix 1*** is a list of the exhibits submitted herewith, attached as ***Appendix 2*** is a list of the legal authorities submitted herewith, and attached as ***Appendix 3*** is a list of the media files submitted herewith.[2] Also accompanying the Statement of Claim are four expert reports: (i) Report on "Pajakan and the Traditional Malay Polity", prepared by Prof. Ernst Ulrich Kratz, dated 13 June 2020 ("**Kratz Report**") (ii) Third Expert Report of Prof. Eckart J. Brödermann, dated 18 June 2020 ("**Third Brödermann Report**"); (iii) Report on "Restitution Value to the Heirs of the Sultan of Sulu", prepared by The Brattle Group, dated 19 June 2020 ("**Brattle Report**"); and (iv) "Analysis of Oil and Gas Fields in the Sabah Basin", prepared by Dr. D. Nathan Meehan, dated 19 June 2020 ("**Meehan Report**").

## I. INTRODUCTION

3. This case is about a lease agreement executed on 22 January 1878 (the "**1878 Lease Agreement**"). The lessor was Sultan Jamal ul-Azam, Sultan of Sulu; the lessees were Messrs. Alfred Dent and Gustavus von Overbeck.[3] Sulu is in the Southern Philippines. When the 1878 Lease Agreement was signed, the Sultanate of Sulu was under Spanish jurisdiction.[4] The original lessees were acting on behalf

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[1] Claimants' word processing software defaults in English to American spelling conventions. For the sake of convenience, Claimants use American spelling throughout this Statement of Claim, except where quoting from sources.

[2] References in the form of "**Doc. C-__**" are to the exhibits submitted by Claimants in these arbitration proceedings. References in the form of "**Doc. CL-__**" are to the legal authorities submitted by the Claimants in these arbitration proceedings. References in the form of "**Doc. CER-__**" are to the media files submitted by the Claimants in these arbitration proceedings. For the sake of simplicity, Claimants request that legal authorities be labeled as "Doc. CL-__" as opposed to "Doc. CLex-__" (which is the format mentioned in ¶ 51.C of Procedural Order No. 1). The nomenclature Claimants propose is also more widely used in international arbitration.

[3] *See* § II.D, *infra*.

[4] *See* § II.B, *infra*.

of a British concern.[5] The leased territory included part of the island of Borneo, a territory known today as Sabah, Malaysia, as well as some smaller adjacent islands (the "**Leased Territories**").

4. The Sultan agreed to 5,000 dollars as annual rent under the 1878 Lease Agreement.[6] The parties updated the amount to 5,300 dollars in 1903 (the "**1903 Amendment**").[7] The 1878 Lease Agreement gave the lessees the right to exploit the Leased Territories.[8]

5. As the years passed, successive parties inherited the 1878 Lease Agreement's rights and obligations:

(i) The Sultan of Sulu ceased to be a temporal ruler; Jamalul Kiram II, the last such Sultan, childless, deeded the lease rights to his nieces and nephews. Claimants are their direct descendants and legal heirs.[9]

(ii) The original lessees formed a company in 1881 (the North Borneo Trading Company or hereinafter the "**Company**") that inherited the lease rights and obligations.[10] The Company passed on those rights and obligations to the British Government in 1946; the British in turn divested the territory to Malaysia in 1963.[11] The Malaysian Government has held the lease ever since.

6. The 1878 Lease Agreement fully compensated the Sultan of Sulu for the loss of his personal gains from the Leased Territories. We know from the contemporary correspondence of Acting Consul-General William H. Treacher that the Sultan earned 5,000 dollars annually from the sale of birds' nests and seed pearls in what would become the Leased Territories, and that on that basis the counterparty had fixed the price of 5,000 dollars as the annual rental.[12] We also know, from contemporaneous records and private correspondence between the original lessees, that they valued the Leased Territories at somewhere between 25,000 and

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[5] *See* § II.E, *infra.*

[6] *See* § II.D, *infra*.

[7] *See* § II.G, *infra*.

[8] *See* § II.D, *infra*.

[9] *See* § II.F, *infra*.

[10] *See* § II.E, *infra*.

[11] *See* § II.J, *infra*.

[12] *See* ¶ 50, *infra.*

45,000 dollars annually, anticipating the Leased Territories' exploration and improvement.[13]

7. The natural resources in the Leased Territories have transformed them from a backwater into among the most strategically and economically valuable for Malaysia. The principal driver of those changed circumstances was the discovery of hydrocarbons (oil and gas) and the cultivation of oil palms in the Leased Territories in the second half of the Twentieth Century.[14]

8. The Leased Territories' value to the British and the Sultan alike of course excluded any consideration of hydrocarbons or palm oil. Neither party to the 1878 Lease Agreement knew that the Leased Territories contained massive reserves of oil and gas. And even if they had known, those reserves would have held no commercial value in an era before hydrocarbon-powered technology existed. Likewise, the cultivation of oil palms was negligible, and the palm oil industry was not even in its inception. The parties could not have anticipated that palm oil would be the second-most profitable industry in the Leased Territories (after hydrocarbons).[15] Today, however, the annual Malaysian share of hydrocarbon and palm oil revenues from the Leased Territories is ***three million times*** greater than the annual lease payment.

9. Like prior lessees, Malaysia regularly made the lease payments from the time it assumed the benefits and obligations of the 1878 Lease Agreement. In Malaysia's case, that was 1963. But in 2013, Malaysia stopped making payments and has not paid since.[16] Claimants have reached out repeatedly to Malaysia, asking it both to cure its breach and to renegotiate the 1878 Lease Agreement in light of the changed circumstances.[17] Malaysia never responded.

10. During the seven years in which Malaysia has been in breach of the terms of the 1878 Lease Agreement, it has gained US$ 25.75 billion in revenues from the Leased Territories' hydrocarbons and US$ 2.58 billion in palm oil, while it has paid

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[13] *See* ¶ 52, *infra.*

[14] *See* § II.M(c)(ii), *infra*.

[15] *See* ¶ 147, *infra.*

[16] *See* § II.K, *infra*.

[17] *See* § II.N, *infra.*

Claimants nothing.[18] And obviously, despite that massive number, Malaysia has gained even more than that if one were to take other industries into account. We have moved from a situation of substantial, but historically common, imbalance in contractual benefits to one of absurd and unprecedented proportions.

11. We thus come to the question: what to do about Malaysia's breach and its unjust enrichment? The solution is neither new nor exotic. This case is unusual in the age of its arbitration clause and the length of the contractual arrangement in dispute. At heart, however, the issue it presents is straightforward: <u>if a contract – originally 5-10 times more valuable to one party than the other – is now some **3 million** times more valuable to one party than the other, should it be terminated or readjusted to reflect the parties' original balance?</u>

12. The obvious answer is "yes". The provisions of the UNIDROIT Principles of International Commercial Contracts (2016) (the "**UNIDROIT Principles**"), general principles of international law, and plain common sense all dictate that a contract so grievously imbalanced cannot stand unchanged.

13. In this Statement of Claim, Claimants will first explain the facts surrounding the execution of the 1878 Lease Agreement and the evolution of the Leased Territories over time.[19] Claimants will then develop their legal arguments under the UNIDROIT Principles, which the Sole Arbitrator has ruled apply to this dispute.[20] Claimants see two alternatives:

14. <u>First</u>. The Sole Arbitrator can, and should, terminate the 1878 Lease Agreement because:

(i) under the doctrine of hardship, the 1878 Lease Agreement has become utterly unbalanced;[21]

(ii) Malaysia has been in breach of the 1878 Lease Agreement since 1 January 2013, when it first began failing to pay annual rent;[22] and

[18] *See* ¶¶ 145-146, 160-161, *infra.*

[19] *See* § II.M, *infra.*

[20] Preliminary Award on Jurisdiction and Applicable Substantive Law, 25 May 2020 ("**Preliminary Award**"), § XI.A.4.

[21] *See* § IV.D, *infra.*

[22] *See* § IV.E, *infra.*

(iii) the UNIDROIT Principles permit the termination of contracts for an indeterminate period, such as the 1878 Lease Agreement.[23]

15. Upon termination of the 1878 Lease Agreement, Malaysia should pay Claimants the restitution value of their rights over the Leased Territories. Specifically, if the Sole Arbitrator deems the 1878 Lease Agreement terminated as of 1 January 2013, he should order Malaysia to pay Claimants the restitution value as of that day, which is equivalent to US$ 32.20 billion.[24] Conversely, if he concludes that the 1878 Lease Agreement terminated as of February 2020 or a later date, the Sole Arbitrator should order Malaysia to pay Claimants the restitution value as of that date, which is currently US$ 26.71 billion, plus non-performance damages for the (adapted or rebalanced) unpaid rent from 2013 to the date of termination, which amounts to US$ 714 million per annum, plus interest.[25]

16. Second. If the Sole Arbitrator chooses not to terminate the 1878 Lease Agreement, he should determine the contours of a properly rebalanced agreement under the hardship doctrine and order the Parties to abide by it. The rebalanced rent should be US$ 714 million per annum. In such case, the Sole Arbitrator should order Malaysia to pay Claimants a lump sum for the (adapted or rebalanced) unpaid rent from 2013 to the date of the arbitral award (currently amounting to US$ 5.72 billion), and further order that Malaysia pay all future annual rent payments in the adapted or rebalanced amount of US$ 714 million per annum.[26]

17. Claimants submit that all amounts awarded be subject to compound interest;[27] they also seek an award on costs.[28]

18. Claimants can enlist an unlikely ally for the proposition that long-term contracts sometimes need to be terminated or rebalanced: the recent Prime Minister of Malaysia, Dr. Mohamed Mahathir. One Malaysian state is a party to a long-term agreement to supply water to Singapore. The original agreement dates to the 1920s; the price of the water was reset in 1962, with one opportunity for escalation

[23] *See* § IV.F, *infra.*

[24] *See* § V.B(f), *infra.*

[25] *See* § V.B(g), *infra.*

[26] *See* § V.C, *infra.*

[27] *See* § V.D(d), *infra.*

[28] *See* § VI, *infra.*

which has long passed. His Excellency Prime Minister Mahathir said of the agreement in late 2019:

> It is ridiculous that something agreed in 1926 – 3 sen per 1,000 gallons of water – is still being used now. At that time, it was reasonable but today, it is no longer reasonable. . . . And yet they get water from us for 3 sen and sell it for more than 1,000% profit.[29]
>
> * * *
>
> Can you find any country selling 1,000 gallons of water at 3 sens, something, a price that was fixed way back in 1926? What was sold at 3 sen in 1926 which is sold at 3 sen now? . . . What we are saying is, it is ridiculous that the state of Johor sells water to the state of Malacca at 50 sen per thousand gallons and yet sells at 3 sen to Singapore. . . . And we all know that Singapore is a developed country, it is a very rich country. Its currency is three times higher than our currency, although before they were the same. And yet they are asking a poorer country to subsidise their economy and their growth. . . . There are also other issues of course. But to say that this is unusual, unfair or unjust is ridiculous. There is no place in the world where water is sold by one entity to another, <u>or petroleum is sold to other countries at a price that was fixed in 1926</u>.[30]

19. Elsewhere, acknowledging that the price of the water was reset in 1962, not 1926, Dr. Mahathir makes the same argument:

> The price of 3 sen per 1,000 gallons was fixed in 1962 and the price remains until now. . . . Looking at the current situation, is it reasonable? I don't think so. Until when [will the price remain unchanged]? Previously, even [with] one sen we can buy many things. But not now, let alone three sen. Today, we no longer talk about millionaires, but billionaires as the income level is getting higher.
>
> But, the only thing that will not increase is the price of water sold to Singapore, at 3 sen per 1,000 gallons. At that rate, we cannot even get nasi lemak [a common Malaysian rice dish].[31]

[29] <u>Doc. **C-55**</u>, Romero María Anna, *Dr. Mahathir: In the World Court, Singapore would lose on water issue*, THE INDEPENDENT, 4 March 2019.

[30] <u>**Doc. C-56**</u>, South China Morning Post, *Manhathir: 'I'm pro-Malaysia, not anti-Singapore'*, BANGKOK POST, 8 March 2019 (emphasis added); *see also* <u>**Doc. CER-2**</u>, *Malaysian Prime Minister says he is not anti-Singapore*, YOUTUBE, 8 March 2019 (available at: https://www.youtube.com/watch?v=sJt0_aOgN9U).

[31] <u>**Doc. C-57**</u>, Nor Ain Mohamed Radhi, *PM: Water sold to Singapore too cheaply*, NEW STRAITS TIMES, 17 February 2019.

20. We agree with the sentiment. Claimants simply ask that Malaysia be ordered to abide by these same standards of justice and fairness that it claims for itself.

## II. STATEMENT OF FACTS

21. This Statement of Claim assumes familiarity with, and unless stated otherwise adopts, the facts, arguments and definitions set forth in Claimants' Notice of Arbitration dated 30 July 2019 ("**Notice of Arbitration**"). For ease of reference, however, we have reproduced, expanded, and updated the facts below.

### A. The Sultanate of Sulu is Formed

22. Borneo is a large island in Southeast Asia, divided today into three different territories:[32] (i) the central and South parts belong to the Republic of Indonesia; (ii) a small piece of the North is Brunei; and (iii) the remainder of the North are the states of Sabah and Sarawak, two of the federal states that comprise Malaysia. About twice the size of Germany, Borneo sits between Java and Sumatra to the West and Papua New Guinea to the East. The name "Borneo" is thought to derive from a Sanskrit word, vāruṇa (varuné), meaning water or rain.[33] The same word was eventually used to describe the small polity in the North of the island, today rendered as "Brunei".

23. At the same time as the Sultanate of Brunei was developing into a regional power, a related group of largely seafaring people from the archipelagic islands in the Sulu Sea was also coalescing into a hierarchical monarchy that eventually evolved into the Sultanate of Sulu.

24. Up until the early 18th century, Brunei was unquestionably the more powerful of the two Sultanates. In 1704, however, a rebellion in Brunei forced its Sultan to call upon the assistance of his ally, the Sultan of Sulu. The Sultan of Sulu duly obliged, sending assistance to quash the rebellion. In exchange for the help, the Sultan of Brunei granted a large swath of Northern Borneo to the Sultan of Sulu.[34]

25. The 18th and early 19th centuries saw the heyday of the Sulu Empire. In addition to its land and island holdings, the Sultanate held sway over much of the

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[32] **Doc. C-3**, Encyclopedia Britannica, "Borneo".

[33] **Doc. C-4**, Sanskritdictionary.com, "vāruṇa"; **Doc. C-5**, Spokensanskrit.org, "vAruNa".

[34] **Doc. C-6**, Geoffrey Marston, *International Law and the Sabah Dispute*, AUSTRALIAN INTERNATIONAL LAW JOURNAL 103 (1967), p. 108; **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 22.

seas. In Southeast Asia during that period, a Sultan of Sulu's worth and wealth were measured much more by his control of (maritime) trade routes and ports than by his possession of any land.[35]

26. The Sulu people were known for their ferocity and their maritime skill.[36] Often they were hired as mercenaries on behalf of one local potentate against another, or plied their trade as privateers.[37] Whatever their occupation or cargo, all Sulu seamen continued to owe, and pay, fealty to their Sultan. All goods from Sulu ships were subject to a tax to the Sultan of between 10% and 25%.[38]

27. Through an extensive trade network, the remit of the Sultanate thus stretched hundreds of kilometers into what is now known (albeit controversially)[39] as the South China Sea.

28. It is thus important, for the purpose of the history of North Borneo, to understand that the subjects of the Sulu Sultanate were less interested in territorial boundaries than they were in the concept of allegiance to the Sultan. The Sultan was the ultimate sovereign – God's representative on Earth.[40] His rule extended as far as any of them stood or sailed.[41] As detailed below,[42] the British would come to understand the mismatch between their understanding of control and the Sultanate's ultimate sovereignty over his subjects only after years of strife in North Borneo.

29. The Sultan's power little resembled the authority of his contemporary rulers in Europe. The closest analogue was the authority of the European rulers' antecedents in the Medieval period, centuries earlier. The Sultan allowed his various nobles to control swathes of his territory; those nobles, in turn, controlled

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[35] Kratz Report, ¶¶ 52, 78-80, 87, 129.

[36] *Id.*, ¶¶ 114-115.

[37] *Id.*, ¶ 115.

[38] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIOECONOMIC PATTERNS OF THE SULU ZONE, 1770-1898 (Australian National University, 1975), p. 18; **Doc. C-59**, Nicholas Tarling, SULU AND SABAH, A STUDY OF BRITISH POLICY TOWARDS THE PHILIPPINES AND NORTH BORNEO FROM THE LATE EIGHTEENTH CENTURY (Oxford University Press, 1978), p. 75.

[39] Because some parts of the sea are contested, it is also variously known as the East Sea (Vietnam), the West Philippine Sea (Philippines), and the North Natuna Sea (Indonesia).

[40] Kratz Report, ¶ 92.

[41] *Id.*, ¶ 87.

[42] *See* § II.F, *infra.*

headmen and other local potentates. Everyone owed allegiance up the chain – the villagers to the headmen, the headmen to the nobles, the nobles to the Sultan, and the Sultan to God.[43]

30. It was into this highly feudal environment that European powers inserted themselves and expanded their influence.

### B. Spain Dominates the Sultanate's Territories

31. The first interactions between the Spaniards and the Sultanate of Sulu trace back to 1578, just a few years after the former set foot in the Philippines in 1565.[44] In 1646, Spain and the Sultanate of Sulu entered into a Treaty whereby they agreed to mutual peace and help.[45] Spain recognized the sovereignty of the Sultan over certain parts of the Sulu Archipelago (*i.e.*, from Tawi-Tawi to Pagahak and Pangutaran), and the Sultanate recognized Spanish sovereignty over others (*i.e.*, Tapul, Siasi, Balangingi and Pangutaran).[46]

32. Later, pursuant to the Capitulations of Peace, Protection and Commerce of 1836 (*Capitulaciones de Paz, Protección y Comercio*), Spain pledged to protect the Sultanate of Sulu. In exchange, the Sultan agreed not to give up control over any of his territories without Spain's prior permission.[47]

33. Despite these Capitulations, the Sultan signed an agreement with Sir James Brooke in 1849. The Brooke family, though British, ruled over a part of Western Borneo called Sarawak. This earned them the moniker "the White Rajahs".[48] The agreement of friendship and trade between Brooke and the Sultan contained a clause stating that the Sultan would not recognize the sovereignty of any nation

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[43] Kratz Report, ¶¶ 88-92.

[44] **Doc. C-8**, Pio A. de Pazos y Vela-Hidalgo, JOLÓ: RELATO HISTÓRICO-MILITAR DESDE SU DESCUBRIMIENTO POR LOS ESPAÑOLES EN 1578 A NUESTROS DÍAS (De Polo, 1878), pp. 1-2.

[45] *Id.*, pp. 29-30.

[46] **Doc. C-9**, Manuel L. Quezon II, *North Borneo (Sabah): An annotated timeline 1640s-present*, QUEZON.PH, 1640s.

[47] **Doc. CL-2**, Marqués de Olivart, COLECCIÓN DE LOS TRATADOS, CONVENIOS Y DOCUMENTOS INTERNACIONALES CELEBRADOS POR NUESTROS GOBIERNOS CON LOS ESTADOS EXTRANJEROS DESDE EL REINADO DE DOÑA ISABEL II HASTA NUESTROS DÍAS (El Progreso Editorial, 1890), Tomo I, pp. 2-4 (of the PDF).

[48] **Doc. C-60**, *White Rajahs*, WIKIPEDIA.

over any part of Sulu territory without prior consent of Great Britain.[49] This directly contradicted the terms of the Sultan's 1836 treaty with Spain.

34. Spain was outraged by the agreement. Spain's umbrage, conveyed by the Spanish ambassador in London, caused the British Government to decline to ratify Brooke's agreement with the Sultan. Although that refusal prevented a diplomatic crisis, an irked Spanish Government took no chances: Spain demanded that the Sultan sign the Additional Capitulations on 27 August 1850. These mandated:

> *[D]e las tierras que son tributarias al Sultán no podrá ceder parte alguna sin previo consentimiento de Su Magestad Católica, pues así deben entenderse las capitulaciones de paz, protección y comercio, que la muy poderosa Reina de las Españas tiene otorgadas al muy Excelente Sultán y Dattos [nobles joloenses] de Joló, en 23 de Setiembre de 1836.*[50]

35. In other words, the Capitulations of 1836 were restated: the Sultan was thus obliged to obtain Spain's prior permission before granting rights of control to anyone over any territory of the Sultanate.

36. Shortly thereafter, in 1851, Spain signed a treaty with the Sultan of Sulu dubbed the "Minutes of New Submission" (*Acta de Nueva Sumisión*). Under this new treaty, Sulu was incorporated into the Spanish monarchy. The Sultan and his Datus (nobles) declared as follows:

> *Que a fin de reparar el ultrage hecho a la nación española . . . desean y suplican sea la Isla de Joló con todas sus dependencias incorporada á la Corona de España, que de algunos siglos á esta parte era ya su única Señora y Protectora: haciendo de nuevo en este día acta solemne de sumisión y adhesión, reconociendo á S.M. C. Doña Isabel II, Reina Constitucional de las Españas, y á los que sucederle puedan en esa Suprema dignidad, por sus soberanos Señores y protectores, según de derecho les corresponde, tanto por los tratados celebrados en épocas remotas, por el de 1836. . . .*
>
> *[D]eclaran nulo y sin fuerza todo tratado celebrado con otra Potencia si éste perjudica á los antiguos é indisputables derechos que la España tiene á todo el archipiélago de Joló,*

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[49] **Doc. C-6**, Geoffrey Marston, *International Law and the Sabah Dispute*, AUSTRALIAN INTERNATIONAL LAW JOURNAL 103 (1967), p. 107; **Doc. C-9**, Manuel L. Quezon II, *North Borneo (Sabah): An annotated timeline 1640s-present*, QUEZON.PH, 1849.

[50] **Doc. CL-2**, Marqués de Olivart, COLECCIÓN DE LOS TRATADOS, CONVENIOS Y DOCUMENTOS INTERNACIONALES CELEBRADOS POR NUESTROS GOBIERNOS CON LOS ESTADOS EXTRANJEROS DESDE EL REINADO DE DOÑA ISABEL II HASTA NUESTROS DÍAS (El Progreso Editorial, 1890), Tomo II, p. 7 (of the PDF).

> *como parte del de Filipinas, y ratifican, renuevan y dejan en toda su fuerza y valor los documentos redactados anteriormente que contienen alguna cláusula favorable al Gobierno Español desde el tiempo más remoto. . . .*[51]

37. Lastly, by way of a further declaration in 1864, a new Sultan recognized that both the Sulu Archipelago and its territories in North Borneo (where Sabah is located) were part of the Spanish Empire pursuant to the Treaty of 1851:

> *[L]os Archipiélagos de Joló, Tawi-Tawi, y gran parte del N. de la isla de Borneo que forman la Sultanía, pertenecen de hecho y por derecho de conquista y anexión á España en virtud de lo establecido en el Tratado de 1851.*[52]

38. The incorporation of the Sulu Sultanate into Spain raised issues about the status of the Sultan of Sulu's possessions in North Borneo. Did Spain only govern Sulu, at the archipelagic Southern tip of the Philippines? Or did Spain, through the Sultan, now also possess his territories in North Borneo? Unsurprisingly, the Spanish Government took the latter view by virtue of the declaration of 1864. But the British disagreed. By 1876, the British (per correspondence from the British Prime Minister to a prominent diplomat) had concluded that any Spanish claim to sovereignty over North Borneo was void for lack of Spanish control over the territories.[53]

### C. A British Concern Seeks a Foothold in North Borneo

39. Into the story now steps one of its central characters, William H. Treacher. A young and ambitious British diplomat, Treacher was the colonial secretary in Labuan – an island off the coast of North Borneo.[54] For the purpose of his dealings in North Borneo itself, Treacher, like his predecessors, styled himself "Acting British Consul General".

40. In late 1877, Treacher learned of a British business venture interested in gaining control over territory in North Borneo. The venture was a concern named

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[51] *Id.*, Tomo II, pp. 8-12 (of the PDF). *See also* **<u>Doc. C-6</u>**, Geoffrey Marston, *International Law and the Sabah Dispute*, AUSTRALIAN INTERNATIONAL LAW JOURNAL 103 (1967), p. 112.

[52] **<u>Doc. C-8</u>**, Pio A. de Pazos y Vela-Hidalgo, JOLÓ: RELATO HISTÓRICO-MILITAR DESDE SU DESCUBRIMIENTO POR LOS ESPAÑOLES EN 1578 A NUESTROS DÍAS (De Polo, 1878), p. 190.

[53] **<u>Doc. C-6</u>**, Geoffrey Marston, *International Law and the Sabah Dispute*, AUSTRALIAN INTERNATIONAL LAW JOURNAL 103 (1967), p. 112.

[54] **<u>Doc. C-7</u>**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 22.

Dent and Company. Its representative happened to be an Austrian, Baron Gustavus von Overbeck.[55]

41. Overbeck told Treacher that he had secured a series of concessions for territory in North Borneo from the Sultan of Brunei. Overbeck had learned, however, (as had Treacher) that the leases from the Sultan of Brunei were not actually his to give – they were for essentially the same territory that the Sultan of Brunei had granted to the Sultan of Sulu in 1704 (explained at ¶ 24 above).[56]

42. Overbeck therefore sought Treacher's help in gaining a commercial concession for the territory at issue.[57] In January 1878, Treacher sailed with Overbeck to Jolo, the capital of Sulu. They were accompanied by Treacher's translator.

43. Treacher likely had ulterior motives for helping Overbeck: to Labuan's Southwest, further down the Borneo coast, lay the territory of Sarawak, still controlled by the Brooke family. Through a combination of artful negotiation, occasional force, and plain theft, the Brooke family had expanded Sarawak so that, by 1878, it was encroaching on Brunei. At that time, the Sultan of Brunei's authority extended only in and close to his capital city.[58]

44. The Brooke family had gotten into a dispute with the British Government over an effort in Labuan to form a coal company. As Consul-General stationed in Labuan, Treacher had an incentive to check Brooke's territorial ambitions.[59]

45. Moreover, Sulu had become an important trading partner for Labuan. The Sultanate's ships stopped frequently there en route to Singapore. Labuan's

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[55] *Id.* Overbeck also was the Austro-Hungarian Consul-General in Hong Kong.

[56] **Doc. C-61**, Letter No. 1 from William H. Treacher to the Earl of Derby, 2 January 1878, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom).

[57] *Id.*

[58] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIO-ECONOMIC PATTERNS OF THE SULU ZONE, 1770-1889 (Australian National University, Canberra 1975), p. 133 (In fact, the Brooke family and the future North Borneo Charter Company born of the 1878 Lease Agreement ultimately drew a boundary north of Borneo; that boundary remains the modern division between the Malaysian States of Sabah and Sarawak. Modern Brunei therefore is surrounded by Malaysia on both sides).

[59] **Doc. C-62**, Letter from William Treacher to the Earl of Derby, 14 May 1878, in Dent and Overbeck Concession 1877-8, The National Archives (United Kingdom), pp. 42-46.

principal export to Sulu was weapons. In fact, the majority of Labuan's weapons were shipped to Sulu.[60]

46. Trade with Labuan increased in the 1870s as trade with Manila decreased, after Spain became increasingly frustrated with the Sultanate of Sulu's continued attempts to destabilize Spanish rule.[61]

47. Treacher well knew that the Sultan was conducting a (losing) battle against Spanish authority. Spanish troops had occupied Jolo, the Sultanate's capital, since 1875. The Sultan needed weapons to continue his defiance of the Spanish; he received them from Labuan. By arranging the 1878 Lease Agreement, therefore, Treacher was guaranteeing Labuan a steady revenue stream for weapons purchases – and causing trouble for an imperial rival in the bargain.[62]

48. In his letter to the British Foreign Minister, Treacher describes his meeting with the Sultan of Sulu:

> The Sultan did me the honour of consulting me on the subject of the Baron's [Overbeck's] request [for an agreement about the North Borneo territory], and I told him that any advice I gave would be given in the capacity of a friend of His Highness, and would bear no official weight, as I had received no instructions from your Lordship in the matter. I informed him that, to the best of my belief, the Baron represented a bona fide British Company or co-partnership, with sufficient capital, or the capacity of raising it, to carry out an undertaking of the kind. . . .[63]

### D. The Sultan and Overbeck Sign the 1878 Lease Agreement

49. On 22 January 1878, the Sultan of Sulu[64] and Overbeck (acting in his own name and also on behalf of his partner, Alfred Dent) executed the lease contract for the Leased Territories. That contract – the 1878 Lease Agreement – was executed in Sulu, the Capital of the Sultanate. It was written in Jawi, a form of Malay in Arabic script.[65] The 1878 Lease Agreement was accompanied by a side letter (also known

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[60] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIO-ECONOMIC PATTERNS OF THE SULU ZONE, 1770-1889 (Australian National University, Canberra 1975), p. 212.

[61] *Id.*, pp. 192-193.

[62] *Id.*, p. 212.

[63] **Doc. C-11**, Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, DENT AND OVERBECK CONCESSION 1877-8, The National Archives (United Kingdom), p. 8 (emphasis added).

[64] Identified as His Majesty and Lord the Sultan Muhammad Jamalul Azam or Paduca Majasari Maulana Sultan Mujamad Dejamalul Alam, depending on the translation used.

[65] **Doc. C-12**, Agreement among Sultan of Sulu, Gustavus von Overbeck and Alfred Dent, 22

as the “**Letter of Authority**”) in which the Sultan appointed Overbeck as Rajah and Datuk Bendahara (Viceroy)[66] of the Leased Territories.

50. Treacher’s letter to the U.K. Foreign Minister describes his discussion about the financial terms of the arrangement:

> His Highness [the Sultan] also consulted me, in a very intelligent manner, on several other points, such as the amount he should ask, &c., and in the advice I ventured to give I endeavoured, so far as possible not to lose sight of His Highness’s own interest while not opposing those of the proposed British Company, which already holds from Brunei a concession of the territories in question.
>
> . . . .
>
> The Sultan assured me that at the present moment he receives annually from this portion of his dominions the sum of 5,000 dollars, namely 300 busings of seed pearls from the Lingabo River alone, which at 10 dollars a busing comes to 3,000 dollars per annum, and about 2,000 dollars from four birds-nest caves in the Kinabatangan River, which are his family possessions.[67]

51. On the basis of the Sultan’s estimate above of his North Borneo family income, Overbeck and the Sultan of Sulu agreed to set the payment for their arrangement at 5,000 dollars. The Sultan was thus compensated for the personal loss of his ability to extract any further commercial benefit from the Leased Territories.

52. In fact, the Dent company seemed to believe that the unimproved value of the Leased Territories stood at between 25,000 and 45,000 dollars, about 5-10 times what they had agreed to pay the Sultan.[68] Dent had been willing to part with 15,000 dollars annually to the Sultan of Brunei for his non-operative leases in the Leased

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January 1878 (original version).

[66] Overbeck’s title indicated that he was subordinate to the Sultan, who was the ultimate authority. Kratz Report, ¶¶ 40, 134-136. The Sultan’s letter to Treacher, complaining that Overbeck was not acting like one of his “Datus” when he ought to have been, demonstrates as much. *See* ¶¶ 202-203, *infra*.

[67] **Doc. C-11**, Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, DENT AND OVERBECK CONCESSION 1877-8, The National Archives (United Kingdom), pp. 8-9.

[68] **Doc. C-63**, Letter from Alfred Dent to Edward Dent, 18 February 1878, in CO 874/180, The National Archives (United Kingdom), p. 9.

Territories.[69] When the Sultan of Sulu discovered this, he wrote a furious, but fruitless, letter to Treacher.[70]

### E. The North Borneo Charter Company is Formed

53. Despite Treacher's enthusiasm for a lease in North Borneo, the lessees themselves were unsure. Overbeck gave up his interest almost immediately to the Dent brothers – though not before the Sultan wrote angrily that Overbeck was acting like a sovereign when he was in fact merely one of his Datus (lords).[71]

54. The Dent brothers, for their part, were initially less interested in the Leased Territories themselves than in the potential to assign the lease rights for a profit.[72] But they ran up against the clause in the 1878 Lease Agreement that Treacher had insisted on: that the lease would not be assigned to anyone without the consent of Her Britannic Majesty's Government (the same provision as in Brooke's unratified agreement from 1849).

55. After Treacher's careful maneuvering, the British Government was not about to permit the Dent brothers to assign the lease to a national of a competing power. By the same token, Britain had no interest in actually governing the Leased Territories. The Dent brothers needed to find another way to capitalize on their investment. They hit upon an outmoded corporate vehicle: the charter company.

56. The Sole Arbitrator devoted a lengthy footnote to the history of British charter companies in his Preliminary Award.[73] The commonly quoted quip about the British Empire is that it was acquired "in a fit of absence of mind".[74] That quip reflects the truth that many of Britain's colonies began as private ventures (albeit sanctioned by the government) for personal and corporate profit. This was the case, most notably, for North America (the Virginia Company of Plymouth and the Virginia Company of

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[69] We calculate that Dent valued the Leased Territories for as little as 25,000 dollars (by contrast with as much as 45,000 dollars) on the basis that he paid a total of 20,000 dollars for the Leased Territories (15,000 to the Sultan of Brunei, 5,000 to the Sultan of Sulu) and can have expected to extract the same 5,000 dollars that the Sultan had received from the Leased Territories in income.

[70] **Doc. C-62**, Letter from William Treacher to the Earl of Derby, 14 May 1878, in Dent and Overbeck Concession 1877-8, The National Archives (United Kingdom), pp. 42-46.

[71] **Doc. C-64**, Letter from Treacher to Salisbury, 22 June 1878, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom), pp. 143-144.

[72] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIO-ECONOMIC PATTERNS OF THE SULU ZONE, 1770-1889 (Australian National University, Canberra 1975), p. 219.

[73] Preliminary Award, n. 177.

[74] **Doc. C-65**, Noel Malcom, *Empire? What empire?* THE TELEGRAPH, 12 December 2004.

London) and Asia (the East India Company). The former evolved into the colonies that eventually became the United States;[75] the latter ran India essentially as a profit-making venture until a rebellion forced Britain to take over government directly in 1858. Much like with the 1878 Lease Agreement, the East India Company administered territory and collected taxes, in exchange for a yearly payment to the sovereign Mughal Emperor.[76]

57. The Dent brothers were surely aware of these precedents. They sought the same status for their Leased Territories. There was opposition from the Colonial Office, which likely feared bankruptcy and the need for the British Government to take over.[77] The Foreign Office, lobbied by its employee, Treacher, supported the formation of a charter company.[78]

58. In 1881, the British Government granted the Royal Charter, and the British North Borneo Company (previously defined here as the "Company") was born.[79] The Company assumed (and honored) the payment obligations undertaken by Dent and Overbeck in the 1878 Lease Agreement.[80] Treacher resigned from his post of Consul-General to serve as the Company's first Governor.

59. Treacher quickly set about expanding the Company's remit. He had previously told the Sultan of Sulu that, although his sovereignty extended at least as far as the Kimanis river in the west, Overbeck would only contract for an area as far as the Pandassan River.[81] This left Treacher free, as the Company's Governor, to plunder a sizeable portion of the Sultan's territory, and march on towards Brunei.

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[75] **Doc. C-66**, *Virginia Company*, JAMESTOWN REDISCOVERY.

[76] **Doc. C-67**, William Bolts, CONSIDERATIONS ON INDIA AFFAIRS; PARTICULARLY RESPECTING THE PRESENT STATE OF BENGAL AND ITS DEPENDENCIES (Printed for J. Almon *et al.*), pp. 29-31. The arrangement was known in India as the Diwani.

[77] The Colonial Office's fears were realised in 1946.

[78] The Colonial Office ceased to exist in 1966. Its duties were transferred to the Commonwealth Office. The Foreign and Commonwealth Offices merged in 1968. *Colonial Office*, WIKIPEDIA (available at: https://en.wikipedia.org/wiki/Colonial_Office#War_and_Colonies_Office_(1801-1854)_and_Second_Colonial_Office_(1854%E2%80%931966).

[79] **Doc. C-18**, Charter Granted to the British North Borneo Company, 1 November 1881, in BRITISH NORTH BORNEO TREATIES (1881), p. 5.

[80] *Id.*, §§ 1 and 2.

[81] **Doc. C-11**, Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom), p. 8.

60. As it turned out, Treacher and the Company had greatly underestimated the Sultanate's authority and reach in Borneo. Sulu tribes from coast to coast continued to view the Sultan as the ultimate authority in the area.[82] Moreover, as a maritime empire, the Sulu Sultanate comprised many subjects who lived principally on the sea, as traders, mercenaries, or pirates.[83] Some of them, the Bajau, are today derogatorily referred to as "sea gypsies".[84]

61. Indeed, fewer than three years after the signing of the 1878 Lease Agreement, the Company realized the Sulu tribes' extensive control of the seas (which, naturally, the Company characterized as piracy).[85]

62. Moreover, despite believing in subsequent years that it was making progress "civilizing" North Borneo, the Company eventually ran into trouble with a major rebellion by the Sultan's subjects. The Company had to enlist the Sultan's help to quell it – although its missteps would reignite the rebellion. At its end, the Company drafted an amendment to the 1878 Lease Agreement. Although the Company made it sound like the amendment was a *pro forma* clarification of the 1878 Lease Agreement, in fact it signaled the recognition that the Company had badly misjudged its ability to acquire territory and patrol the waters without the Sultan's prior consent.[86] We discuss these events in § II.F below.

63. Meanwhile, the European powers resolved their disagreements over their Southeast Asian spheres of influence in 1885. Under the Madrid Protocol of that year, between Spain, Britain, and Germany, Britain and Germany recognized Spain's hegemony over the Philippines, including the Sulu Archipelago. At the same time, Spain renounced any claim to the Sultan of Sulu's territories in Sabah (the Leased Territories).[87]

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[82] Kratz Report, ¶¶ 78, 88-92.

[83] *Id.*, ¶¶ 79, 87.

[84] **Doc. C-68**, Gollan Stephan, *A Journey into Bajau Laut, The Sea Gypsies of Borneo*, UNCHARTERED BACKPACKER.

[85] **Doc. C-62**, Letter from William Treacher to the Earl of Derby, 14 May 1878, in Dent and Overbeck Concession 1877-8, The National Archives (United Kingdom), p. 42.

[86] Kratz Report, ¶ 139.

[87] **Doc. C-19**, Official Gazette of Philippines, *British North Borneo, 1885: Protocol of 1885*, 7 March 1885, Article III.

64. Spain then set about teaching the Sultan a lesson and quashed his resistance once and for all by 1887.[88] As a result, Labuan's arms trade plummeted, leaving it with almost no revenue.[89] The British, having no further use for Labuan, offered it to the Company in 1890.[90]

### F. The Company Seeks the Sultan's Aid to Gain Control Over the Restive Territory

65. Treacher spent seven years as Governor of the Company, quitting the post in 1888.[91] Using the Company's superior military and naval resources, Treacher began to assert the Company's power throughout the Leased Territories. He then used the further reaches of those Territories as a stepping-stone to occupy land that historically been the Sultan of Brunei's. Treacher's land grabs met with little resistance; his successors were not so fortunate.

66. In 1895, a Borneo native named Mohamed (Mat) Salleh began to organize resistance to the Company's rule. Salleh was the son of a Sulu Datu and a Bajau woman.[92] By this time, Sultan Jamalul Kiram II, the last universally-recognized Sultan of Sulu, had inherited the throne from his father. One of his relatives, Dayang Bandang, married Mat Salleh.

67. In 1897, with a force made up largely of Sulu and Bajau sailors and warriors, Salleh sailed to the island of Gaya and destroyed what had been the Company's principal outpost in the West.[93] Only the Bajau settlement on the island was left untouched. Its inhabitants supported Salleh's revolt against the Company.[94] The

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[88] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIO-ECONOMIC PATTERNS OF THE SULU ZONE, 1770-1889 (Australian National University, Canberra 1975), p. 214.

[89] *Id.*

[90] **Doc. C-69**, British North Borneo Company Books, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom), pp. 268-269.

[91] After Treacher stepped down from the post in 1888, Dr. Peter Leys was named Consul General of North Borneo. Eventually, in the early 1900s, Sir John Anderson K.C.M.G. served as British Consul General for Sarawak and British North-Borneo, High Commissioner for Brunei, and Governor of the Straits Settlements. *See also* **Doc. C-70**, Hansard's Parliamentary Debates, Third Series: Commencing with the Accession of William IV, Volume CCCIII, Second Volume of the Session (Cornelious Buck & Son, 1886), pp. 801-802; **Doc. C-71**, THE STATESMAN'S YEAR-BOOK: STATISTICAL AND HISTORICAL ANNUAL OF THE STATES OF THE WORLD FOR THE YEAR 1908 (MacMillan and Co., 1908), p. 188.

[92] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 299.

[93] *Id.*, p. 311. *See also* **Doc. C-73**, K.G. Tregonning, *The Mat Salleh Revolt (1894-1905)*, JOURNAL OF THE MALAYAN BRANCH OF THE ROYAL ASIATIC SOCIETY Vol. 29, N. 1 (173) (May 1956), pp. 20, 24.

[94] *Id.*, p. 24.

outpost was never rebuilt; the Company instead created a new outpost on the West coast of the mainland of Borneo named Jesselton, known today as Kota Kinabalu.

68. Salleh's blow against the Company made its officers and directors aware, for the first time, of their vulnerability. Leicester Beaufort, the Governor of the Company at the time, stated to the governing council that "'[t]he whole country . . . is frightened and upset'".[95] In evident desperation, the Company dispatched William Cowie, its London-based Director-General, to speak with the Sultan of Sulu.[96]

69. Cowie implored the Sultan to intercede with his subject, Mat Salleh, on the Company's behalf. History does not record whether the Sultan was enthusiastic about doing so, but he nonetheless sent a letter to Dayang Bandang, his relative and Salleh's wife, instructing Salleh to negotiate with the Company.[97]

70. The intervention succeeded. Salleh and his men surrendered to the Company and came to terms. The resulting agreement was named the Palatan Peace Pact.[98] But the Company quickly bungled the peace: notwithstanding the Peace Pact, the situation deteriorated and fighting broke out anew.

71. Salleh, as a regional Datu, began to exercise his influence over the Southwest Bajau and others loyal to him, in the far Southern reaches of Sabahan land and waters.[99] In October 1899, Salleh and his retinue travelled down the Southwest coast as far as Lawas, beyond Sabah's borders and into Sarawak.[100]

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[95] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 314.

[96] *Id.*, p. 321. *See also* **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), pp. 83, 87.

[97] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 321. *See also* **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), p. 87.

[98] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 322-323; *see also* **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), pp. 83, 87.

[99] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 337.

[100] *Id. See also* **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), pp. 89-90.

72. Various skirmishes ensued. In one such skirmish, in January 1900, a Company party shelled Mat Salleh's fort.[101] A shot from a Maxim gun[102] struck Salleh in the head and killed him. His followers, however, fought on until 1903.[103]

73. Salleh's rebellion was unlikely ever to cause enough havoc to dislodge the Company. But it did show the Company's shaky grip on the Leased Territories it purported to govern. As one scholar of the region put it, "[t]he main significance of these turbulent years was that they revealed, if Mat Salleh had not already done it, the negligible hold of the Company on its territory".[104]

74. This was especially true of the seafaring Bajau. Hugh Clifford, the latest in a line of short-lived Company Governors, opined that the Bajau were under Company control "only by a stretch of the imagination."[105]

75. It took some 25 years of purported control over Sabah for the Company to realize that the power and scope of authority of the Sultan of Sulu – however nominal Treacher and the Company might have deemed it to be – governed the loyalties of people across the far-flung breadth of the Sultanate's Islamic communities, throughout North Borneo and hundreds of miles beyond. In the end the Sultan, no matter how distant or impoverished, was still the Sultan.[106]

### G. The Company Acknowledges the Scope of the Sultan's Authority with the 1903 Amendment

76. It was thus in April 1903 that the Company sought to amend the 1878 Lease Agreement (previously defined as the "1903 Amendment"). Realizing that the key to stability lay in confirming the overlap of its authority with the Sultan's, the Company asked Sultan Jamalul II to sign a "Confirmatory Deed". In that document,

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[101] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), pp. 338-339. *See also* **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), pp. 89-90.

[102] The Maxim gun was an American-made machine gun operated on a tripod. It was the first recoil-operated machine gun (where the recoil from the prior shot is used to load the next cartridge).

[103] **Doc. C-74**, D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017), pp. 89-90. *See also* **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), pp. 339-340.

[104] **Doc. C-72**, Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970), p. 343.

[105] *Id.*, p. 352.

[106] Kratz Report, ¶¶ 78, 88-92.

the Sultan reaffirmed the lease of the Leased Territories, and added that, for the avoidance of doubt, a series of islands around North Borneo also formed part of the lease.[107]

77. There is ample reason to doubt that the 1903 Amendment was a mere "confirmation" of the 1878 Lease Agreement. First, the events of the Mat Salleh Rebellion, detailed in § II.F above, show how greatly the Company had underestimated the role and function of a Sultan over even his distant subjects. Mat Salleh might well have stayed quiescent after Sultan Jamalul II had instructed him to make peace with the Company, had it not been for the Company's subsequent belligerence.

78. Second, the naming of a series of islands in the 1903 Amendment – including Gaya, the site of Mat Salleh's sack of the Company headquarters, and Dinawan, another island in the West – confirmed the Company's belated understanding that the Sultanate's maritime reach was extensive and unquantifiable by the terms of the 1878 Lease Agreement. Dinawan had also been the subject of a supposed lease with the Sultan of Brunei as recently as 1897.[108] Like in 1878, a subsequent agreement with the Sultan of Sulu corrected the deficiencies of an earlier agreement with the Sultan of Brunei.

79. Third, several islands named in the 1903 Amendment lay well outside the 9-mile nautical limit that delineated the extent of the 1878 Lease Agreement.[109] These territories were formally added via the 1903 Amendment and did not form a part of the original 1878 Lease Agreement negotiations.

80. Fourth, the 1903 Amendment added 300 dollars to the annual rental, paid retroactively. The addition of this sum and its retroactivity strongly suggest that this

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[107] **Doc. C-17**, Official Gazette of Philippines, *Confirmatory Deed of 1903*, 22 April 1903.

[108] **Doc. C-75**, Grant of Kinarut and Dinawan, The National Archives (United Kingdom), 14 May 1897.

[109] The original 1878 Lease Agreement includes "all islands so encompassed up to nine miles from the shoreline" Present-day measurements of the distance between the island of Borneo and islands mentioned in the 1903 agreement- Langkayan, Bakungan, Taganak, Baguan, Mantanbuan, Siamil, and Kapalaya- show that these islands are located beyond the 9 mile nautical limit agreed upon in the 1878 Lease Agreement. **Doc. C-13**, Official Gazette of Philippines, Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck, 13 July 1878; **Doc. C-17**, Official Gazette of Philippines, *Confirmatory Deed of 1903*, 22 April 1903.

marked a change on the Company's side to the understanding of the 1878 Lease Agreement's remit, rather than a mere confirmation of its terms.

81. Fifth, the region had recently changed: Spain had been removed from the equation after the Spanish-American War in 1898. In its place stood the United States, an increasingly formidable power with extensive naval ambitions. Although on generally friendly terms, Britain and the United States had clashed frequently over the previous century; the "Special Relationship" between the two bulwarks of Anglo-Saxon civilization lay decades in the future. The United States was not a part of the Madrid Protocol of 1885,[110] so it might have sought to claim influence over North Borneo via the Sultan's holdings.[111] It therefore behooved the Company to make as explicit a statement as possible about the new reach of its lease via the 1903 Amendment, so that the British Government would feel obligated to back up its claims.

### H. The Sultan Loses Temporal Authority in Sulu but Retains it in Borneo

82. The Company's fear was well-founded. In 1915, the Sultan of Sulu relinquished sovereign rights over his territories, at the insistence of the American Governor of the Department of Mindanao and Sulu, Frank W. Carpenter. Henceforth, at least in the Philippines, the Sultan would exercise spiritual and moral authority alone.[112]

83. Five years later, however, the Company's fears abated: Governor Carpenter clarified in 1920 that the termination of the sovereignty of the Sultanate within American territory was understood to be:

> [W]ithout prejudice or effect as to the temporal sovereignty and ecclesiastical authority of the Sultanate beyond the jurisdiction of the United States Government especially with reference to the portion of the island of Borneo which as a dependency of the Sultanate of Sulu is understood to be held under lease by

[110] *See* ¶ 63, *supra.*

[111] **Doc. C-76**, Letter from Sir Ernest Woodford Birch, Governor of the British North Borneo Company to Charles Prestwood Lucas, Colonial Office, 21 June 1903, The National Archives (United Kingdom).

[112] **Doc. C-22**, Letter from Teopisto Guingona, on behalf of the Government of the Philippine Islands Department of the Interior, Bureau of Non-Christian Tribes, to the Sultan of Sulu, Jamalul Kiram II, 30 July 1920, The National Archives (United Kingdom), p. 1; **Doc. C-23**, Official Gazette of Philippines, *Memorandum: Carpenter Agreement, March 22, 1915*, 22 March 1915.

> the chartered company which is known as the British North Borneo Government. . . .[113]

84. In addition, the American Governor-General of the Philippine Islands at the time, General Francis B. Harrison, stated even more explicitly that the 1915 agreement "did not interfere with the Sultan's status of sovereignty over British North Borneo lands".[114]

### I. The Macaskie Decision Clarifies that the Heirs Retain Rights to North Borneo

85. Jamalul Kiram II, the Sultan of Sulu since 1894, died in 1936 without an heir.[115] In his will, he gifted his possessions – including the Leased Territories and the payment rights thereto – to his nieces and other members of his family.

86. The Company had hitherto paid one individual – the Sultan – for its rights under the 1878 Lease Agreement. Now that a Sultan had died without an immediate heir, the payments were interrupted.[116] The heirs named in the Sultan's Will petitioned Charles F.C. Macaskie, the Deputy Governor of North Borneo (who also served as Chief Justice), for payment along the lines of the Will.

87. Macaskie ruled in 1939 that payments pursuant to the 1878 Lease Agreement should duly be resumed to the heirs in the proportion dictated in the late Sultan's Will (the "**Macaskie Decision**").[117] There were nine such heirs (today, because of subsequent deaths without issue and the consolidation of bloodlines, there are eight Claimants).[118]

88. In his Preliminary Award, the Sole Arbitrator declared that he "is satisfied with Claimants' characterization of the type of action decided in those court proceedings as «…*merely a question as to who these inheritors might be*…»; to wit, an

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[113] **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 28 (emphasis added); **Doc. C-24**, Official Gazette of Philippines, *Memorandum Agreement between the Governor-General of the Philippine Islands and the Sultan of Sulu*, 22 March 1915, p. 2; **Doc. C-6**, Geoffrey Marston, *International Law and the Sabah Dispute*, AUSTRALIAN INTERNATIONAL LAW JOURNAL 103 (1967), p. 135.

[114] **Doc. C-24**, Official Gazette of Philippines, *Memorandum Agreement between the Governor-General of the Philippine Islands and the Sultan of Sulu*, 22 March 1915, p. 2 (emphasis added).

[115] **Doc. C-20**, *Dayang Haji Piandao Kiram of Jolo Philippines & 8 others v. The Government of North Borneo & Others*, High Court of North Borneo, Civil Suit No. 169/39, Judgment, 18 December 1939, p. 1.

[116] *Id.*, pp. 2-3.

[117] *Id.*, p. 7.

[118] *See* § V.E, *infra.*

interpleader procedure".[119] Therefore, Claimants do not find it necessary to devote further discussion to the Macaskie Decision, and refer the Sole Arbitrator to § III.E of their Counter-Memorial on Jurisdiction.

### J. The British Government Takes Over North Borneo

89. World War II saw North Borneo fall to Imperial Japan. At the War's close, the Company was bankrupt. Despite the post-war trend of decolonization, North Borneo's peculiar circumstances led to the reverse: on 26 June 1946, the Company assigned all of its rights to the British Government.[120] The Company was no more; from its ashes rose the British colony of North Borneo.[121]

90. Like its predecessors-in-interest, Britain honored the financial terms of the 1878 Lease Agreement. A 27 November 1946 memorandum from the office of none other than Clement Attlee, the Prime Minister, sought information about the heirs under the Macaskie Decision so that the British Government could continue to make the annual payments in the wake of the Company's demise.[122]

91. Indeed, the memorandum mentioned that this office hoped to "resume payment of the cession [*sic*] monies without delay" because the failure to pay such monies was "being used as a pretext for claiming that the concession granted to the Company by the late Sultan ha[d] terminated".[123] In subsequent discussions about the status of North Borneo spanning to 1962, Britain would boast to the

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[119] Preliminary Award, ¶ 103 (emphasis original, footnotes omitted). *See also id.*, ¶ 105 ("It seems that the parties in that case had a common interest –and not oppositional ones– to determine the proper parties of the Deed. This is undisputed by the Parties, as previously explained in the Preliminary Award. The object of the 1939 action is different from the cause of action sought by Claimants in the present arbitration where, as admitted, they seek to vindicate their commercial rights under the terms of the Deed, as they plead that the surrounding circumstances at the time of its signature were radically changed by the subsequent discovery of natural resources which were not contemplated by the parties when they signed the Deed". – footnotes omitted).

[120] **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, pp. 131-142 (reprinting the Agreement for the transfer of the Borneo Sovereign Rights and Assets from the British North Borneo Company to the Crown, dated 26 June 1946; see, in particular, Clauses 1 and 2).

[121] *Id.*, pp. 143-145 (reprinting the North Borneo Cession Order in Council 1946 at Buckingham Palace on 10 July 1946; see Article 2). *See also* **Doc. C-25**, Official Gazette of Philippines, *The North Borneo Cession Order in Council 1946*, 10 July 1946, Article 2.

[122] **Doc. C-26**, Memorandum from Sgd. D.F. MacDermot for Prime Minister Attlee, Attlee to the Foreign Office, 27 November 1946, The National Archives (United Kingdom), "Sultan Sulu Agreement 1878".

[123] *Id.* (emphasis added).

Philippine ambassador that Britain had "scrupulously observed" the rights of the heirs in connection with the 1878 Lease Agreement.[124]

92. Through the course of the 1950s and early 1960s, the heirs of the Sultan delegated the role of advocate for the Sultanate's rights over the Leased Territories to the Government of the Philippines. In 1962, the British Government formed a commission to study the future of North Borneo in light of the recent independence of nearby British protectorates that had evolved into the Federation of Malaya. It was clear that the inclination of the British Government was to hand over the colony of North Borneo to that new Federation.[125]

### K. Malaysia Assumes Responsibility for the 1878 Lease Agreement and the Payments Due Under It

93. Under protest from the Governments of the Philippines and Indonesia, North Borneo became part of the Federation of Malaya on 31 August 1963 pursuant to the Manila Accord.[126] On 16 September 1963, the Federation of Malaya accepted the transfer of the territory, henceforth naming itself Malaysia.[127]

94. The Malaysian Government assumed the role of the contractual counterparty under the 1878 Lease Agreement previously held by Dent and Overbeck, the Company, and then the British Colony of North Borneo. True to precedent, the Malaysian Government began rendering annual payments to the heirs of the Sultan. Malaysia itself conceded as much in its letter of 19 September 2019:

> From the beginning, Malaysia paid to your clients the agreed annual sum (Cession Monies) of 5300 dollars in Malaysian Ringgit, that is, 5300 MYR. The payment of Cession Monies had been made to the rightful heirs of the Sulu Sultanate, consistent with the judgment delivered by Chief Justice C.F.C. Macaskie on 18th December 1939 in the High Court of the State of North Borneo. . . .
>
> Malaysia had continuously paid the Cession Monies to the heirs of the Sulu Sultanate through their appointed attorney Ulka T. Ulama until 2010. For the years 2011 and 2012, the Cession Monies were paid directly to the heirs of the Sulu Sultanate and not through their appointed attorney as the Ambassador of

[124] **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 156.

[125] *Id.*, Volume I, pp. 152-161.

[126] *Id.*, Volume I, pp. 159-160; Volume II, pp. 46-48, 52.

[127] *Id.*, Volume II, p. vii.

> Malaysia to the Republic of the Philippines had received complaints from the heirs to the Sulu Sultanate on the delay of payments made previously and costs charged by the attorney for such services. Due to these complaints, the Ambassador of Malaysia to the Republic of Philippines decided to make payment directly to the heirs of the Sulu Sultanate. The payment of the Cession Monies were made in Philippine Peso based on the prevailing exchange rates. . . .
>
> Regrettably, payments ceased in 2013. Malaysia is now ready and willing to pay your clients all arrears from 2013 to 2019, and agrees to fully comply with the 1878 Grant and the 1903 Confirmation of Cession from henceforth with regards to future payments. As to the arrears, Malaysia is also agreeable to paying simple interest of 10% p.a. on the annual payments for each of the years concerned. . . .[128]

95. Claimants also have records of these payments.[129]

## L. Malaysia Breaches the 1878 Lease Agreement

96. Early in 2013, a member of the extended Sulu royal family falsely declared himself Sultan. The pretender's brother took a small force of men across the Sulu Sea to Sabah and stated his intention to "reclaim" the territory on behalf of the Sultanate of Sulu.[130]

97. Claimants did not endorse this individual as Sultan; indeed, one of the Claimants himself is the duly-recognized Sultan.

98. Claimants knew nothing of the invasion, condemned the recourse to violence, and disclaimed the pretender's actions. Nonetheless, the Malaysian Government ceased to make any lease payments at all since then.

99. The pretender died later in October 2013.[131] His daughters have likewise rejected his call for violence to resolve the Sabah issue; one of those daughters has inherited a portion of the instant claim under the Macaskie Decision and is one of the Claimants here.[132]

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[128] **Doc. C-52**, Letter from Respondent to Paul Cohen, 19 September 2019, ¶¶ 7-9 (emphasis added).

[129] **Doc. C-31**, Sample of Checks and Receipts.

[130] **Doc. C-33**, Floyd Whaley, *Conflict in Northern Borneo Seems Poised to Escalate*, NY TIMES, 12 March 2013.

[131] *Id.*

[132] Namely, Sheramar T. Kiram.

100. As noted in ¶ 94 above and as further detailed in § IV.B(h) below, Malaysia acknowledged in the Attorney-General's letter of 19 September 2019, copied to the Sole Arbitrator, that it was in breach of the 1878 Lease Agreement. In its anti-arbitration injunction papers, Malaysia conceded that the pretender's invasion was the reason for Malaysia's failure to honor the contract since 2013.[133]

### M. An Unforeseen Change in Circumstances Radically Imbalances the 1878 Lease Agreement

101. Over the past few years, even with oil prices oscillating between high and low (and notwithstanding the temporary collapse of prices during the COVID-19 pandemic), the annual revenues to Malaysia of the Leased Territories remain some *three million times* greater than the annual amount called for under the 1878 Lease Agreement. Never (to paraphrase Churchill) has someone paid so little, for so long, in exchange for so much.[134]

#### (a) The Sabah Region Developed From a Rudimentary Economy to One that Exploited Tobacco, Rubber and Timber

102. The economy of the Leased Territories has undergone significant and dramatic changes since the execution of the 1878 Lease Agreement. Malaysian historian Prof. Amarjit Kaur has described the economy of the Leased Territories in 1878 as highly rudimentary, based on a few agricultural and forestry commodities:

> The territory [of Sabah] comprised a number of tribal societies which, while not existing in total isolation, did not develop a form of political organisation like the political structures that emerged in Peninsular Malaysia.[135]
>
> . . . .
>
> In Sabah, the three zones were identified, with firstly, the gathering of sea produce from the shoals and reefs off shore the coastal regions; secondly, the cultivation of wet rice on the

[133] Malaysia in the High Court of Sabah and Sarawak at Kota Kinabalu, Originating Summons, Affidavit in Support, December 2019, ¶ 13.

[134] Churchill made his "Battle of Britain" speech on 20 August 1940. Referring to the heroics of Royal Air Force pilots in keeping the Luftwaffe at bay, rendering a ground invasion of Britain impossible, Churchill stated: "Never in the field of human conflict was so much owed, by so many, to so few".

[135] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), p. 4 (Professor Amajarit Kaur is a well-recognized author and historian with more than thirty years of sustained research in the history and economic development of East Malaysia and Southeast Asia. She holds a PhD from Columbia University and was a professor of the History Department of the University of Malaysia. She has been a visiting scholar and fellow to Oxford, Harvard and Cambridge Universities, among others).

> western lowlands; and thirdly, the swidden cultivation (dry/hill padi, maize and root crops) of the interior highlands.[136]

103. Treacher's letter to the Earl of Derby, written on the 1878 Lease Agreement's execution date, likewise characterized the economy of the Leased Territories as rudimentary:

> This portion of Borneo at the present time, from want of a settled Government, is very sparsely inhabited, and for the most part still clothed with jungle, much of which, however, would become valuable as timber for exportation; but the soil in many places, notably Kinabatangan River, is known to be of excellent quality and well adapted for tropical produce, while everything, reports of natives and the character of the country, &c., in favour of the existence of valuable mineral resources, and the trade in bird-nests, rattans, camphor, seed pearls has been ascertained to be valuable and only to require development.[137]

104. In another contemporary letter, Treacher described Dent's and Overbeck's intention to focus on the development of certain basic crops and harvests:

> Baron de Overbeck, on arriving at Labuan, waited upon me at Government House, and briefly informed me that it was his intention to acquire all Mr. Torrey's concessions, and that he was acting in conjunction with Mr. Alfred Dent, a member of the British firm of Dent Brothers, of London, who, indeed, had the principal interest in the scheme; that the object proposed was to buy out the American interest, and form a British Company, the main desire being to <u>develop the agricultural resources of the northern portion of Borneo, which, as your Lordship is aware, is considered to be the most fertile part of the island, and well adapted for the cultivation of sugar, pepper, gambier, and coffee, its hills affording at different altitudes the various degrees of temperature requisite</u>.
>
> . . . .
>
> Not only does this portion of Borneo contain the best harbours, but it also possesses the best soil, and is richest in natural productions, such as <u>bird's nests (in which the River Kinabatangan is especially rich), camphor, rattan, sago, gutta-percha, &c.</u>, and there can be but little doubt but that when explored it will be found to contain valuable minerals; the existence of coal is already known.[138]

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[136] *Id.*, p. 15.

[137] <u>**Doc. C-11**</u>**,** Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, DENT AND OVERBECK CONCESSION, 1877-8, The National Archives, United Kingdom (emphasis added).

[138] Preliminary Award, ¶ 129 (quoting from a letter from Treacher to the Earl of Darby dated 2 January 1878) (emphasis added, footnotes omitted).

105. The undeveloped state of the Leased Territories naturally affected how the Sultan of Sulu quantified his income from them:

> The Sultan assured me that at the present moment he receives annually from this portion of his dominions the sum of 5,000 dollars, namely 300 busings of seed pearls from the Lingabo River alone, which at 10 dollars a busing comes to 3,000 dollars per annum, and about 2,000 dollars from four birds-nest caves in the Kinabatangan River, which are his family possessions.[139]

106. For the colonial powers, Borneo represented a strategic foothold on the important shipping and trade routes in the South China Sea. It was also a suspected source of valuable then-known minerals inland, with the potential to become a promising market for manufactured goods.[140] Overbeck's venture in the Leased Territories was grounded in the desire to develop their main commercial resources – timber, minerals thought to be extractable, and land – a motivation which endured during the Company's subsequent years from 1888 onwards.[141]

107. In 1881, following Overbeck's departure from North Borneo, the Company continued exploiting the lease in similar fashion, administering the Leased Territories, while leaving the industrial endeavors to private ventures:

> In Sabah, the Company initially decided that it would function as an administrative Company only. The commercial development of the territory's main resources – <u>timber, reputed minerals and land</u> – was to be left to other private interests. . . . The economic rationale underlying the acquisition of the territories was very important and hinged upon the exploitation of the three main resources – <u>minerals, land and forest products</u>.[142]

108. For more than fifty years, the Company thrived in North Borneo exploiting its agricultural and forestry resources. The Company owed its success to the various agricultural ventures it carried out, and to other private actors. This led to three important 'booms': tobacco (1890s-1910s), rubber (1910s-1940s), and timber (1910s-1960s, although production remained strong into the 1990s).

109. The export economy created from tobacco was largely the result of a growing demand for cigarettes in Europe and North America in the early 20th century. The

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[139] *Id.*, pp. 8-9.

[140] *Id.*, p. 3.

[141] **<u>Doc. C-77</u>**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), p. 10.

[142] *Id.* (emphasis added).

rapid surge of exports in rubber and timber, by contrast, occurred through a series of unforeseen circumstances.[143] In the case of rubber, the introduction of the internal combustion engine and the resulting mass production of the automobile in the 20th century created a global market for pneumatic tires. As for timber, the construction market grew unprecedentedly with the consolidation of a young, burgeoning middle class after World War I, and then again – with even more dynamism – after World War II.[144]

110. Timber in particular powered the economy of Sabah. Sabah's internal waterways, the route to most of its forestry resources, experienced the first wave of investment, permitting a substantial increase in export revenues.[145] The drivers behind this growth in production were not only soaring demand for new buildings during the 1950s and 1960s (most of which required wood for their structural components), but also the introduction of ground-breaking technology for logging and log hauling, including chainsaws and skidder tractors.[146]

111. Mining ventures were also common in Sabah during the first half of the 20th century. Starting in 1910, the Company began to promote ventures in mineral extraction. Of all the minerals that were prospected, the only ones that yielded even minor success were gold, coal and manganese. None of these, however, led to revenues comparable to those of timber and rubber. By the end of the 1930s, no substantial mining operation was running.[147]

112. Thus, during the eighty-five years of British presence in Sabah (*i.e.,* from the execution of the 1878 Lease Agreement until 1963, when Sabah joined the free Federation of Malaya), the 1878 Lease Agreement became increasingly imbalanced, to the detriment of the Sultan of Sulu and his successors.

113. In 1963, in the months following Sabah's formal annexation to the Malay Federation, state government revenues amounted to almost MYR 98 million.[148] That

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143 *Id.*, pp. 11-12.

144 *Id.*, p. 91.

145 *Id.*, pp. 90-93.

146 *Id.*, p. 15.

147 *Id.*, pp. 28-29.

148 *Id.*, p. 205 (Table 7.10 shows Sabah and Sarawak State Government Revenue from Forestry and Petroleum, 1963-1990 (RM Million). In 1963, Sabah got RM 14.1 in revenue for forestry which represented 14.4.% of the total State government revenue; hence, applying a simple rule of three,

is, while one Party to the 1878 Lease Agreement, the lessor, received the unvarying sum of 5,300 dollars, the other Party, the lessee, received a direct benefit close to twenty thousand times greater.

### (b) The Two Main Industries in the Leased Territories Today

114. Today, the two largest industries in the Leased Territories are hydrocarbons (oil and gas) and palm oil. Musa Bin Haji Aman, former Chief Minister of Sabah, said as much in a speech on 25 December 2016 to the Federal Government in Kuala Lumpur:

> Except for the oil & gas and the oil palm industry, no other economic sectors in Sabah possess a significant potential to attract foreign direct investments to expand the state GDP. Therefore, in order to have a chance of reaching the 2020 target of US15,000 GDP per capita, Sabah needs to focus aggressively in industrialising the oil & gas and oil palm sectors.[149]

115. Extractive industries – almost exclusively comprising hydrocarbons – accounted for 29.6% of Sabah's GDP as of 2016.[150] Likewise, the agricultural sector, representing 19.1% of the region's GDP that same year, consists mainly of the massive cultivation and export of palm oil and its derivative produce in Eastern Sabah.[151] By limiting the analysis to these commodities, we can account for almost half of the region's GDP; we can also more easily ascertain how much Malaysia made from these commodities – as opposed to other goods – through the well-documented royalties and export duties that Malaysia receives from them.

116. The following chart shows the evolution of the main export commodities in the Leased Territories since Sabah became part of Malaysia in 1963. It shows that in 1965, rubber and timber products together accounted for 99% of Sabah's exports by value. Palm oil accounted for a mere 1%; hydrocarbons were not even on the

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100% amounts to roughly RM 98).

[149] **Doc. C-78** *Speech by Y.A.B. Datuk Seri Panglima Musa Haji Aman, Chief Minister of Sabah, at the launching of Biomass Development Plans of Sabah and Sarawak*, Sabah-Gov, 25 February 2016.

[150] Department of Statistics Malaysia, Official Portal, THE SOURCE OF MALAYSIA OFFICIAL STATISTICS, 17 September 2017.

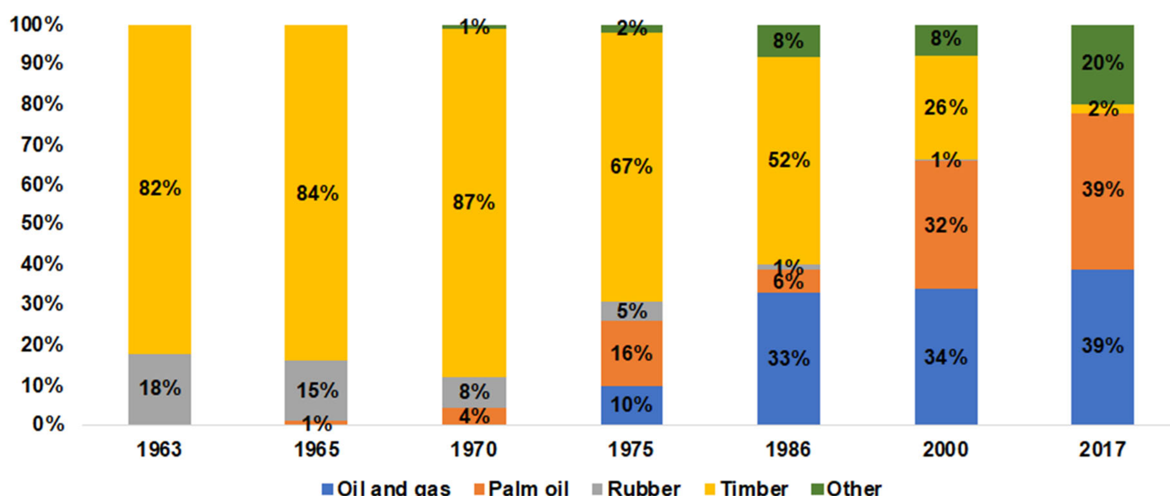
(available at:

https://www.dosm.gov.my/v1/index.php?r=column/cthemeByCat&cat=102&bul_id=VS9Gckp1UUpKQUFWS1JHUnJZS2xzdz09&menu_id=TE5CRUZCblh4ZTZMODZIbmk2aWRRQT09).

[151] *Id.*

list. But by 2017, when this arbitration formally commenced,[152] oil and gas and palm oil products jointly accounted for more than 78% of the total value of exports.

**Figure 1**. Sabah's main export commodities since independence (% of total value of exports)[153]




### (c) The Value of the Rights Over the Leased Territories to Malaysia Grew Exponentially with Development of the Oil and Gas Industry

#### (i) Introduction

117. Significant oil and gas production began after 1970. It was not – and could have not been – anticipated in the 1878 Lease Agreement, or in the 1903 Amendment.[154] Likewise, a significant expansion of palm oil production has also occurred over the last 40 years, and again was unanticipated in 1878 or 1903.[155] The Brattle Report details the estimated economic benefits that Malaysia has

[152] The request for appointment of an arbitrator was sent to Malaysia on 2 November 2017. **Doc. CL-1**, Spanish Law 60/2003, of 23 December, on Arbitration, Article 27 ("Unless otherwise agreed by the parties, arbitration will commence on the date on which a request to submit the dispute to arbitration is received by the respondent.").

[153] **Doc. C-79**, Regina Lim, FEDERAL-STATE RELATIONS IN SABAH, MALAYSIA: THE BERJAYA ADMINISTRATION, 1976-85 (Institute of Southeast Asian Studies, 2008), p. 75 (for 1963-1986); **Doc. C-80**, Thomas Enters *et al.*, *Impact of incentives on the development of forest plantation resources in Sabah, Malaysia – Chan Hing Hon and Chiang Wei Chia*, Fao-Org, 2004 (for 2000); *Malaysia Day: Economic corridors: Game changer for Sabah, Sarawak*, THE MALAYSIAN RESERVES, 3 April 2017 (for 2017) (available at: https://themalaysianreserve.com/2017/04/03/malaysia-day-economic-corridors-game-changer-for-sabah-sarawak/).

[154] *See* § IV.D(a)(ii)(2), *infra*.

[155] Bratte Report, § V.

received and will receive from (i) hydrocarbons (oil and gas) production and (ii) palm oil production in the Leased Territories.[156]

### (ii) The Oil Industry in the Leased Territories

118. Minor oil exploration ventures had taken place in North Borneo since 1910, mostly in Miri, in the coastal area west of Brunei.[157] The first important oil exploration activities took place in the 1960s.[158] The first major discovery was Shell's Termana oil field in 1962, close to the Baram Delta. Shell made further discoveries in the same region during the rest of the 1960s.[159]

119. But no significant oil industry existed in Sabah until the 1970s.[160] There are several reasons why:

(i) ***Supply***: almost all of the oil fields discovered and exploited in Sabah are offshore, making them prohibitively expensive before drilling technology improved.[161] The two most productive oil fields in Sabah, Gumusut and Kikeh, are both located 120 km offshore, and at depths of 1,200 m and 1,300 m, respectively.[162] The technology to drill and exploit oil fields deeper than 100m did not exist until 1963 with the launch of the first purpose-built, semi-submersible drilling machine, the Ocean Driller.[163]

(ii) ***Demand***: at the time of the 1878 Lease Agreement's execution, industries globally were still almost exclusively coal-based. North Borneo was no exception. Coal accounted for up to 90% of the world's energy consumption in 1900, and remained the primary source of energy in Europe and the United States until the 1950s. It was even fundamental for the industrialization of China until the latter part of the 20th century.[164] The surge in oil as a global commodity did not come about until after the internal combustion engine was used to power cars in the 1900s, and,

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156 *Id.*, §§ IV and V.

157 Meehan Report, p. 10.

158 *Id.*; Brattle Report, ¶ 27.

159 **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), p. 205; Brattle Report, ¶ 33.

160 Brattle Report, ¶¶ 34-35; Meehan Report, p. 10.

161 *Id.*, p. 13. *See also* **Doc. C-84**, J.K. Forrest *et al.*, *Samarang Field – Seismic to Simulation Redevelopment Brings New Life to an Old Oilfield, Offshore Sabah*, INTERNATIONAL PETROLEUM TECHNOLOGY CONFERENCE (IPTC) (2009), p. 9.

162 *Kikeh Floating Production, Storage and Offloading Development*, OFFSHORE TECHNOLOGY (available at: https://www.offshore-technology.com/projects/kikeh/); *see also Gumusut-Kakap Deepwater Oil and Gas Project*, OFFSHORE TECHNOLOGY (available at: https://www.offshore-technology.com/projects/gumusut-kakap-deepwater-oil-gas/).

163 **Doc. C-81**, *Offshore Drilling: History and Overview*, OFFSHORE TECHNOLOGY, 25 June 2010.

164 **Doc. C-82**, Jan J. Boersema *et al.*, PRINCIPLES OF ENVIRONMENTAL SCIENCES (Springer, 2010), p. 39.

later, larger vehicles such as ships, planes and submarines during World War I and II.[165]

120. Sabah's oil industry finally took off in the 1970s, nearly a century after the conclusion of the 1878 Lease Agreement. In 1971, the State of Sabah made oil deposits available for commercial use, allowing international companies such as Conoco, Shell, Esso and Exxon to exploit the oil fields discovered a decade earlier.[166] The oil industry also benefited from the high prices in the wake of the 1973 and 1979 oil price shocks.[167]

121. In fact, the Sabah Government received no revenue from oil at all until 1975. In 1975, the oil fields in Tembungo (Exxon) and Samanang (Shell), were producing more than 18,000 barrels per day (bpd), leading to the first ever petroleum royalty of MYR 900,000 for the State Government of Sabah.[168] It was then that the change of circumstances fundamentally altered the (already-imbalanced) contractual equilibrium between the lessee and the lessor of the 1878 Lease Agreement. The amount that the Heirs of the Sultan of Sulu received became negligible, if not downright absurd, compared to the benefits Malaysia reaped from exploiting the Leased Territories' resources.

122. In 1976, Malaysia issued the Petroleum Development Act to redirect the booming revenues of the Sabah oil industry to the Federal Government via the State-owned company Petroliam Nasional Berhad ("**Petronas**") – thereby limiting the State of Sabah's revenue to only a 5% royalty over export value.[169] To the consternation of the Sabahan people, that limit remains today.[170]

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[165] **Doc. C-83**, Brian C. Black, *How World War I ushered in the century of oil*, THE CONVERSATION, 4 April 2017.

[166] Brattle Report, ¶ 34; Meehan Report, p. 10.

[167] **Doc. C-84**, J.K. Forrest *et al.*, *Samarang Field – Seismic to Simulation Redevelopment Brings New Life to an Old Oilfield, Offshore Sabah*, INTERNATIONAL PETROLEUM TECHNOLOGY CONFERENCE (IPTC) (2009), p. 9; *see also* **Doc. C-85**, Sorkhabi Rasoul, *Borneo's Petroleum Plays*, 9(4) GEOXPRO (2012).

[168] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), p. 205.

[169] *Id.*, p. 182.

[170] *See* ¶¶ 461, 465, *infra.*

123. The oil industry transformed the value of exports in Sabah. Between 1975 and 1980 alone, oil exports rose from MYR 85.5 million to almost MYR 1.8 billion – growing more than twenty times.[171]

124. Still, the real momentum in Sabah's oil industry came with the discovery of deep-water oil fields in the late 1990s and the 2000s,[172] including the discovery in 2011 of "substantial oil reserves".[173] Like the initial offshore exploitation of the 1970s, these operations were made possible because of important technological advancements in deep-water drilling taking place in recent decades.[174]

### (iii) The Gas Industry in the Leased Territories

125. The oil industry boom was complemented by the discovery and exploitation of vast natural gas reserves. Exploration operations of natural gas in North Borneo began in 1969 and carried on apace through the 1980s.[175] In 1980 alone, as many as five gas fields were discovered.[176] The gas industry in the Leased Territories took off in the 1990s, with further discoveries in the 2000s.[177] As Prof. Rasoul Sorkhabi states:

> On the eastern side of Borneo, Shell's discoveries of Kebbangan (1994) and Kamunsu (2000) gas fields offshore Sabah were pioneering steps. What particularly gave momentum to deepwater ventures in Sabah was Kikeh-1, drilled in 2002 by Murphy (Petronas 20%) in SB-K Block in 1,340m of water. Murphy entered Malaysia's offshore blocks in 1999 and drilled the field after doing methodic homework. Kikeh is estimated to contain 536 MMboe (million barrels of oil equivalent) and came onstream in 2007. Other notable deepwater discoveries offshore Sabah include Gumust-Kakap (Shell, 2003-2005), Malikai (Shell, 2004), Jangas (Murphy,

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[171] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), p. 183.

[172] Meehan Report, pp. 11-18 (describing the main characteristics of the Sabah basin's oil and/or gas fields).

[173] *Id.*, p. 18.

[174] *Id.*, pp. 10-11. *See also id.*, p. 19 ("Oil and gas fields offshore Sabah are particularly susceptible to improvements in rates and recoveries from new technology and new business models. The vast majority of advanced technologies used to improve oil and gas recoveries offshore Sabah have been successful. . . .").

[175] Brattle Report, ¶ 35.

[176] *Id.*

[177] Meehan Report, p. 10; Brattle Report, ¶ 36.

2005), Ubah Crest (Shell, 2005), Pisangan (Shell, 2005), and Wakid (Petronas, 2011).[178]

126. In 2014, technology developments allowed Malaysia to "embark[ ] on a new era of innovation" given that Malaysia has "the perfect mix of ingredients to be a regional energy hub".[179] Gas production in Sabah expanded significantly in late 2014, following the construction of the Sabah-Sarawak pipeline and the development of a cluster of gas fields.[180] Dr. Meehan describes the characteristics of the main Sabah fields in his report, confirming that they are exploited with cutting-edge technology developed recently.[181]

127. The consolidation of the natural gas industry in Sabah is also the result of circumstances unforeseeable to the parties in 1878. Like oil, natural gas exploitation in Sabah is highly dependent on offshore drilling technology which, as explained before, only became available in the 1960s (and saw significant improvements in recent years). Commercial usage of natural gas was unheard of before the invention of the Bunsen burner in 1885, seven years after the execution of the 1878 Lease Agreement.[182] Furthermore, the demand for natural gas in the 19th century was all but nonexistent; in 1900, natural gas accounted for less than 1% of global energy demand.[183]

128. Natural gas did not become widespread for commercial and household use until an efficient transport system was developed. Mass pipeline development did not occur until after World War II, when new welding techniques such as pipe rolling and metallurgy were made available.[184] As a result of these advancements, natural

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[178] **Doc. C-85**, Sorkhabi Rasoul, *Borneo's Petroleum Plays*, 9(4) GEOXPRO (2012).

[179] Meehan Report, p. 11 (citing the words of Malaysia's Prime Minister).

[180] Brattle Report, ¶ 81.

[181] Meehan Report, pp. 10-11. *See also id.*, p. 19 ("Oil and gas fields offshore Sabah are particularly susceptible to improvements in rates and recoveries from new technology and new business models. The vast majority of advanced technologies used to improve oil and gas recoveries offshore Sabah have been successful. . . .").

[182] **Doc. C-86**, *A Brief History of Natural Gas*, AMERICAN PUBLIC GAS ASSOCIATION (2020); *see also* **Doc. C-87**, Cutler J. Cleveland, CONCISE ENCYCLOPEDIA OF HISTORY OF ENERGY (ElSevierInc., 2009), p. 15 (although an earlier version of the Bunsen burner had been invented in 1855 by English scientist Michael Faraday, the prototype invented in 1885 by German scientist Robert Bunsen was the one that triggered a commercial demand for natural gas).

[183] **Doc. C-82**, Jan J. Boersema *et al.*, PRINCIPLES OF ENVIRONMENTAL SCIENCES (Springer, 2010), p. 39.

[184] **Doc. C-86** *A Brief History of Natural Gas*, AMERICANPUBLICGASASSOCIATION (2020).

gas became a common energy source for cooking and home heating; by 1980 it fueled more than 20% of the global energy grid.[185]

#### (iv) Malaysia's Past Economic Benefit from Oil and Gas (1965-2020)

129. Brattle and Dr. Meehan explain that 33 oil fields currently operate in the Leased Territories, producing significant quantities of crude oil.[186] Likewise, 23 gas fields now operate in the Leased Territories.[187] Dr. Meehan confirms that the oil and/or gas taken into consideration in the Brattle Report belong to the Sabah basin, which is located within the Leased Territories.[188]

130. Malaysia granted Petronas the exclusive right to explore and develop its oil and gas resources. Petronas partners with contractors to achieve the goal of exploration and development.[189] The substantial development of the Leased Territories' oil and gas resources has proceeded under production-sharing contracts ("**PSC**"s) between Petronas and contractors. PSCs are among the most common contractual arrangement between an exploration and production ("**E&P**") company and a petroleum-producing state.[190]

131. Under a typical PSC, a contractor explores a prospective field, incurs development and operating costs, and in return obtains a share of the oil and gas produced. The host State obtains the remaining share together with direct tax revenue from the contractor.[191] In our case, Malaysia enters into the PSCs through Petronas. Petronas in turn established Petronas Carigali Sdn Bhd ("**Petronas Carigali**") in 1978 for the purpose of oil and gas exploration. Petronas Carigali was a junior member of many of the contractor consortia for Malaysian PSCs in the Leased Territories, and more recently has been the senior contractor.[192]

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[185] **Doc. C-82**, Jan J. Boersema *et al.*, PRINCIPLES OF ENVIRONMENTAL SCIENCES (Springer, 2010), p. 39.

[186] Brattle Report, ¶ 27; Meehan Report, pp. 9-11.

[187] *See* n. 186, *supra*.

[188] Meehan Report, p. 18 ("The oil and gas fields evaluated in the Brattle Report correspond to a subset of the fields that would belong to the sovereign entity with such rights in the Sabah portion of Borneo").

[189] Brattle Report, ¶ 50.

[190] *Id.*, ¶ 51.

[191] *Id.*

[192] *Id.*, ¶ 53.

132. Brattle identifies 7 streams of economic benefits for Malaysia from oil and gas in the Leased Territories:[193]

(i) First, Malaysia levies a 10% royalty on the value of all oil and gas produced in Sabah. The royalty applies directly to the oil and gas revenues and is payable in cash. Malaysia assesses oil and gas production at the sales point.

(ii) Second, a 38% Petroleum Income Tax applies to the profits that both contractors and Petronas earn from fields in Sabah.

(iii) Third, each PSC defines a supplementary payment of either 50%, 60%, or 70% of any excess revenues from profit oil above a contractually defined base price. The base price is usually close to the prevailing per barrel price at the time the parties entered into a PSC.

(iv) Fourth, Malaysia levies a 10% export duty on the contractor's share of exported profit oil. Malaysia considers the export duty a tax-deductible expense for the contractor.

(v) Fifth, Malaysia levies a 0.5% research contribution on the contractor.

(vi) Sixth, Petronas obtains its share of oil and gas production income under the relevant PSCs, net of the applicable Petroleum Income Tax. Income and cash flows from oil and gas fields in the Leased Territories contribute to Petronas's overall income and cash flow, and in turn to Petronas's distribution to its 100% owner, the Malaysian Government.

(vii) Seventh, Petronas Caligari receives money for its contracting activities.

133. Brattle has focused its assessment of economic benefits on developed oil and gas fields; it has ignored the potential for future benefits from contingent fields or new oil and gas discoveries.[194] This results in a more conservative – and thus lower – estimate of revenues for Malaysia.

134. Table 1 (taken from the Brattle Report) reflects historical oil and gas production in the Leased Territories from 1965 through to February 2020. It also indicates forecasted oil and gas production in the Leased Territories from March 2020 through to 2044.[195]

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[193] *Id.*, ¶ 66.

[194] *Id.*, ¶¶ 39, 44-45.

[195] *Id.*, ¶ 47.

Table 1: Oil and gas production (Wood Mackenzie)

| | Time period | | | Total |
|---|---|---|---|---|
| | 1965 to 2012 | 2013 to Feb. 2020 | Feb. 2020 onwards | |
| | [A] | [B] | [C] | [D] |
| | See note | See note | See note | [A]+[B]+[C] |
| Oil Production | 1,316 | 600 | 1,154 | 3,070 |
| Gas Production | 201 | 163 | 1,365 | 1,728 |

Notes and sources:
All figures in mln bbl.
Oil production figures include condensate production.
[A] to [C]: Brattle Workpapers A, PSC Model.

135. Oil production in the Leased Territories amounted to 1,916 million barrels between 1965 and February 2020. Brattle's sources forecast an additional 1,154 million barrels of oil production from February 2020 until 2044. Gas production amounted to 364 million barrels of oil equivalent through February 2020. Brattle's sources forecast a further 1,365 million barrels of oil equivalent in gas production from 2020 to 2044.

136. Brattle estimates the economic benefits to Malaysia from 1965 through February 2020 under each relevant PSC in the Leased Territories.[196] Table 8 below (taken from the Brattle Report) aggregates the results across the full set of PSCs in the Leased Territories. Brattle reports the value of the seven types of economic benefits for Malaysia under the PSCs, net of the costs Malaysia incurs. Brattle performs its historical calculations in U.S. dollars, since the revenues and costs of oil and gas fields worldwide are determined in U.S. dollars. The values are expressed in nominal U.S. dollars and do not include interest to bring them to the present.[197]

[196] *Id.*, ¶ 30.

[197] *Id.*, ¶¶ 100-101.

Table 8: Undiscounted historical benefits to Malaysia (oil and gas)

| | 1965 to 2012 [A] See note | 2013 to Feb. 2020 [B] See note | Total from 1965 [C] [A]+[B] |
|---|---|---|---|
| **Benefits to Malaysia, USD bln** | | | |
| Royalty Income | 6.52 | 4.95 | 11.47 |
| Petroleum Income Tax - Petronas | 12.17 | 6.44 | 18.62 |
| Petroleum Income Tax - contractor | 4.04 | 3.82 | 7.85 |
| Export Duty | 1.08 | 0.62 | 1.70 |
| Supplementary Payment | 5.45 | 1.56 | 7.02 |
| Research Levy | 0.13 | 0.15 | 0.28 |
| PETRONAS Oil/Gas/Cond. Share | 14.51 | 6.99 | 21.50 |
| Petronas Carigali Share | 4.14 | 1.21 | 5.35 |
| Total Undiscounted Benefit to Malaysia | 48.04 | 25.75 | 73.79 |
| **Benefits to Malaysia, MYR bln** | | | |
| Royalty Income | 20.65 | 19.49 | 40.13 |
| Petroleum Income Tax - Petronas | 39.22 | 25.11 | 64.34 |
| Petroleum Income Tax - contractor | 12.31 | 14.93 | 27.24 |
| Export Duty | 3.33 | 2.44 | 5.77 |
| Supplementary Payment | 17.15 | 5.55 | 22.70 |
| Research Levy | 0.41 | 0.60 | 1.01 |
| PETRONAS Oil/Gas/Cond. Share | 45.70 | 27.18 | 72.88 |
| Petronas Carigali Share | 14.15 | 4.47 | 18.63 |
| Total Undiscounted Benefit to Malaysia | 152.92 | 99.77 | 252.69 |

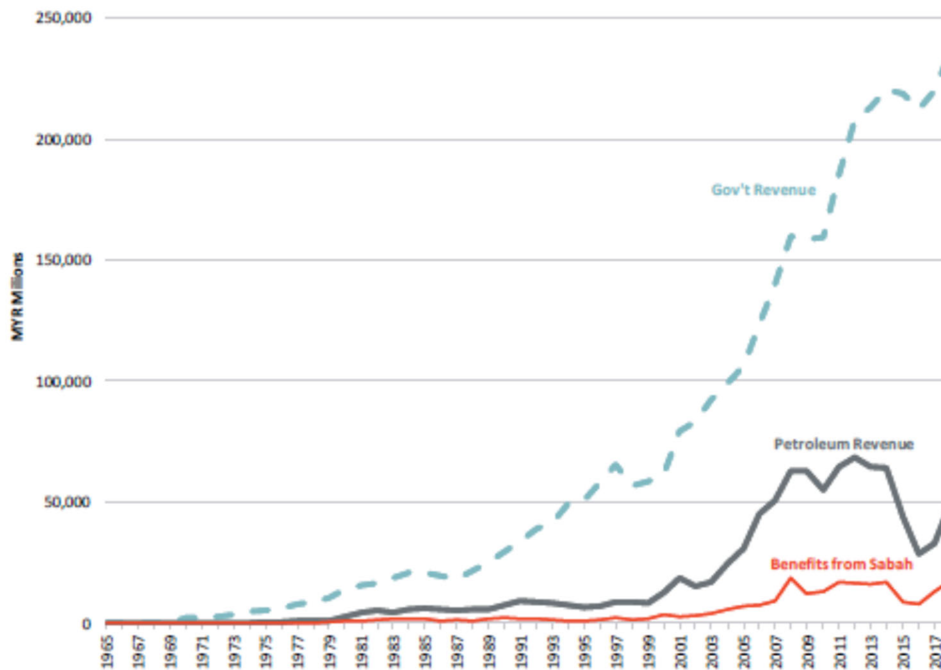
Notes and sources:
All figures in bln.
[A] to [B]: Brattle Workpapers A, PSC Model.

137. Column [C] indicates that Malaysia has obtained an economic benefit from oil and gas production in the Leased Territories of as much as US$ 73.79 billion between 1965 and February 2020 (equivalent to MYR 252.69 billion).[198] This includes US$ 25.75 billion from oil and gas production in Sabah from January 2013 to February 2020 (equivalent to 99.77 billion MYR).

138. Figure 11 (taken from the Brattle Report) compares the economic benefits obtained by Malaysia from oil and gas production in the Leased Territories with the Malaysian Government's total revenues from taxes and duties.[199] For example, the economic benefits obtained by Malaysia from oil and gas production in the Leased Territories were equivalent to roughly 6% of the Malaysian government's total tax revenue, and 25% of the Malaysian government's total revenues from oil and gas.[200]

[198] *Id.*, ¶ 102.
[199] *Id.*, ¶ 103.
[200] *Id.*

Figure 11: Petroleum Benefits vs Malaysian GDP and Government Revenues




### (v) Malaysia's Expected Economic Benefit from Oil and Gas (2020-2044)

139. Brattle forecasts Malaysia's profits from oil and gas in the Leased Territories through 2044.[201] There are no reliable forecasts beyond 2044. Brattle analyzes the aforementioned 7 streams of economic benefits net of the costs which Malaysia may incur. Dr. Meehan considers Brattle's forecast to be reasonable, and notes that Brattle could have assumed a higher upside production:

> Many of the fields evaluated in this report have significant upside producing potential remaining. I do not believe that the full extent of this potential has been incorporated in the Brattle Report, specifically the potential for future discoveries. This results in a lower valuation in the Brattle Report.
>
> Based on a limited review of the oil and gas reserves and/or resources in the fields evaluated in the Brattle Report, the producing rates and reserves along with the decline curves, R/P ratios and other producing characteristics are largely consistent with my expectations for the behavior of such fields in general.
>
> In the case of the largest fields, the producing rates and reserves along with the decline curves, R/P ratios and other producing characteristics are consistent with my expectations for those specific fields.

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201 *Id.*, ¶¶ 38-39.

> Oil and gas fields offshore Sabah are particularly susceptible to improvements in rates and recoveries from new technology and new business models. The vast majority of advanced technologies used to improve oil and gas recoveries offshore Sabah have been successful. Significant exploration potential remains which has not been incorporated into the Brattle Report. This results in a lower valuation in the Brattle Report.[202]

140. Brattle discounts the forecast of its economic benefits for Malaysia back to a February 2020 present value.[203] Discounting forecast cash flows to present value is standard practice.[204] Brattle follows recommended best practice in financial valuation and uses the Capital Asset Pricing Model ("**CAPM**") to derive the applicable risk-adjusted discount rates.[205]

141. According to Brattle, applying the CAPM equation results in (i) a discount rate of 7.51% for the two streams of benefits (taxes on contractors and Petronas Caligari profits) comparable to E&P companies; and (ii) a corresponding discount rate of 5.86% for the remaining five streams of benefits comparable to royalty trusts.[206]

142. In order to be as conservative as possible, Brattle assessed the potential for disruptions of Malaysian oil and gas production and applied an additional discount to its forecasts to reflect the chance of a supply disruption.[207]

143. Table 10 below (taken from the Brattle Report) reflects the total economic benefits forecast for Malaysia from oil and gas in the Leased Territories between February 2020 and 2044.[208] The values are expressed in nominal U.S. dollars:

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[202] Meehan Report, pp. 18-19 (emphasis added).

[203] Brattle Report, ¶ 104.

[204] *Id. See also* § V.A(c), *infra.*

[205] Brattle Report, ¶ 111. *See also* **Doc. CL-57**, Shannon P. Pratt *et al.*, LAWYER'S BUSINESS VALUATION HANDBOOK (American Bar Association, 2010), p. 63 (The CAPM is "considered by many to be the most theoretically correct model for estimating an equity discount rate"); **Doc. CL-58**, Mark Kantor, VALUATION FOR ARBITRATION (Wolters Kluwer, 2008), pp. 162-163 ("CAPM is accordingly the 'equity cost of capital' model most commonly used by corporate finance practitioners".); **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 198 (noting that CAPM "is a technique frequently used to estimate the risk of an investment, and consequently, the applicable discount rate").

[206] Brattle Report, ¶ 113.

[207] *Id.*, ¶¶ 106-107 and § IV.F.2.

[208] *Id.*, ¶ 123.

Table 10: Future benefits to Malaysia

| | Undiscounted benefit USD bln [A] See note | Discounted benefit USD bln [B] See note | Discounted benefit MYR bln [C] See note |
|---|---|---|---|
| **Benefits to Malaysia** | | | |
| Royalty Income | 17.82 | 10.57 | 43.98 |
| Petroleum Income Tax - Petronas | 31.56 | 17.64 | 73.43 |
| Petroleum Income Tax - contractor | 6.08 | 3.58 | 14.91 |
| Export Duty | 4.50 | 2.62 | 10.91 |
| Supplementary Payment | 1.66 | 0.78 | 3.25 |
| Research Levy | 0.52 | 0.32 | 1.33 |
| PETRONAS Oil/Gas/Cond. Share | 29.64 | 16.49 | 68.63 |
| Petronas Carigali Share | 12.75 | 5.88 | 24.46 |
| Total Benefit to Malaysia | 104.53 | 57.88 | 240.91 |

Notes and sources:
The discounted benefits in MYR use the exchange rate of 4.16 MYR/USD as of 2/1/2020.
Oil includes condensate.
[A] to [B]: Brattle Workpapers A, PSC Model.

144. Brattle thus estimates that Malaysia will receive a total of US$ 104.53 billion in economic benefits from ongoing oil and gas production in the Leased Territories between February 2020 and 2044, corresponding to a total present value of US$ 57.88 billion (equivalent to MYR 240.91 billion).[209]

### (vi) Malaysia's Total Economic Benefit from Oil and Gas (2013-2044)

145. Table 11 (taken from the Brattle Report) combines Brattle's assessments of Malaysia's past and future economic benefits from oil and gas production in the Leased Territories.[210] The benefit between January 2013 and February 2020 amounted to US$ 25.75 billion (equivalent to MYR 99.77 billion). The future benefits until 2044 amount to a further US$ 57.88 billion (equivalent to MYR 240.91 billion) in present value as of February 2020.[211]

[209] *Id.*

[210] *Id.*, ¶ 125.

[211] *Id.*

Table 11: Historical and future discounted benefits to Malaysia

| | Undiscounted benefits | | Discounted benefits | Total Benefits |
|---|---|---|---|---|
| | 1965 to 2012 | 2013 to Feb. 2020 | Feb. 2020 onwards | 2013 onwards |
| | [A] | [B] | [C] | [D] |
| | See note | See note | See note | [B] + [C] |
| **Benefits to Malaysia, USD bln** | | | | |
| Royalty Income | 6.52 | 4.95 | 10.57 | 15.52 |
| Petroleum Income Tax - Petronas | 12.17 | 6.44 | 17.64 | 24.08 |
| Petroleum Income Tax - contractor | 4.04 | 3.82 | 3.58 | 7.40 |
| Export Duty | 1.08 | 0.62 | 2.62 | 3.24 |
| Supplementary Payment | 5.45 | 1.56 | 0.78 | 2.35 |
| Research Levy | 0.13 | 0.15 | 0.32 | 0.47 |
| PETRONAS Oil/Gas/Cond. Share | 14.51 | 6.99 | 16.49 | 23.48 |
| Petronas Carigali Share | 4.14 | 1.21 | 5.88 | 7.08 |
| Total Benefit to Malaysia | 48.04 | 25.75 | 57.88 | 83.62 |
| **Benefits to Malaysia, MYR bln** | | | | |
| Royalty Income | 20.65 | 19.49 | 43.98 | 63.47 |
| Petroleum Income Tax - Petronas | 39.22 | 25.11 | 73.43 | 98.55 |
| Petroleum Income Tax - contractor | 12.31 | 14.93 | 14.91 | 29.84 |
| Export Duty | 3.33 | 2.44 | 10.91 | 13.34 |
| Supplementary Payment | 17.15 | 5.55 | 3.25 | 8.81 |
| Research Levy | 0.41 | 0.60 | 1.33 | 1.93 |
| PETRONAS Oil/Gas/Cond. Share | 45.70 | 27.18 | 68.63 | 95.81 |
| Petronas Carigali Share | 14.15 | 4.47 | 24.46 | 28.93 |
| Total Benefit to Malaysia | 152.92 | 99.77 | 240.91 | 340.68 |

Notes and sources:
All figures in bln.
The Feb. 2020 onwards benefits in MYR use the exchange rate of 4.16 MYR/USD as of 2/1/2020.
[A] to [C]: Brattle Workpapers A, PSC Model.

146. Thus, from 1 January 2013 through to Brattle's forecast horizon of 2044, Malaysia will have obtained as much as US$ 83.62 billion (equivalent to MYR 340.68 billion) in economic benefits from oil and gas production in the Leased Territories.[212] As mentioned, this amount excludes the potential for future benefits from contingent fields or new oil and gas discoveries.[213]

### (d) Malaysia Sees Another Windfall with the Development of the Palm Oil Industry in the Leased Territories

#### (i) Overview of the Palm Oil Industry in the Leased Territories

147. As unbelievable as it may seem, hydrocarbons are not the only commodities that have fundamentally altered the equilibrium of the 1878 Lease Agreement. In the last few decades, palm oil has become another notably profitable industry in Sabah.

148. The oil palm tree produces plum-sized fruit clustered together in fresh fruit bunches, which can weigh between five and twenty kilograms. At the center of the

[212] *Id.* ¶ 126.

[213] *Id.*, ¶¶ 39, 44-45.

fruit is the palm nut, or kernel. Crushing the fruit and kernel produces crude palm oil ("**CPO**"); crushing the kernel exclusively produces crude palm kernel oil ("**CPKO**").[214] Manufacturers now refine the intermediary products, CPO and CPKO, to produce oils for cooking, cosmetics, sanitary products and biofuels.[215]

149. Like oil and gas, revenues from palm oil are the result of circumstances unforeseen to the original parties to the 1878 Lease Agreement.

150. The earliest commercial cultivation of oil palm trees in Malaysia occurred in 1917. The first plantations produced CPO and CPKO for use as industrial lubricants.[216] The Malaysian Government has promoted the cultivation of oil palm trees in Sabah since the 1960s.[217] Major private oil palm plantations began to emerge in the 1980s.[218]

151. Oil palm, and its main commercial derivative, CPO, were not commonly known until the 1960s, following a steady post-War increase in the processed foods industry. CPO is an edible vegetable oil commonly used as an additive in food production or as a cooking oil. Its use did not become widespread until the early 1990s, when scientific research began to show that the hydrogenation process with conventional vegetable oils, such as those in margarine, were producing trans fats, compounds even unhealthier than saturated fats. Fearing a backlash from the scientific community and negative consumer pressure, British-Dutch food conglomerate Unilever triggered the first wave of food industry investment in palm oil plantations in 1994. This led to a surge in production in Malaysia, the world's main productive hub.[219] In more recent years, CPO has also become a valuable source for biofuel production.[220]

152. Private plantations collectively accounted for 3.54 million hectares in 2019, representing the vast majority of all Malaysian oil palm plantations.[221] The total area

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[214] *Id.*, ¶ 131.

[215] *Id.*

[216] *Id.*, ¶ 132.

[217] *Id.*, ¶ 133.

[218] *Id.*, ¶ 136.

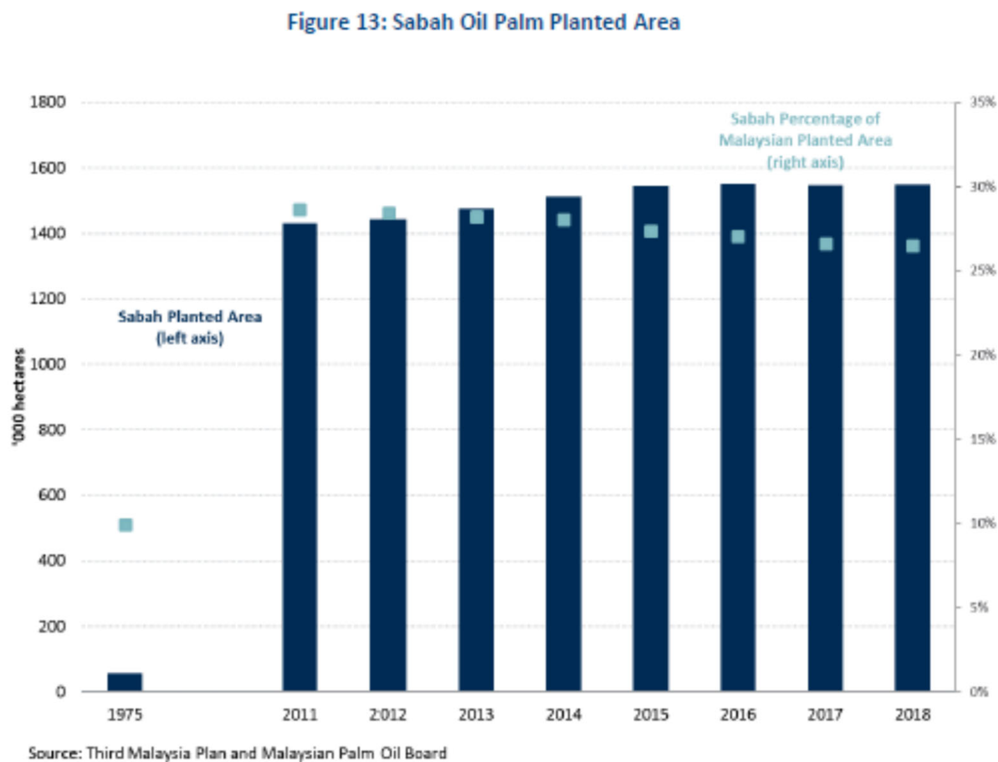
[219] **Doc. C-88**, Paul Tullis, *How the world got hooked on Palm Oil*, THE GUARDIAN, 19 February 2019.

[220] **Doc. C-89**, Khairul Azly Zahan *et al.*, *Biodiesel Production from Palm Oil, Its By-Products, and Mill Effluent: A Review*, RESEARCHGATE, 18 July 2018.

[221] Brattle Report, ¶ 136.

of Malaysian land dedicated to oil palm plantations increased from 55,000 hectares in 1960 to 5.9 million in 2019.[222]

153. Figure 13 (taken from the Brattle Report) confirms the expansion of oil palm plantations in the Leased Territories.[223] It indicates the land area devoted to oil palm cultivation in different years (blue bars and left-hand axis). It also indicates the ratio of the land area devoted to oil palm cultivation in Sabah to the total land area devoted to oil palms in Malaysia as a whole (blue squares and right-hand axis).[224]




154. Malaysia saw a massive expansion of oil palm cultivation since 1975. The cultivation of oil palm trees accounted for just 0.8% of the land mass of the Leased Territories in 1975, but now accounts for as much as 21% of the entire land mass in Malaysia – an expansion of over 2,600% in the past 45 years.[225] Notably, the land area in Sabah devoted to oil palm cultivation increased from less than 100,000 hectares in 1975 to more than 1.4 million hectares in 2011, representing an increase

[222] *Id.*

[223] *Id.*, ¶ 138.

[224] *Id.*, ¶ 139. The gap in Figure 13 between 1975 and 2011 reflects the lack of publicly available data during this period.

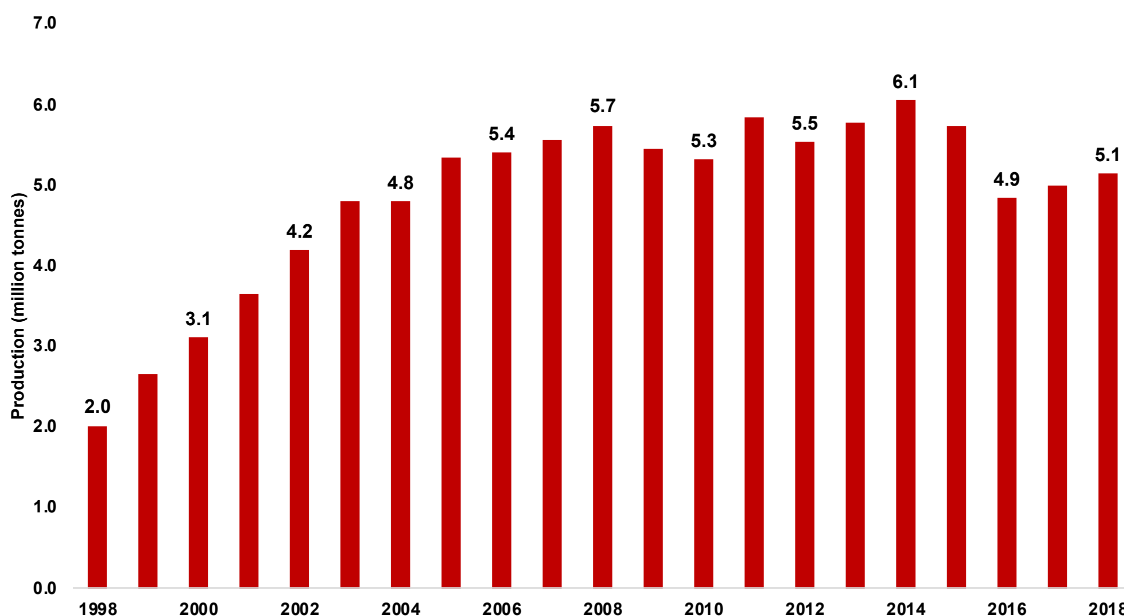
[225] *Id.*, ¶ 128.

of 1,300%. The growth in planted area moderated after 2011, with landed area standing at close to 1.55 million hectares in 2018.[226]

155. Yet the expansion in Sabah was far above that of elsewhere. In 1975, Sabah accounted for roughly 10% of the land area devoted to oil palm cultivation in Malaysia.[227] It now accounts for close to one third.[228]

156. The following chart shows the evolution of CPO production in Sabah since 1998. In the last two decades, the total production in the region has grown three-fold, with a maximum output in 2014 of over 6 million tons. This is an even more impressive growth rate if one takes into account the production level in 1990, which amounted to only 679 thousand tons.

Production of Crude Palm Oil (CPO) in Sabah (million tons)[229]




157. Similarly, the chart below shows the total export value (in Malaysian Ringgit) of CPO exports from Sabah. The disproportionate increase in export value as compared to the production statistics shows how coveted CPO has recently become in international markets. In the last two decades, export value has risen from MYR 1.6 to MYR 24.8 billion (more than a fifteen-fold increase).

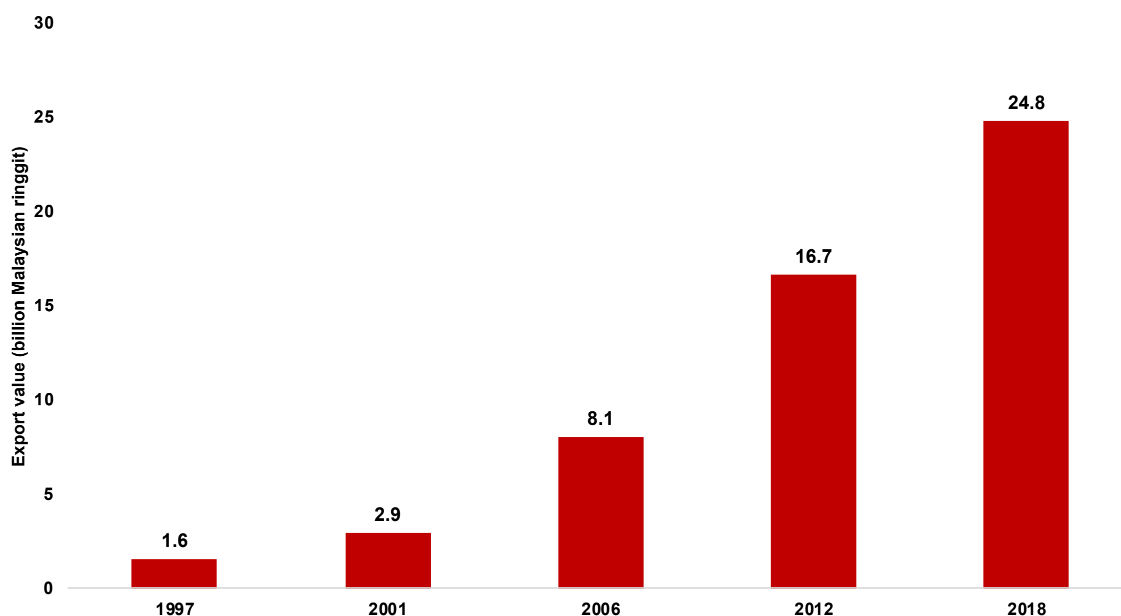
[226] *Id.*, ¶ 139.

[227] *Id.*, ¶ 140.

[228] *Id.*

[229] **Doc. C-90**, Kushairi A. *et al.*, *Oil Palm Economic Performance in Malaysia and R&D Progress in 2017*, 30(2) JOURNAL OF OIL PALM RESEARCH (June 2018).

Export value of CPO in Sabah (RM billion)[230]




158. Brattle explains that Malaysia obtains three main economic benefits from the production of palm oil in the Leased Territories:

(i) The first and largest economic benefit comes from corporate income tax revenues obtained from palm oil producers.[231] Brattle considers Malaysia's tax receipts in relation to upstream plantation and milling activities, and ignores Malaysia's tax receipts in relation to downstream refining and marketing.[232] Malaysian upstream palm oil producers paid corporate income tax at a rate of 25% before 2014, after which the rate decreased to 24%.

(ii) Second, Malaysia collects an export duty from producers of crude palm oil and crude palm kernel oil.[233] The effective export duty rate for crude palm was approximately 20% prior to 2013. Malaysia implemented a new export duty structure in 2013, reduced the effective duty rate on crude palm oil to less than 5% and effectively eliminated export taxes on crude palm kernel oil.

(iii) Third, Malaysia collects an excess profit tax from crude palm oil producers, which depends on the level of crude palm oil prices.[234]

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[230] *Id.*

[231] Brattle Report, ¶ 150.

[232] This approach is a conservative calculation of profit and reflects the fact that downstream operations may be located outside the Leased territories.

[233] *Id.*, ¶ 151.

[234] *Id.*, ¶ 152.

159. Market prices for CPO and CPKO are primary drivers of Malaysia's palm oil-related tax receipts.[235] Brattle has obtained historical monthly Malaysian CPO prices from Bloomberg, and forecasted monthly CPO prices based on the prices for the future delivery of Malaysian CPO.[236] Notably, Brattle's price forecasts are lower than those developed by independent forecasters in the normal course of business.[237]

#### (ii) Malaysia's Past Economic Benefit from Palm Oil (2013-2020)

160. Brattle estimates Malaysia's income from upstream production of CPO and CPKO within Sabah between January 2013 and February 2020. The results are provided in Table 17 (taken from the Brattle Report):[238]

Table 17: Historical benefits from palm oil

| | | Jan 2013 to Feb 2020 |
|---|---|---|
| | | [A]<br>See note |
| **Benefits to Malaysia, USD mln** | | |
| | Export Duty | 70.29 |
| | Excess Profit Tax | 5.95 |
| | Corporate Income Tax | 2,500.77 |
| Total Benefit to Malaysia | | 2,577.01 |
| **Benefits to Malaysia, MYR mln** | | |
| | Export Duty | 267.27 |
| | Excess Profit Tax | 24.85 |
| | Corporate Income Tax | 9,774.24 |
| Total Benefit to Malaysia | | 10,066.35 |

Notes and sources:
Brattle Corporate Income Tax, Excess Profit and Export Duty Workpapers.

161. Therefore, between January 2013 and February 2020, Brattle estimates that Malaysia obtained as much as US$ 2.58 billion from the production of palm oil derivatives in Sabah, equivalent to MYR 10.06 billion.[239]

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[235] *Id.*, ¶ 129.
[236] *Id.*, ¶ 147.
[237] *Id.*, ¶ 148.
[238] *Id.*, ¶ 176.
[239] *Id.*, ¶ 177.

### (iii) Malaysia's Expected Economic Benefit from Palm Oil (2020 to Perpetuity)

162. As with oil and gas, Brattle has forecasted palm oil production though 2030.[240] After 2030, Brattle continues to assume that palm oil production in Sabah will remain broadly constant out to perpetuity.[241] Unlike oil and gas fields, palm oil plantations can be renewed. Palm oil trees may age and produce less fruit, but the trees can be replaced, and fruit production recovered.[242] Brattle incorporates a terminal value based on the textbook formula for a growing perpetuity.[243]

163. Brattle discounts its forecast of the economic benefit streams (listed in ¶ 158 above) back to a February 2020 present value.[244] Brattle again applies the CAPM and adopts the same "risk-free rate" and market risk premium assumptions as in its analysis of oil and gas, the only difference being the asset beta.[245] Applying the standard CAPM equation results in an overall discount rate for the palm oil benefits of 4.49%.[246] Brattle also considers production disruption to be the only material risk facing the streams of economic benefits for Malaysia from palm oil beyond those embedded in the discount rate.[247]

164. Table 18 below (taken from the Brattle Report) shows the undiscounted benefits from 2020 to 2030 and then into perpetuity, and the corresponding present values for each of the three palm oil-related benefits to Malaysia.[248]

[240] *Id.*, ¶ 145.
[241] *Id.*, ¶ 146.
[242] *Id.*
[243] *Id.*, n. 136.
[244] *Id.*, ¶ 178.
[245] *Id.*, ¶ 179.
[246] *Id.*
[247] *Id.*, ¶ 180.
[248] *Id.*, ¶ 182.

Table 18: Future benefits to Malaysia

| | Undiscounted Benefits | Discounted Benefits | Discounted Terminal Value | Total Discounted Benefits |
|---|---|---|---|---|
| | Jan 2020 - Feb 2030 [A] See note | Jan 2020 - Feb 2030 [B] See note | Feb 2030 onwards [C] See note | Feb. 2020 onwards [D] [B]+[C] |
| **Benefits to Malaysia, USD mln** | | | | |
| Corporate Income Tax | 2,610.04 | 2,014.80 | 6,513.72 | 8,528.52 |
| Export Duty | 139.26 | 104.31 | 459.61 | 563.92 |
| Excess Profit Tax | 5.61 | 5.28 | 17.65 | 22.93 |
| Total USD Benefit to Malaysia | 2,754.91 | 2,124.39 | 6,990.98 | 9,115.38 |
| **Benefits to Malaysia, MYR mln** | | | | |
| Corporate Income Tax | 12,022.16 | 8,386.55 | 27,113.21 | 35,499.76 |
| Export Duty | 652.54 | 434.19 | 1,913.10 | 2,347.30 |
| Excess Profit Tax | 26.42 | 21.99 | 73.46 | 95.46 |
| Total RM Benefit to Malaysia | 12,701.11 | 8,842.74 | 29,099.77 | 37,942.51 |

Notes and sources:
Brattle Corporate Income Tax, Excess Profit and Export Duty Workpapers.

165. Brattle estimates that Malaysia will receive a present value of US$ 9.11 billion out to perpetuity from palm oil (equivalent to MYR 37.94 billion).[249]

### (iv) Malaysia's Total Economic Benefit from Palm Oil (2013 to Perpetuity)

166. Table 19 (taken from the Brattle Report) summarizes the historical and future economic benefits to Malaysia from palm oil within the Leased Territories. Malaysia has obtained and will obtain a grand total of US$11.69 billion from palm oil production since 2013 (equivalent to MYR 48.00 billion). Roughly one quarter of those benefits have accrued between 2013 and February 2020, with the remaining three quarters expected in the future.

[249] *Id.*

Table 19: Historical and future discounted benefits to Malaysia

| | Historical Benefits (w/o PAI) | Discounted Benefits | Total Benefits |
|---|---|---|---|
| | Jan. 2013 to Feb. 2020 | Feb. 2020 onwards | Feb. 2020 onwards |
| | [A] | [B] | [C] |
| | See note | See note | [A]+[B] |
| **Benefits to Malaysia, USD mln** | | | |
| Corporate Income Tax | 2,500.77 | 8,528.52 | 11,029.30 |
| Export Duty | 70.29 | 563.92 | 634.21 |
| Excess Profit Tax | 5.95 | 22.93 | 28.89 |
| Total USD Benefit to Malaysia | 2,577.01 | 9,115.38 | 11,692.39 |
| **Benefits to Malaysia, MYR mln** | | | |
| Corporate Income Tax | 9,774.24 | 35,499.76 | 45,274.00 |
| Export Duty | 267.27 | 2,347.30 | 2,614.56 |
| Excess Profit Tax | 24.85 | 95.46 | 120.30 |
| Total MYR Benefit to Malaysia | 10,066.35 | 37,942.51 | 48,008.86 |

Notes and sources:
Brattle Corporate Income Tax, Excess Profit and Export Duty Workpapers.

### (e) Balance

167. In the prior sections, we explained that, from 1 January 2013 through to Brattle's forecast horizon of 2044, Malaysia will have obtained as much as US$ 83.62 billion (equivalent to MYR 340.68 billion).[250] Additionally, Malaysia has obtained and will obtain a grand total of US$11.69 billion from palm oil production since 2013 (equivalent to MYR 48.00 billion).[251] In total, Malaysia has and will obtain as much as USD 95.32 billion of economic benefits from the production of oil and gas, and palm oil in Sabah since 2013, equivalent to MYR 388.69 billion.[252]

168. Malaysia has not paid under the 1878 Lease Agreement since 2013. Malaysia obtained US$ 25.75 billion of economic benefits between 2013 and February 2020 (equivalent to MYR 99.77 billion) from oil and gas, and US$ 2.58 billion in economic benefits between 2013 and February 2020 (equivalent to MYR 10.06 billion) from palm oil.[253] This totals US$ 28.33 billion from 2013 until today.

169. In exchange, had it honored the 1878 Lease Agreement, Malaysia would have paid Claimants as little as MYR 42,400 (roughly US$ 9,935) in lease payments between 2013 and February 2020. Hence, Malaysia reaped several million times

[250] *See* ¶¶ 136-137, *supra*.

[251] *See* ¶ 166, *supra*.

[252] Brattle Report, ¶ 10.

[253] *Id.*, ¶¶ 8-9.

as much from oil, gas and palm oil revenues in the Leased Territories during this period as it (ought to have) paid under the 1878 Lease Agreement.

### N. Claimants Requested Renegotiations Multiple Times Without Response

170. Repeated attempts to renegotiate the commercial terms of the 1878 Lease Agreement have been met with silence. In 1989, with the blessing of the Philippine Administration at that time, Claimants (and in some cases their predecessors) reached out to the Government of Malaysia in order to negotiate revised terms to the 1878 Lease Agreement. They floated the concept of formally ceding sovereignty to Malaysia by terminating the 1878 Lease Agreement, in exchange for a lump sum payment.[254] Malaysia did not respond.

171. In 1999, Claimants again wrote to Malaysia to propose an increase in the annual payment under the 1878 Lease Agreement to US$ 749 million.[255] Although this obviously would have represented a massive increase in the annual payment, that sum represented only about 5% of the region's petroleum revenues at that time – a time of historic lows for oil prices.[256] Malaysia failed to reply to Claimants' request.

172. Further attempts, equally unsuccessful, were made to negotiate with the Malaysian Government over the following 15 years.[257] In November 2016, soon after current counsel took over the case, they wrote to a senior advisor of the Malaysian Prime Minister, Najib Razak, seeking to negotiate the claim.[258] In April 2017, counsel followed up with another letter to Mr. Razak himself, formally seeking negotiation.[259]The Prime Minister did not respond. In 2018, after Claimants had filed their petition with the Superior Court of Madrid to appoint an arbitrator, they wrote

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[254] **Doc. C-29**, Letter from Ulama Law Office, on behalf of the Claimants, to the Prime Minister of Malaysia, 17 September 2012, pp. 2-3 (recounting the 1989 offer of the Claimants to Malaysia).

[255] **Doc. C-30**, Memorandum of the Philippine Secretary of Foreign Affairs for the Executive Secretary, 16 April 1999, p. 1 (recounting a 1 February 1999 letter from the Claimants to Malaysia).

[256] **Doc. C-91**, *OPEC disappoints, oil slides*, CNNMONEY, 30 November 1998; *see also* **Doc. C-92**, Thomas Fuller, *Oil Price Plunge Confounds Malaysia*, NEWYORKTIMES, 8 July 1998.

[257] *See e.g.*, **Doc. C-29**, Letter from Ulama Law Office, on behalf of the Claimants, to the Prime Minister of Malaysia, 17 September 2012, p. 3.

[258] **Doc. C-93**, Letter from Paul H. Cohen, on behalf of the Claimants, to Hasnan Zahedi bin Ahmad Zakaria, advisor of the Prime Minister of Malaysia, 15 November 2016.

[259] **Doc. C-94**, Letter from Paul H. Cohen, on behalf of the Claimants, to the Prime Minster of Malaysia, 28 April 2017.

to the new Prime Minister, the aforementioned Dr. Mahathir Mohamed, again requesting negotiations and an amicable resolution of the Claim.[260] Again the Prime Minister did not respond.

173. Until 19 September 2019, the sole formal correspondence received from Malaysia constituted cover letters for the annual payments to the heirs of the Sultanate.[261]

## III. PROCEDURAL HISTORY

174. The full procedural history of this Claim is provided in § IV of the Sole Arbitrator's 25 May 2020 Preliminary Award on Jurisdiction and Applicable Substantive Law (previously defined as the "Preliminary Award"),[262] and in § II of Claimants' 10 February 2020 Counter-Memorial on Jurisdiction and Applicable Law (the "**Counter-Memorial on Jurisdiction**").[263]

175. In the interest of efficiency, Claimants refer to the procedural history set forth in both the Preliminary Award and the Counter-Memorial on Jurisdiction.

176. Since the Preliminary Award, the only significant procedural event is that, on 2 June 2020, Claimants requested the clarification and correction of discrete parts of it.[264] On the same day, the Sole Arbitrator acknowledged receipt and granted Malaysia until 2 July 2020 to reply to Claimants' petition for clarification and correction. The Sole Arbitrator's decision in this regard is pending.

## IV. LEGAL ARGUMENT

### A. The UNIDROIT Principles Apply to This Claim

177. The Sole Arbitrator noted in the Preliminary Award that, "[w]hen dealing with international commercial contracts such as the Deed, which have the added characteristic of involving a State, the view generally held is that the normal principles of private international law that are followed in contracts between private companies should also be applied to contracts involving state parties".[265]

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[260] **Doc. C-95**, Letter from Paul H. Cohen, on behalf of the Claimants, to the Prime Minister of Malaysia, 2 July 2018.

[261] **Doc. C-31**, Sample of Checks and Receipts.

[262] Preliminary Award, ¶¶ 9-66.

[263] Counter Memorial on Jurisdiction and Applicable Law, 10 February 2020, ¶¶ 7-39.

[264] Email from Paul H. Cohen to the Sole Arbitrator, 2 June 2020.

[265] Preliminary Award, ¶ 138.

178. The Sole Arbitrator ruled that he "is satisfied that the Claimants' plead on the application of the UNIDROIT Principles as the applicable substantive law of the arbitration is well founded", and therefore "Claimants' petition on this issue is upheld".[266] The Sole Arbitrator concluded:

> The Arbitrators decides that Claimants' plead on the application of the UNIDROIT Principles as the *lex causæ* of this arbitration is well founded and upheld. The Arbitrator declares that he should apply general principles of international law to the merits of the dispute and, specifically, the Principles of International Commercial Contracts endorsed by the International Institute for the Unification of Private Law, amended in 2016, to wit, the UNIDROIT Principles.[267]

179. Claimants understand that the first layer of applicable *lex causæ* to this arbitration is the UNIDROIT Principles. However, any matter not regulated by the UNIDROIT Principles, should be analyzed through the lens of the second layer of *lex causæ*, the "general principles of international law", as the above-quoted passage from the Preliminary Award makes clear.

180. Claimants will argue the merits of this Claim accordingly.

## B. The 1878 Lease Agreement is a Lease

### (a) Introduction

181. One of the most enduring untruths concerning the 1878 Lease Agreement, common in Malaysia, is that it provided a permanent grant of territory to Baron Overbeck and his successors. Malaysia perpetuates this error in its letter of 19 September 2019 (describing the 1878 Lease Agreement as a "Grant", referring to the Sultan having "granted" the Leased Territories, calling the 1903 Amendment a "Confirmation of Cession" and describing the rent as "Cession Monies").[268]

182. This misconception stems from a British (mis)translation of the original language of the 1878 Lease Agreement, namely the Jawi (formal Malay in Arabic script).[269] Whether deliberately or otherwise, the British rendered the operative Malay description of the contractual arrangement as "to grant and cede".

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[266] *Id.*, ¶ 144.

[267] *Id.*, § XI.A.4 (emphasis added).

[268] **Doc. C-52**, Letter from Respondent to Paul Cohen, 19 September 2019, ¶¶ 3, 5-8, 12.

[269] **Doc. C-12**, Agreement among Sultan of Sulu, Gustavus von Overbeck and Alfred Dent, 22 January 1878 (original version).

183. This translation is quite simply wrong. A plethora of both contemporary and modern sources show beyond doubt that the key term in the 1878 Lease Agreement – "pajakan" – means "to lease".

#### (b) The Authoritative, Contemporary Spanish Translation Characterizes the Agreement as a Lease

184. Less than six months after the parties executed the 1878 Lease Agreement, Alejo Alvarez and Don Pedro Ortuoste, official interpreters of the Kingdom of Spain, translated it into Spanish.[270] They likewise translated the side letter that accompanied it, in which the Sultan appointed Overbeck as Governor of the Leased Territories (previously defined as the "Letter of Authority"). The Sole Arbitrator has already determined that the contemporary translation of the 1878 Lease Agreement should prevail to interpret it:

> The Spanish translation of the Deed – not of its side letter – differs slightly from its English version, as it contains a last paragraph which apparently might have conformed the side letter of the Deed. There is no mention whatsoever in its wording to the side letter contained in the English translation. Official translators of the Spanish Government, Mr. Alejo Alvarez and Mr. Pedro Ortuoste, made a sworn translation of the Deed from its Arabic version, dated July 16, 1878 and therefore contemporary to the date on which the Deed was dated as signed: January 4, 1878. The English version of the Deed contains no declaration of validity and seems to be a private translation by Mr. W.H. Treacher, the then H.B.M. Acting Consul General in Borneo. It also contains a side letter, apparently absent from the Spanish sworn version of the Deed.
>
> It is the Arbitrator's view that the Spanish translation prevails over the English one for various reasons. The Spanish translation is a sworn one, done by official translators of the Spanish Government, directly from its Arabic version. On the contrary, the English translation of the Deed is validated by the world renowned expert, Dr. Annabel Teh Gallop, on July 19, 2019 and therefore it is not as contemporary as the Spanish translation of Deed, nor is it sworn.[271]

[270] **Doc. C-13**, Official Gazette of Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878.

[271] Preliminary Award, ¶ 126 (footnotes omitted, emphasis added).

185. Elsewhere in the Preliminary Award, the Sole Arbitrator confirmed that the Spanish translation of the 1878 Lease Agreement is the "prevailing version of the Deed".[272]

186. The Spanish text of the 1878 Lease Agreement unambiguously describes it as a lease. The very title of the translation is "*Contrato de arrendo de Sandacan en Borneo, con el Baron de Overbeck".* The Spanish text mentions the term "*arrendamiento*" ("lease") several times:

> *[S]epan que esta es nuestra voluntad asi como la de los Dattos; de haber convenido en terminar el <u>contrato de arrendamiento</u> de Sandakan;*
>
> *Convenimos desde este dia el <u>arriendo</u> de dichos puntos con el Sr. Baron de Overbeck y Alparid Denet Ascubir asi como nuestros descendientes y sus socios sucesores y descendientes;*
>
> *cualquiera, de ellos puede Governar dichos puntos y si acaso no quedara ya ningimo de los <u>arrendatarios</u> no podran estos cederla a Estrangero ni a otra Compania sin la voluntad del Rey;*
>
> *Así tambien hara saber a todas las demas naciones . . . asi como las demas tierras inmediatas al etro lado del Rio Sibucu, las Yslas que se encuentran en dicha zona, por hallarse incluidas en el <u>contrato del arrendamiento</u>.*[273]

### (c) English-Speaking Scholars are Virtually Unanimous in Translating "Pajak" or "Pajakan" as "Lease"

187. Reputed scholars agree with the Spanish translation of the 1878 Lease Agreement in the sense that the territory was "leased" (as opposed to "granted", "assigned" or "ceded") by the Sultan of Sulu.

188. In 1946, the translation of Prof. Harold Conklin of Yale University rendered the word 'pajak' in the agreement as 'lease'.[274] So did Dr. Annabel Teh Gallop,[275] the lead curator for Southeast Asian documents at the British Library and a world-renowned expert on Malay and Indonesian manuscripts.[276] As noted in the Notice

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[272] *Id.*, ¶ 127.

[273] **<u>Doc. C-13</u>**, Official Gazette of Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878 (emphasis added).

[274] **<u>Doc. C-7</u>**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 23 (emphasis added).

[275] **<u>Doc. C-15</u>**, Profile of Annabel Teh Gallop.

[276] **<u>Doc. C-14</u>**, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz.

of Arbitration, Claimants asked that she produce a fresh translation of the agreement from the original Malay text. Prof. Ernst Ulrich Kratz, Professor Emeritus at the famed Centre of Southeast Asian Studies (formerly the School of Oriental and African Studies) at the University of London, concurred with Dr. Gallop's translation.[277]

189. Hence, Dr. Gallop and Prof. Kratz concur in using the word "lease" in several instances in their English translation:

> Wherefore we, His Majesty and Lord the Sultan Muhammad Jamalul Azam, son of the late Majesty the Sultan Muhammad Fadlu, sultan of the state of Sulu and its dependencies, on our own behalf and on behalf of our heirs and successors, and with the consent of the assembly of Datuks, have consented to lease, freely and willingly
>
> . . . .
>
> In consideration for receiving this lease, the aforementioned Mr Gustavus Baron de Overbeck and Alfred Dent Esquire promise to pay His Majesty and Lord the Sultan Muhammad Jamalul Azam and to his heirs and successors the fee of five thousand dollars per year, to be paid annually.
>
> . . . .
>
> Wherefore those aforementioned dependencies from today have been leased to the aforementioned Mr Gustavus Baron de Overbeck and to Alfred Dent Esquire . . . but on no account should the powers and authority consented to through this lease be given or transferred to another nation or another foreign company.[278]

190. More recently, for the purpose of this arbitration proceeding, Prof. Kratz has issued the Kratz Report in which he reviews the political context in the Sultanate of Sulu in 1878, as well as the meaning of the of the word "*pajak*" in the 1878 Lease Agreement. After a thorough review of contemporary dictionaries and other historical sources, he concludes that the contract is a lease:

> There is no doubt, that the term '*pajak*' – to farm – is applied to the letting and renting of privilege called *pajakan*.
>
> The Contract of 1878 signed and sealed by Sultan Jamal-ul Azam (1862-1881) is unambiguous about the nature of the agreement. The Declaration of 1903 signed and sealed by

[277] **Doc. C-16**, Profile of Ernst Ulrich Kratz.

[278] **Doc. C-14**, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz (emphasis added).

> Sultan Jamal-ul Kiram II (1894-1936) reiterates that position in order to make absolutely clear and show, that the ruler contractually remains in full control of the process and of the territories let to farming.
>
> The term *pajakan* describes in clearly defined terms the delegation of a ruler's authority. It neither implies nor suggests the surrender of a ruler's authority over the territories given over to farming in the fiscal sense.[279]

191. Elsewhere in his report, Prof. Kratz explains that this kind of lease agreement was common in the Malay region at that time:

> To conclude, a short comment on what the acquisition of a royal lease implies to the leaseholder starting from the fact that a sultan's power was absolute. Commonly in the traditional Malay system of governance, a Malay ruler's business partners, leaseholders and merchants alike, always act under his instruction and on his behalf, irrespective of any possible personal freedom of action specified under the terms of their lease or agreement. This point is driven home to the ruler's subjects by the fact that leaseholders and merchants alike tend to be formally integrated into the locally prevailing system of governance by the bestowing of titles meaningful within the Malay court hierarchy and within the structure of government of what was the Sultan's to control. This, on the one hand, put leaseholders and merchants alike at all times under the sultan's command but, at the same time, it sets them above all other traditional and courtly ranks within the leaseholders' lease or trade, thus giving them full authority within their farm and under their lease to act freely as they saw best. Examples of this have been documented in traditional legal and semi-historical texts since the days of the Melaccan sultanate of the 15th century and they can be witnessed equally in the late treaties concluded between the sultans of Sulu and agents of British interests with the conferment of two titles, Datu Bendahara and Raja Sandakan.[280]

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[279] Kratz Report, ¶¶ 4-6. *See also id.*, ¶ 51 ("*pajakan* is a Malay term which essentially means farm in the fiscal and legal sense of the word. In history farming, i.e. the letting or leasing of a privilege, itself is a well-known practise that had gained foot all over the world".).

[280] *Id.*, ¶ 39. *See also id.*, ¶ 51 ("Pajakan was a system that lent itself to considerable abuse by the leaseholder, but in the Malay Speaking World, the letting and leasing of privilege became an instrument of choice for legal authorities, i.e. the ruler, who lacked the funds to invest into the setting up of the necessary bureaucracy, and for entrepreneurs who saw farming as a golden opportunity to generate a regular and considerable surplus income. For colonial governments it was a cheap way to raise revenue without involving themselves directly. pajakan was then also used in the farming out of licenses for the exploitation of natural resources and the introduction of business activities generally, which had been outside the horizons of local interest, experience and skill. . . . In light of this, it will come as no surprise that the term pajakan is used clearly and repeatedly in two historical documents of 1878 and 1903, a contract and a later referred to as an Addendum, respectively signed by the then ruling sultans of Sulu, Sultan Jamal ul-Azam who reigned between 1862 and 1881 and his successor but two, Sultan Jamalul-Kiram II, whose reign between 1894 and

* * *

> The pajakan system sat squarely within the Sulu traditional system of governance by allowing the sultan to appoint whoever he saw best suited to pursue the polity's economic, fiscal, and political goals, albeit, in the case of North Borneo, a Westerner. A lease to someone like Dent and Overbeck along the terms of the 1878 and 1903 Agreements would not be outside the well-established Malay model of governance and would keep the ruler in his supreme position.[281]

#### (d) Contemporary British Sources Characterize the Agreement as a Lease

192. The British themselves initially described the arrangement under the 1878 Lease Agreement as a "rental". Treacher, in his 22 January 1878 letter to the Earl of Derby, describes the geographical scope of the agreement and refers to the payments as a "rental":

> He [the Sultan] would ask no additional rental if the limits were fixed as he desired.[282]

193. Similarly, when describing the prior agreement between Overbeck and the Sultan of Brunei, Treacher referred indistinctly to "grant or concession",[283] confirming that Treacher understood a grant in his writings as equivalent to a concession. Elsewhere, Treacher wrote that under the 1878 Lease Agreement Overbeck "obtained[ed] the concession of the country".[284] The word "concession" also appears in the office of the U.K. Prime Minister's correspondence on 25 April 1878 when referring to Overbeck and Dent's venture.[285] The office continued to use the word concession through 1946.[286] A concession, which is akin to a lease, does not convey ownership.

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1936 witnessed the demise of the Sulu sultanate as a traditional Malay polity".).

[281] *Id.*, ¶ 116.

[282] **Doc. C-11**, Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, DENT AND OVERBECK CONCESSION 1877-8, The National Archives (United Kingdom) (emphasis added).

[283] *Id.*, p. 8.

[284] *Id.*

[285] *Id.*, p. 12 ("It appears that this Society is composed partly of foreigners and partly of British subjects, but it does not seem clear whether it is to be considered as a British of foreign undertaking. If the latter, there would be no means of preventing those to whom the concession purports to have been granted from disposing of their rights, should they see fit to do so, to a foreign Government" – emphasis added). Note that this means that the U.K. Prime Minister therefore doubted whether the 1878 Lease Agreement's language regarding the permission of the Britannic Majesty's permission to transfer the land was operative.

[286] **Doc. C-26**, Memorandum from Sgd. D.F. MacDermot for Prime Minister Attlee, Attlee to the

194. Britain's Foreign Secretary likewise disclaimed any sovereign pretensions to North Borneo. In a dispatch to the Netherlands Government in 1879, the Foreign Secretary states that "Her Majesty's Government recognized no rights over the north-east of Borneo, except those of the Sultans of Sulu and Brunei, and at present the object of Her Majesty's Government was not to do anything in derogation of their rights".[287]

195. As if that were not evidence enough, Alfred Dent himself conceded in private correspondence in April 1878 that the Sultan had given a leasehold, rather than an outright sale of the property.

> Borneo. Treaty of 1847. I have a copy of it here; the Sultan evades the treaty clause by giving us a sort of perpetual **leasehold** (instead of a freehold).[288]

#### (e) Contemporary Spanish Sources Likewise Characterize the Agreement as a Lease

196. In ¶¶ 130-133 of the Preliminary Award, the Sole Arbitrator described an exchange of correspondence in 1878 between Mr. Carlos Martínez (then Colonel-General of Sulu) and Mr. Overbeck in which the former repeatedly described the 1878 Lease Agreement as a lease:

(i) ***Letter of Mr. Carlos Martínez to Mr. Overbeck dated 22 July 1878***: "The capitulation adjusted to-day by the Commissioners who under my presidency represent his Excellency the Governor Captain-General of the Philippines, with the Sultan of this Archipelago, and representatives of the country, gives me information that an engagement has been contracted with you for a lease of Sandakan and its dependencies, which contract the Sultan cancels for the reasons expressed in the letter which he addresses to me, and I enclosed to you in copy translated and certified. . .".[289]

(ii) ***Letter of Mr. Carlos Martínez to Mr. Overbeck dated 24 July 1878***: "I have received your letter in answer to that which I had the honour of writing to you on the 22nd of this month. With regard to your observations

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Foreign Office, 27 November 1946, The National Archives (United Kingdom), "Sultan Sulu Agreement 1878" (the memorandum mentioned that this office hoped to "resume payment of the cession [*sic*] monies without delay" because the failure to pay such monies was "being used as a pretext for claiming that the concession granted to the Company by the late Sultan ha[d] terminated". – emphasis added).

[287] **Doc. C-96**, Letter from The Marquis of Salisbury to Mr. Stuart, 24 November 1879, British and Foreign State Papers, Volume 73, Foreign and Commonwealth Office, H.M. Stationery Office, 1889, pp. 1069-1070.

[288] **Doc. C-97**, 11 April 1878 letter, Alfred Dent to Edward Dent, The National Archives (United Kingdom) (emphasis added).

[289] Preliminary Award, ¶ 130 (emphasis added).

> respecting the rights of Spain to the territory of this Sultanate, I have to inform you that they have never ceased to exist, and if you made a contract of lease with the very excellent Sultan while he was at war with us, and while there were previous Treaties in existence, and lastly, one in 1851, which states in a public and definitive manner what are the rights of Spain, you will understand the value of your contract. At all events, I report under this date to his Excellency the Governor-General of the Philippines for such decision as he may choose to come to. . .".[290]

#### (f) The Sultan Retained Sovereignty over the Territories, Meaning that They Could Only Have Been Leased

197. In case there was any doubt as to the accuracy of the terms used in the Spanish or English translations, both the 1878 Lease Agreement and the Letter of Authority contain numerous references indicating that the Sultan remained sovereign. A sovereign who hands over territory to another person while retaining sovereignty is, by definition, leasing that territory. For instance, the 1878 Lease Agreement states:

> *Asi tambien hara saber a todas las demas naciones de como el Paduca Majasan M.S. Mujamad D. Alam, hijo del difunto P.M.M. Sultan Muj. Pulalun, que es el que gobierna Jolo, sus dependencias y archipelago asi como se han enterado todos los Dattos de que he concedido y entregado generosamente al nombrado Sr. Baron de Overbeck y a Alparid Denet Ascubir para que administren las tierras que son de mi dominio. . . .* [291]

198. The underscored passage makes clear that the Sultan governed the territories; the literal translation of the second underlined passage is "*so that they administer the lands that are of my dominion*". In other words, the parties' intention was that the Sultan remain the owner of his domains and that Dent and Overbeck "*administer*" the Leased Territories. This language is unequivocal and could not have been misinterpreted by the Spanish translators.

199. The Letter of Authority also states:

> Wherefore we have, in all legality, leased to our trusted and beloved friend named Mr Gustavus Baron de Overbeck and to Alfred Dent Esquire those lands in our kingdom . . . together with all islands within these boundaries, because all these fall under the revenues of the specified lease;
>
> His Majesty and Lord the Sultan, have appointed and nominated the aforementioned Gustavus Baron de Overbeck as Datuk

[290] *Id.*, ¶ 132 (emphasis added).

[291] **Doc. C-13**, Official Gazette of Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878 (emphasis added).

> Bendahara and Raja of Sandakan, with full power of life and death over all inhabitants of that state, and over all our affairs and over all revenues of that state, <u>with authority to rent out land</u>;
>
> And in the event that some problem that might befall him, and he withdraws from his role as Datuk Bendahara, then the Company in charge of this <u>leased area</u> may in accordance with procedures appoint a Governor to replace him;[292]

200. The above references confirm that the bargain was a lease and that the Sultan continued to be the sovereign over the Leased Territories.

201. As Prof. Kratz explains in detail in his report, the idea that the Sultan would willingly give away his territory to the British fundamentally misconstrues the nature of his rule.[293] The Sultan understood that he was delegating Overbeck as a senior advisor and viceroy over his North Borneo possessions. This kind of arrangement was the norm in the Sultanate.[294] It in no way meant that the Sultan was ceding his possessions, any more than his other Datus' control over their local lands meant that they were Sultans in their own right.[295]

202. The historical record supports Prof. Kratz. In a letter from June 1878, Treacher records the Sultan's displeasure with Overbeck's behavior in the territory:

> I gather that he is of opinion that the Baron [Overbeck], by being installed as Datu Bandhara and Rajah of Sandakan, thereby became virtually one of his [the Sultan's] Datus or Chiefs, subordinate to him and not, as the Baron claims to be, an independent ruler.[296]

203. Overbeck could not be an independent ruler.[297] The titles of Datu and Rajah, assigned to Overbeck in the 1878 Letter of Authority, indicated precisely that he was subordinate to the Sultan.[298]

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[292] <u>**Doc. C-14**</u>, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz (emphasis added).

[293] Kratz Report, ¶¶ 131, 133.

[294] *Id.*, ¶ 134.

[295] *Id.*, ¶ 109. *See also id.,* ¶¶ 40, 134-136.

[296] <u>**Doc. C-98**</u>, Letter from William H. Treacher to Lord Salisbury, 22 June 1878, in Borneo, British North Borneo Company 1903, The National Archives (United Kingdom), pp. 143-144.

[297] Kratz Report, ¶¶ 109-110, 134.

[298] *Id.*, ¶¶ 40, 134-136. In fact, it is not until 1915 that the Sultan actually relinquishes his sovereign powers with the signing of the Carpenter Agreement. *See* ¶¶ 82-84, *supra.*

204. Once again, the contemporaneous record is telling: on 4 July 1878 – again less than six months from the execution of the 1878 Lease Agreement – the Sultan wrote to the Governor of the Philippines, stating:

> With regard to what the Singapore newspapers have said, that I have ceded Sandakan to Overbeck, it is not true. [Overbeck] came to me and offered to lease Sandakan".[299]

205. More than 40 years later, the situation remained unchanged. Governor Carpenter of the Department of Mindanao and Sulu wrote in 1920 that the termination of the Sultan's temporal authority in Sulu was

> [W]ithout prejudice or effect as to the temporal sovereignty and ecclesiastical authority of the Sultanate beyond the jurisdiction of the United States Government especially with reference to the portion of the island of Borneo which as a dependency of the Sultanate of Sulu is understood to be held under lease by the chartered company which is known as the British North Borneo Government. . . .[300]

206. General Francis B. Harrison, the American Governor-General of the Philippine Islands at the time, was even more explicit: he stated that the 1915 agreement "did not interfere with the Sultan's status of sovereignty over British North Borneo lands".[301]

207. Finally, during the British-Philippine talks in London in 1963, Jovito Reyes Salonga, a Philippine Congressman specialized in the Philippine claim to North Borneo, made the following statement in reply to the then Parliamentary Undersecretary of the United Kingdom describing the 1878 Agreement as a lease:

> It is our thesis that the contract of 1878 was one of lease, and not of transfer of ownership and sovereignty. We have in our possession documents of the highest evidentiary value which support this proposition. Some of these documents are under the signature of Dent himself, written after the contract had been signed, referring to the contract of 1878 as a *lease* and to the Sultan as *lessor*. We have reports of Treacher the British Consul who accompanied Overbeck to Sulu and who after the signing

[299] **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 69 (emphasis added).

[300] *Id.*, p. 28 (emphasis added).

[301] **Doc. C-24**, Official Gazette of Philippines, *Memorandum Agreement between the Governor-General of the Philippine Islands and the Sultan of Sulu*, 22 March 1915, p. 2 (emphasis added).

of the contract characterized the contract as a *lease* and referred to the money payments as *annual rentals.*[302]

#### (g) The 1878 Lease Agreement Resembles Other Arrangements that the British Made in the 18th and 19th Centuries

208. Lease arrangements such as the one made in 1878 were common in British spheres of influence. The British entered into similar such agreements in the 19th century throughout Asia and Africa.

209. As the economic dynamics of the industrial age made it attractive for European nations to keep expanding their geographic control over raw materials, leasing territory became a viable alternative for colonial growth. Companies obtained leases that were then assumed by the European states themselves through arrangements with the rulers or by nationalizing the companies.

210. Much like the 1878 Lease Agreement, the East India Company administered territory in India and collected taxes, in exchange for a yearly payment to the sovereign Mughal Emperor.[303] The East India Company ran India as a profit-making venture until a rebellion forced Britain to rule directly from 1858.

211. The 1819 Singapore Treaty gave the British East India Company the right to set up a trading post in Singapore. In exchange, Sultan Hussein Shah of Johor was to receive a yearly sum of 5,000 Spanish dollars while Temenggong Abdu'r Rahman would receive a yearly sum of 3,000 Spanish dollars.[304] The native chief was considered the proprietor of the land, even within the bounds of the British trading post. The 1819 treaty was replaced by a subsequent treaty in 1824, in which Singapore and its surrounding islands were ceded to the British. In return, the Sultan and Temenggong received a lump sum of money, had their allowances raised, and were allowed to continue living on land set aside for them in Singapore.[305]

212. Leasing was also common in the African colonies. In 1887, the British East Africa Association obtained a 50-year lease from Zanzibar's sultan for a section of

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[302] **Doc. C-7**, PHILIPPINE CLAIM TO NORTH BORNEO (Manila: Bureau of Printing, 1963), Volume I, p. 25 (emphasis added).

[303] **Doc. C-67**, William Bolts, CONSIDERATIONS ON INDIA AFFAIRS; PARTICULARLY RESPECTING THE PRESENT STATE OF BENGAL AND ITS DEPENDENCIES (Printed for J. Almon *et al.*), pp. 29-31. The arrangement was known in India as the Diwani.

[304] **Doc. C-99**, *1819 Singapore Treaty*, SINGAPOREINFOPEDIA, 15 May 2014.

[305] *Id.*

coastal territory on the mainland of Africa.[306] The British Government assumed control of the leased territory, making it a protectorate and committing to paying an annual rent of £11,000 to Zanzibar.[307] In the early 20th century, Italy acquired title to the leased area by purchasing it from Zanzibar for £144,000.[308]

213. The examples above of the Singapore purchase in 1824 and the Zanzibar sale in the early 20th century show that Britain, and other colonial powers, knew how to draft a cession agreement when they wanted to. When the British conceded to foreign governments that local potentates maintained their sovereignty; when the arrangement was a commercial undertaking by a private company; when the contours of that arrangement comported with the standard local practice (in this case, of the "pajakan"); and, where a disinterested, contemporaneous Spanish translation of the agreement renders the operative instrument as "*contrato de arrendo*," we can be confident that the 1878 Lease Agreement is exactly that.

214. Last but not least, the nature and frequency of payment agreed by the parties – a fixed, annual sum – is typical of a lease. What form of sovereign grant or cession of territory envisages regular, periodic payments? Surely a sale of the territory would have been executed by lump-sum payment.

215. The idea that the Sultan gave away what became known as Sabah finds no basis in language, logic, or history. It is, bluntly, an untruth perpetrated out of self-interest by the Company and the British and maintained for similar reasons by Malaysia.

### (h) Either Way, Malaysia has Acknowledged the Contractual Validity of the 1878 Lease Agreement and Its Obligations Thereunder

216. In a sense, however, it matters little whether the 1878 Lease Agreement is indeed a lease or some other arrangement. The fact remains that, until recently,

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[306] **Doc. C-100**, Sir Edward Hertslet, K.C.B, THE MAP OF AFRICA BY TREATY VOL.1 (Printed for her Majesty's Stationery Office by Harrison and sons, St. Martin's Lane, 1894).

[307] **Doc. C-101**, U.K. House of Commons, Statements by Sir Edward Grey, Undersecretary of State for Foreign Affairs, June 13, 1895, in *Hansard*, Ser. 4, Vol. 34 (London, 1895), 1087-1092.

[308] **Doc. C-102**, A Complete Collection of the Treaties and Conventions, and Reciprocal Regulations at Present Subsisting Between Great Britain and Foreign Powers: And of the Laws, Decrees, Orders in Council Concerning the Same, So Far as They Relate to Commerce and Navigation, the Slave Trade, Post Office Communications, Copyright, and to the Privileges and Interests of the Subjects of the High Contracting Parties. Compiled and edited by Richard W. Brant and Godfrey E.P. Hertslet, Esq. Volume XXIV, London (1907), pp. 685-691.

Malaysia consistently paid Claimants the sum set forth in the 1878 Lease Agreement, as revised by the 1903 Amendment.

217. Malaysia confirmed as much in the letter of Attorney-General Tan Sri Tommy Thomas to Paul Cohen dated 19 September 2019. The 1878 Lease Agreement is unambiguous about the operation of its contractual terms: the Sultan of Sulu and his heirs lease the territory; Messrs. Dent and Overbeck and their successors make the annual lease payments. There are no exceptions or caveats. Malaysia does not dispute this in its 19 September 2019 letter (quoted at ¶ 94 above).[309]

218. In that letter, Attorney-General Thomas observes that Malaysia had paid Claimants and their antecedents what Malaysia terms "cession monies" in respect of the 1878 Lease Agreement since the State of Sabah became part of Malaysia in 1963.[310] In that same letter, Attorney-General Thomas concedes that Malaysia had not paid Claimants pursuant to the 1878 Lease Agreement since 2013.[311] Attorney-General Thomas likewise concedes that Malaysia ought to have made these payments.[312]

219. Malaysia, however, has failed to make payments for seven years, and counting. Malaysia has provided no reason for its failure to pay – not that the 1878 Lease Agreement identifies any justifiable excuse. The common term for enjoying the benefits of an agreement without paying for its burdens is "breach of contract".

220. Malaysia cheerfully admits the breach: as the Attorney-General notes, "[r]egrettably payments ceased in 2013"; he adds that "Malaysia is now ready and willing to pay your clients all arrears from 2013 to 2019, and agrees to fully comply with the 1878 Grant and the 1903 Confirmation of Cession from henceforth with regards to future payments".[313]

221. The Attorney-General purports to cure Malaysia's breach of contract by offering to resume payments, with interest up to 10% on the missed payments

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[309] **<u>Doc. C-52</u>**, Letter from Respondent to Paul Cohen, 19 September 2019, ¶ 3.

[310] *Id.*, ¶ 6 ("From 1963 to 2012, that is, for an unbroken and continuous period of 49 years, Malaysia had been, under the 1878 Grant, paying your clients (themselves the successors-in-title to the Sultan of Sulu) the annual sum of 5300 dollars. The payment was increased by 300 dollars per annum by way of the 1903 Confirmation of Cession".).

[311] *Id.*, ¶ 9.

[312] *Id.*

[313] *Id.*

dating back to 2013.[314] The problem with Malaysia's offer is that it is conditioned upon Claimants discontinuing this arbitration: "Indeed, this payment will be paid on that basis".[315]

222. As noted above, the 1878 Lease Agreement lists no conditions precedent for contractual performance. It would be a strange condition indeed that premised contractual performance on refraining from exercising one's rights in the dispute clause. What purpose would that clause then serve?

223. Malaysia of course cannot cure a breach of contract conditioned on Claimants not exercising their rights under that agreement, including the right to dispute resolution. Malaysia therefore remains in breach of the 1878 Lease Agreement.

### C. The 1878 Lease Agreement is a Long-Term Contract under the UNIDROIT Principles

224. Article 1.11 of the UNIDROIT Principles defines a "long-term contract" as "a contract which is to be performed over a period of time and which normally involves, to a varying degree, complexity of the transaction and an ongoing relationship between the parties".[316]

225. According to Section 3 of the Official Commentary (the "**Official Commentary**" or the "**Commentary**")[317] to Article 1.11 of the UNIDROIT Principles, "the essential element is the duration of the contract, while the latter two elements are normally present to varying degrees but are not required".[318] Obviously, "normally" does not mean "always", and therefore the key element is whether the contract is intended to be in force over an extended period of time.

226. There can be little doubt that the 1878 Lease Agreement is a "long-term contract". In fact, the Commentary to Article 1.11 provides as examples of long-term contracts the likes of "leases" and "concession agreements". Renowned scholars also consider lease agreements and concessions to be long-term contracts.[319] Prof. Brödermann, in his Third Report, agrees, noting:

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[314] *Id.*

[315] **Doc. C-52**, Letter from Respondent to Paul Cohen, 19 September 2019, ¶ 11.

[316] Emphasis added.

[317] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016).

[318] Emphasis added.

[319] **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-

> It was clear from the outset that the private company would be founded to exploit the Territory indefinitely. Under the UNIDROIT Principles, as applicable as general principles of law, this long-time nature of the contract qualifies the 1878 Lease Agreement as a long-term contract in the sense of article 1.11 4th hyphen.[320]

227. In any event, the Sultans and their heirs have been complying with the 1878 Lease Agreement since 1878. Malaysia and its antecedents had likewise performed until 2013, when Malaysia failed to pay the rent. The contract therefore has operated for at least 135 years; this undeniably meets the criterion of extended duration under Article 1.11.

228. In light of the foregoing, the 1878 Lease Agreement should be considered a "long-term contract" for all purposes under the UNIDROIT Principles.

### D. The Unforeseen Circumstances in This Case Qualify Both as Hardship Under the UNIDROIT Principles and for *Rebus Sic Stantibus* Treatment Under Spanish Law

#### (a) The Hardship Doctrine under the UNIDROIT Principles

##### (i) Introduction

229. As explained in § II.M above, it is indisputable that unforeseen circumstances have rendered the 1878 Lease Agreement utterly imbalanced.

230. The Latin term *rebus sic stantibus* translates to "as long as things remain the same". The term stands for the principle that when a long-term contract suffers a substantial alteration which breaks its economic balance, it may lead to that contract's termination or modification.[321] *Rebus sic stantibus* is known as an exception to the binding nature of contracts, *pacta sunt servanda*. According to Prof. Bin Cheng, the principle of *rebus sic stantibus* derives from the general principle of good faith:

> While the principle of good faith prohibits the evasion of an obligation as established by the common intention of the parties, <u>it also prohibits a party from exacting from the other party</u>

TERM CONTRACTS (Oxford University Press, 2014), ¶¶ 3.107, 3.109(3); **<u>Doc. CL-61</u>**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 236.

[320] Third Brödermann Report, ¶ 428.

[321] **<u>Doc. CL-62</u>**, *Rebus sic stantibus clause definition*, WOLTERSKLUWER.

> advantages which go beyond their common and reasonable intention at the time of the conclusion of the treaty. . . .[322]

231. *Rebus sic stantibus* is considered a general principle of international law; various legal systems use different terms and expressions for it: the French refer to it as "*imprévision*," which translates to "unforeseeability"; the Germans as "*Wegfall der Geschäftsgrundlage*," which translates to the "cessation or loss of business fundamentals," that is, the frustration of a contract's purpose; and the Italians as "*eccesiva onerosità sopravvennuta*," which translates to "unreasonably onerous".[323]

232. The principle is not only crystallized in several legal systems, but is also embodied in many international conventions, such as Article 62 of the Vienna Convention and the Law of Treaties, where it is referred to as a "Fundamental Change of Circumstances".[324] The principle has also made its way to the UNIDROIT Principles, where it is defined (in English) as "Hardship".[325]

233. According to Prof. Brödermann, the rules on hardship constitute an integral part of the General Principles of Law, as embodied in the UNIDROIT Principles, for three reasons:

> a) The rules on hardship in the UNIDROIT Principles are part of a set of rules developed as a coherent system out of the same underlying principles;
>
> b) the rules on hardship from 1994 are subject to the emerging *opinio iuris* which qualifies the UNIDROIT Principles as an embodiment of general principles of law, as manifested by the UNCITRAL Resolutions of 2007 and 2012; and
>
> c) the practice of international arbitral tribunals and national courts which rely on the UNIDROIT Principles includes the use of the rules on hardship and thereby correlates with the emerging *opinio iuris*.[326]

234. Hardship constitutes a modern approach to the general principles of contract law, especially those of good faith and fair dealing in light of the occurrence of

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[322] **Doc. CL-63**, Bin Cheng, GENERAL PRINCIPLES OF LAW AS APPLIED BY INTERNATIONAL COURTS AND TRIBUNALS (Cambridge University Press, 1994), p. 118 (emphasis added).

[323] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Introduction to Article 6.2.1.

[324] United Nations Convention on the Law of Treaties signed at Vienna, May 23, 1969. Article 62.

[325] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.2.

[326] Third Brödermann Report, ¶ 397.

events which fundamentally alter the equilibrium of the contract. In the words of Prof. Brödermann:

> The rules on hardship in section 6.2. of the UNIDROIT Principles of International Commercial Contracts ("UNIDROIT Principles") are part of the general principles of law of which the UNIDROIT Principles constitute a manifestation that can be applied in the field of international contract law in international arbitration. They express the current understanding of the international legal community of the conditions under which "general principles of law", "general principles of civilised nations", "general principles of commercial contract law", require (i) a right to renegotiation or, if such negotiations do not lead to a result or cannot be had; (ii) a determination by the competent "court" – which includes an Arbitral Tribunal - to either adapt the contract or to terminate the contract.[327]

#### (ii) Prerequisites of Hardship under the UNIDROIT Principles

235. The UNIDROIT Principles first refer to hardship as an exception to Article 1.3 ("binding character of a contract"), which derives from the general principle of law *pacta sunt servanda* – whereby parties are bound to a valid contract until they agree otherwise. The UNIDROIT Principles enumerate the exceptions to *pacta sunt servanda*. The Commentary to Article 1.3. states:

> A corollary of the principle of *pacta sunt servanda* is that a contract may be modified or terminated whenever the parties so agree. Modification or termination without agreement are on the contrary the exception and can therefore be admitted only when in conformity with the terms of the contract or when expressly provided for in the Principles (see Articles 3.2.7(2), 3.2.7(3), 3.2.10, 5.1.8, 6.1.16, **6.2.3**, 7.1.7, 7.3.1 and 7.3.3).[328]

236. Article 6.2.3 (on hardship, as we shall discuss) is one of the express exceptions to Article 1.3. In the same vein, Article 6.2.1 addresses hardship under the heading "contracts to be observed":

> Where the performance of the contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship.[329]

[327] *Id.*, ¶ 398 (emphasis added).

[328] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 1.3 (emphasis added).

[329] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.1 (emphasis added).

237. The Commentary clarifies that the principle *pacta sunt servanda* is not absolute; it makes way, for example, when supervening circumstances are such that they lead to a fundamental alteration of the contract's equilibrium and create an exceptional situation defined as "hardship".[330] As mentioned in ¶ 233 above, hardship stems from the general principle of good faith (set forth in Article 1.7 of the UNIDROIT Principles), by which the observance of fair dealing and avoidance of unfairness between the parties must prevail.[331]

238. Prof. Brödermann confirms this:

> The rules on hardship in the UNIDROIT Principles overcome a conflict between the binding nature of contracts (*pacta sunt servanda*, bindingness of contracts) and the observance of good faith and fair dealing; i.e. a conflict which has been discussed since Roman times.[332]

239. Article 6.2.2. of the UNIDROIT Principles defines hardship thus:

> There is hardship where the <u>occurrence of events fundamentally alters the equilibrium of the contract</u> either because the cost of a party's performance has increased or <u>because the value of the performance a party receives has diminished</u>, and
>
> a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
>
> b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
>
> c) the events are beyond the control of the disadvantaged party; and
>
> d) the risk of the events was not assumed by the disadvantaged party.[333]

240. The Commentary emphasizes that hardship occurs only when events fundamentally alter the equilibrium of the contract, provided that those events meet the requirements of subparagraphs a) to d).[334]

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[330] *Id.*, Commentary (2).

[331] *Id.*, Article 1.7.

[332] Third Brödermann Report, ¶ 357.

[333] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.2 (emphasis added).

[334] *Id.*, Comment 1.

241. In his expert legal report, Prof. Brödermann extrapolates from Article 6.2.2 to arrive at six conditions to meet the criteria of hardship under the UNIDROIT Principles:

> There is hardship where **[FIRSTLY]** the occurrence of events fundamentally alters the equilibrium of the contract, **[SECONDLY]** either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and **[THIRDLY]** **(a)** the events occur or become known to the disadvantaged party after the conclusion of the contract; **[FOURTHLY]** **(b)** the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; **[FIFTHLY]** **(c)** the events are beyond the control of the disadvantaged party; and **[SIXTHLY]** **(d)** the risk of the events was not assumed by the disadvantaged party.[335]

242. The 1878 Lease Agreement meets all these conditions:

#### (1) The Character of the 1878 Lease Agreement has been Fundamentally Altered (Condition 1)

243. The first condition requires that the events that take place alter the contract. Alteration here is not a mere shift in the contract's initial conditions, but rather something that fundamentally disrupts its equilibrium.

244. Prof. Brödermann discusses this condition at length in ¶¶ 417-444 of his Third Report. He concludes that the unforeseen changes in this case, *i.e.,* from traditional agricultural exploitation in the late 19th and early 20th centuries by a private enterprise to industrial exploitation of oil, gas and palm oil in the 20th and 21st centuries by a sovereign state using modern tools and techniques, imply a "fundamental change of the nature of the contract" and "a fundamental alteration of the contractual equilibrium in the sense of art. 6.2.2".[336]

245. The unforeseen changes in circumstance here have clearly altered the 1878 Lease Agreement equilibrium. The discovery of oil and gas and the cultivation of palm oil in the Leased Territories, and their subsequent exploitation with ensuing increased revenues, constitute a radical alteration of the 1878 Lease Agreement's equilibrium. This is evident from the fact that the rent has no correlation whatsoever

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[335] Third Brödermann Report, ¶ 371.

[336] *Id.*, ¶ 444.

with the value of the Leased Territories, which is approximately three million times greater (*see* § II.M above).

246. Often the concept of hardship is associated with one party finding it difficult, or impossible, to perform. But there is more to the doctrine than just that. Article 6.2.2 of the UNIDROIT Principles states that "[t]here is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished".[337] As we explain below, this language quite deliberately encompasses situations where the changed circumstances massively benefit one party, even if they pose no obstacle to the other party's performance.

247. Prof. Brödermann opines that the hardship provisions of the UNIDROIT Principles apply when one party benefits from windfall profits as a result of fundamentally changed circumstances.[338] In such circumstances, as Prof. Brödermann highlights, "a party gives away something for value which has decreased considerably as compared to the current value".[339] The legislative history of the UNIDROIT Principles illustrates that the drafters intended to include these windfall scenarios under the hardship umbrella. That history is discussed in detail at ¶¶ 446-474 of the Third Brödermann Report.

248. While initial drafts of the hardship provisions in 1986 and 1987 failed to include language that would cover windfall profits, those drafts prompted extensive discussions concerning how exactly hardship should be defined. The UNIDROIT Principles' Working Group ultimately took inspiration from the hardship provision of the International Chamber of Commerce (ICC), which focused on the alteration of the "equilibrium" of a contract.[340] A majority of the Working Group expressed a preference for this equilibrium approach.[341]

249. A subsequent draft of the hardship provision from September 1990 included the equilibrium language, noting that hardship exists when the occurrence of events

[337] Emphasis added

[338] Third Brödermann Report, ¶ 447.

[339] *Id.*, ¶ 448.

[340] *Id.*, ¶ 454.

[341] *Id.*, ¶ 455.

"alters the equilibrium of the contract . . .".[342] This September 1990 draft still failed to specifically address hardship in the presence of windfall profits, but it sparked new discussions that ended up advancing such an approach.[343]

250. During these deliberations, we see for the first time a reference to the presence of hardship because the value of performance has diminished for one party.[344] The reference came about when the Chairman of the Working Group, Prof. Michael Bonell, introduced the idea of adding "something along the lines of the EEC draft [the draft of the Principles of European Contract Law], which contained this line of reasoning.[345] The Summary Records of the Working Group show this initial inclusion of diminished value at that time – a formulation which ended up in the final version of the hardship provisions.[346]

251. Critically, Prof. Allan Farnsworth explicitly noted at the time that such a hardship formula would cover the alteration of contractual equilibrium not only "*because it was worse for A, but [also] because it was better for B*".[347] Prof. Farnsworth commented that the language "'alters the equilibrium of the contract' clearly contemplated looking at both parties".[348] Prof. Farnsworth's observation triggered additional conversations amongst the Working Group members; some highlighted the possibility of hardship in hypothetical scenarios in which one party is burdened because the value received for performance has decreased considerably when compared to its current value. They specifically provided the example of a long-term contract for the provision of oil at a fixed price, where the cost of oil production remains constant for the producer but the price of oil increases astronomically, benefiting the counterparty who can sell it for a higher price.[349] Prof. Bonell argued that such a situation would indeed place a burden on the producer,

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[342] *Id.*, ¶ 458.
[343] *Id.*, ¶¶ 459-461.
[344] *Id.*, ¶¶ 463-464.
[345] *Id.*
[346] *Id.*
[347] *Id.*, ¶ 465.
[348] *Id.*
[349] *Id.*, ¶ 466.

as it "would have to give something for a value which had decreased considerably as compared to the current value".[350]

252. Ultimately, the rapporteur for the provisions on hardship, Prof. Dietrich Maskow, argued in favor of maintaining the equilibrium language, as it would cover both sides of the hardship coin more satisfactorily.[351] Prof. Farnsworth supported this approach, and "suggested that something similar to the EEC addition referred to by Bonell be added to the equilibrium formula".[352] When it was time for a vote, the approach proposed by Bonell, Maskow and Farnsworth prevailed – the drafters adopted the equilibrium formula with the EEC addition specifically addressing both sides of the coin (*i.e.*, either when the cost of performance increases or when the value of the performance a party receives has diminished).[353]

253. Considering this background, Prof. Brödermann observes:

> In light of the extensive discussions prior to the vote, the legislative history leaves no doubt that the equilibrium formula was also meant to cover diminished value because of windfall profits of the other party. It covers scenarios in which the occurrence of events – like an astronomic price increase – caused a fundamental alteration of the equilibrium because "it was better for B" . . . and a burden for A who "would have to give something for value which had decreased considerably as compared to the current value. . .".[354]

#### (2) The Value of Claimants' Performance has Drastically Diminished (Condition 2)

254. The second step states that the fundamental alteration must result in an increase in cost, or a diminution in value, of contractual performance. Here again this step is easily met.

255. The Commentary states that the decrease in the performance value a party receives must be substantial, due either to drastic changes in the market or to the frustration of the contract's purpose:

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[350] *Id.*

[351] *Id.*, ¶ 470.

[352] *Id.*, ¶ 471.

[353] *Id.*, ¶ 474.

[354] *Id.*, ¶ 473.

> The performance may relate either to a monetary or a non-monetary obligation. <u>The substantial decrease in the value or the total loss of any value of the performance may be due either to drastic changes in market conditions</u> (e.g. the effect of a dramatic increase in inflation on a contractually agreed price) or the frustration of the purpose for which the performance was required (e.g. the effect of a prohibition to build on a plot of land acquired for building purposes or the effect of an export embargo on goods acquired with a view to their subsequent export). Naturally the decrease in value of the performance must be capable of objective measurement: a mere change in the personal opinion of the receiving party as to the value of the performance is of no relevance.[355]

256. It is important to understand what performance means for each party in a lease agreement of this kind. For a lessee, the performance is the commercial value it can obtain from exploiting the natural resources of the rented area. For a lessor, it is simply the rent. When the parties entered into the 1878 Lease Agreement, there was a sense of equilibrium with respect to the terms and required performance of each party – a payment of 5,000 dollars, later updated to 5,300 dollars, accounted for the total value the lessor obtained from the commercial use of the territory and minerals (described at § II.M(a) above). Nowadays, however, the amount due from the lessee is approximately three million times less than the value of the land provided by the lessors. Prof. Brödermann explains the implications of a significant change in the performance for one of the parties of a lease agreement:

> Generally, if a lessor hands over to a lessee the rights to exploit a territory against payment of an annual rent, the "value" of the performance of the lessor to leave the rights to exploit the territory with the lessee is represented by the rent. If the value of the leased rights has increased in a fundamental way, as a matter of logic, the value of the rent received by the lessor – for the synallagmatic performance of leaving the rights of exploitation to the lessee– has diminished.[356]

257. In § II.M above we explained the economic benefit that Malaysia has obtained from 1965 to 2020 and expects to receive in the future from oil, gas and palm oil. There is no doubt that the performance value of the Leased Territories for one of the Parties (namely, Claimants') has fundamentally decreased, so as to make it astoundingly disproportionate compared to the other Party's (namely, Malaysia's)

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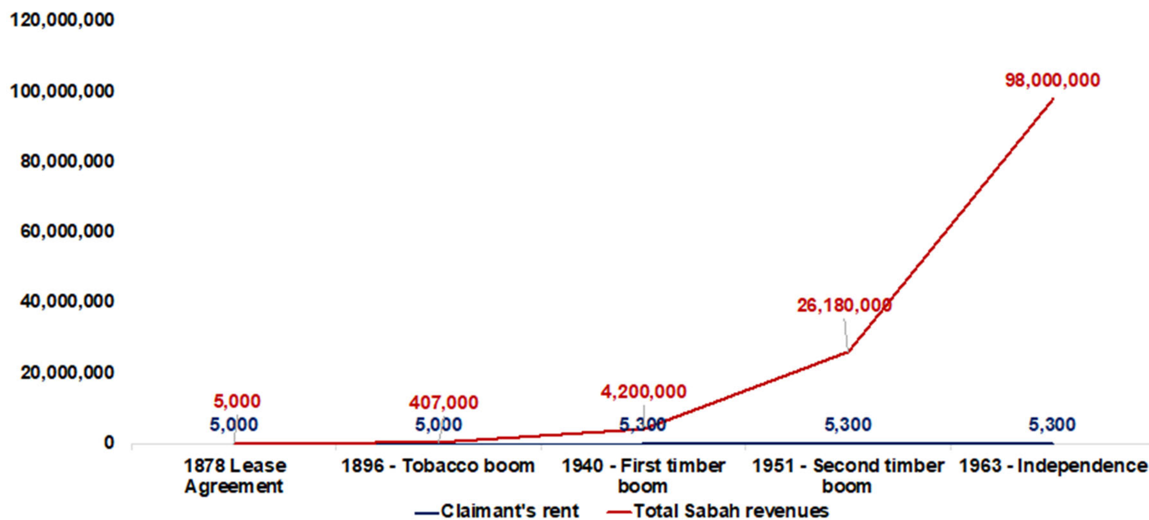
[355] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.2, Commentary(b) (emphasis added).

[356] Third Brödermann Report, ¶ 479.

increase in performance value. Claimants are receiving three million times less than the lessees; as a consequence, Malaysia is currently receiving several billion in exchange for only a few thousand.[357] It is hard to imagine a more drastic diminution.

258. The following graph shows the lessees' revenues from the Leased Territories compared with the rent paid to Claimants' antecedents during the years of British, or British-affiliated occupation (1878-1963). Recall that in 1878, the total performance value of the Leased Territories was 5,000 dollars (updated to 5,300 dollars in the 1903 Amendment), equaling the Sultan of Sulu's revenue from the two predominant traded commodities at that time (*i.e.*, bird nests and pearls).[358]

**Figure 1.** Historic evolution of the total performance value of the Leased Territories vis à vis the rent paid to the Sultan of Sulu and heirs (MYR)[359]




259. As striking as the difference between both parties' performance values from the Leased Territories might seem before 1963, the most substantive decrease in Claimants' performance value occurred after the discovery and subsequent exploitation of vast offshore oil and gas reserves in the 1970s, and the additional boom of crude palm oil which peaked in the 1990s (explained in § II.M *supra*). The following graph shows the evolution in the total performance value of the Leased Territories, using the lessees' revenues until 1963, and subsequently the benefits

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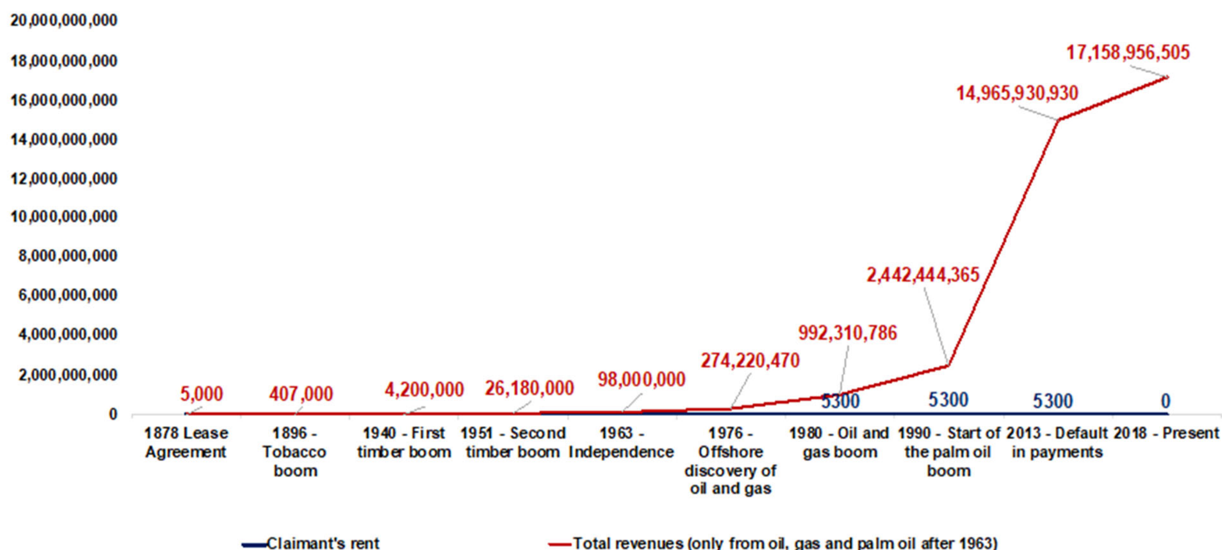
[357] *See* § II.M, *supra*.

[358] *See* ¶¶ 102-107, *supra*.

[359] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), pp. 113, 123, 202, 205.

Malaysia enjoyed from the commercialization of Sabah's most important export commodities (*i.e.*, oil, gas and palm oil).

**Figure 2.** Historic evolution of the total performance value of the Leased Territories vis à vis the rent paid to the Sultan of Sulu and heirs (MYR Million)[360]



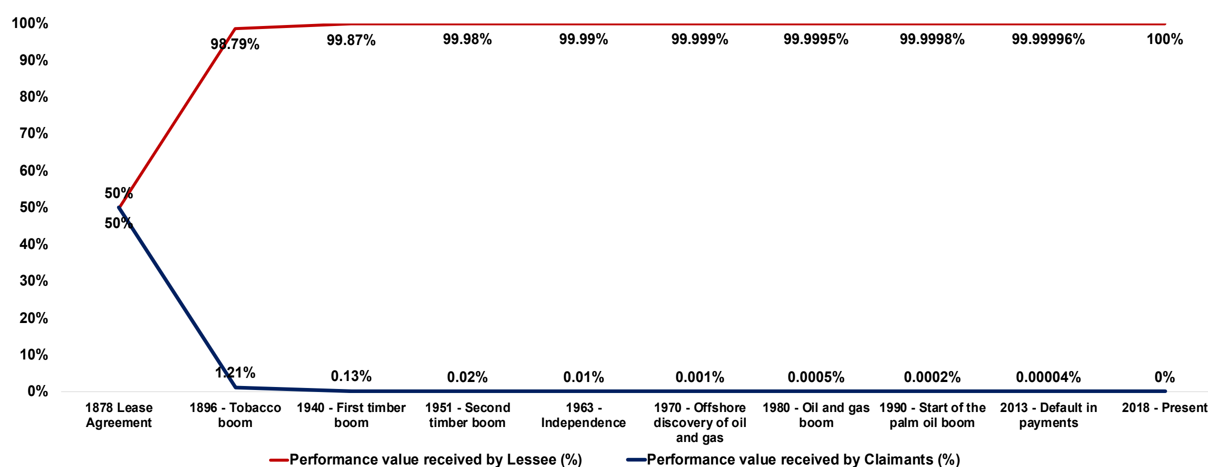

260. The cleft between both parties' performance value until 1963 is negligible in comparison to the divergence thereafter – to a point where the pre-1963 difference is now not graphically visible. As shown in the graph, in 2012, the last year Malaysia paid the agreed 5,300 dollars rent to Claimants, the total performance value of the Leased Territories, understood as the total benefits from the export and trade of oil, gas and palm oil, was more than MYR 15 billion – more than 2.8 million times greater than the constant lump sum paid to Claimants. Subsequently, after Malaysia defaulted on its payments, the total value of the Leased Territories increased to more than MYR 17 billion in 2018 – more than 3.2 million times greater than the lump sum paid until 2013.[361]

261. Figure 3 below shows the total value of the Leased Territories, along with the percentage of the parties' performance value over time.

[360] *Id. See also* Brattle historical calculations (the file contains the relevant cash flows to Malaysia for oil, gas and palm oil from Sabah in MYR and USD).

[361] *See* n. 360, *supra*.

**Figure 3.** Historic distribution of the total performance value of the Leased Territories between Lessor (Claimants) and Lessees[362]




262. We can reasonably assume that both parties entered into the 1878 Lease Agreement in a more or less even scenario: the Sultan of Sulu received a lump sum for the total revenues from the exploitation of the main commodities at the time, and the lessee at the time agreed to exploit the Leased Territories at a break-even point of 5,000 dollars[363] (updated to 5,300 dollars in the 1903 Amendment).[364] In the ensuing years the performance value of the Leased Territories increased exponentially, but only to the lessees' advantage. By the middle of the tobacco boom years, in 1896, less than 20 years after the lease began, the Company was already receiving roughly 98.8% of the Leased Territories' performance value. Since Malaysia started exploiting the region in 1963, its performance value has consistently been above 99.99%. After the default in payments in 2013, it has been an absolute 100%.[365] There is no way but to conclude that the 1878 Lease

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[362] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), pp. 113, 123, 202, 205. *See also* Brattle Work Papers (the file contains the relevant cash flows to Malaysia for oil, gas and palm oil from Sabah in MYR and USD).

[363] Dent and Overbeck expected the Leased Territories eventually to reap 5-10 times as much as the rental, judging by the total they paid for the Leased Territories including the inoperative leases from the Sultan of Brunei and the internal correspondence between the Dent brothers. Both they and the Company nonetheless manifestly understood that costs would come close to matching – and perhaps outstrip – profits for many years to come. This appears to have been the case until the tobacco boom (see ¶ 52 *supra*); **Doc. C-69**, British North Borneo Company Books, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom), pp. 268-269.

[364] *See* § II.G, *supra*.

[365] **Doc. C-77**, Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998), pp. 113, 123, 202, 205; *see also* Brattle Work Papers (the file contains the relevant cash flows to Malaysia for oil, gas and palm oil from Sabah in MYR and US$); **Doc. C-103**, Department of Statistics Malaysia Official Portal, GDP by State, 2010-2016, at current prices MYR Million; **Doc. C-103**, Department of Statistics Malaysia Official Portal, GDP by State, 2015-

Agreement's performance value for Claimants has dropped to virtually – and since 2013, actually – nothing. This has led to a preposterous disequilibrium, at Claimants' expense.

263. Consistent with the Commentary, this fundamental decrease in Claimants' performance value is the indisputable result of drastic changes in the market which were unforeseeable in 1878 or 1903. First and foremost, in the 1870s the global economy was almost exclusively fueled by coal. As mentioned in ¶ 119(ii) *supra*, even at the turn of century, 90% of the world's energy grid was coal-based. Likewise, when the 1878 Lease Agreement was signed, the Second Industrial Revolution was just starting; key changes such as the adoption of the internal combustion engine for mass automobile production, the invention of any gas-fueled machine, and the surge of a global market for processed foods, had not yet occurred. A global market for oil, gas and palm oil was therefore simply unimaginable.[366]

264. Additionally, communication between Sabah and the rest of the world was extremely limited, depending almost exclusively on news from Singapore. In 1878, several decades before all these fundamental and unforeseen changes began to occur, the market in Sabah was overwhelmingly local, lacking almost any form of technology, and without any means of accurately predicting what would unfold during the following century.[367]

265. In light of the above, Prof. Brödermann also concludes that the changes in this case constitute a fundamental alteration of the contractual equilibrium under Article 6.2.2.[368]

#### (3) The Events Leading to Fundamental Changes Occurred After the Parties Signed the 1878 Lease Agreement (Condition 3)

266. The third condition for establishing hardship provides that "the events occur or become known to the disadvantaged party after the conclusion of the contract". In the case at hand, the historical evidence is self-explanatory. The parties entered

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2019, at current prices MYR Million.

[366] *See* § II.M(c), *supra.*

[367] *See* § II.M(a), *supra.*

[368] Third Brödermann Report, ¶ 612.

into the 1878 Lease Agreement in (obviously) 1878 with the aim of developing basic crops and agriculture (described at ¶¶ 102-107 above). The discovery of offshore oil and gas fields did not take place until the 1960s, with ensuing exploitation in the 1970s, a century later.[369] Likewise, the global market for crude palm oil did not achieve exponential growth until the evolution of the processed food industry and Unilever's strategic move to shift to palm oil because of nutritional health concerns in the 1990s.[370]

267. Prof. Brödermann concurs with this conclusion.[371]

#### (4) The Sultan Could Not Reasonably Have Taken These Events Into Account in 1878 (Condition 4)

268. The fourth condition for hardship requires that "the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract". Again, it is beyond doubt that the parties could not have foreseen the discovery of oil, gas and palm oil when they entered into the 1878 Lease Agreement. As explained at ¶ 50 above, the only revenue that the Sultan received at that time came from harvesting seed pearls and collecting birds' nests. Dent and Overbeck intended exclusively to develop basic crops (described at ¶¶ 102-107 above). The lessee used the Leased Territories for almost 100 years:

(i) Without exploiting oil and gas, and without any knowledge that they would have been able to exploit it.[372] In fact, the technology that would have made the discovery and exploitation of the offshore fields possible was not even invented until 1963, that is, 85 years after the entry into force of the agreement.

(ii) Without any significant oil palm cultivation; it was only in the 1960s that initial plans were implemented to start a palm oil industry in the Leased Territories (and which only took off in the 1990s).[373]

269. Claimants' predecessor-in-interest, the Sultan, could not possibly have foreseen these circumstances in 1878. Prof. Brödermann concurs with this conclusion.[374]

[369] *See* § II.M(c)(ii) and (iii), *supra.*

[370] *See* § II.M(c)(iv), *supra.*

[371] Third Brödermann Report, ¶¶ 483-484.

[372] *See* § II.M(c)(ii) and (iii), *supra.*

[373] *See* § II.M(c)(iv), *supra.*

[374] Third Brödermann Report, ¶¶ 487-488.

### (5) The Events Were Beyond the Sultan's and His Successors' Control (Condition 5)

270. The fifth condition for finding hardship requires that the events be "beyond the control of the disadvantaged party". Again, there can be no dispute here that the Sultan of Sulu had no control over the technological developments that led to the consolidation of a deep-water oil and gas industry almost 100 years after his death, or the surge in global demand for CPO in a similar timeframe.

271. Prof. Brödermann concurs with this conclusion.[375]

### (6) The Sultan Did Not Assume (and Could Not Possibly Have Assumed) the Risk of these Events (Condition 6)

272. The sixth condition to establish hardship requires that the disadvantaged party did not assume the risk of adverse changes in circumstances. In the words of the Commentary:

> [T]here can be no hardship if the disadvantaged party had assumed the risk of the change in circumstances. The word "assumption" makes it clear that the risks need not have been taken over expressly, but that this may follow from the very nature of the contract.[376]

273. There is nothing in the 1878 Lease Agreement to indicate that the Sultan of Sulu would have assumed the risk of receiving such a negligible payment in exchange for the use of territory that produces such high revenue. Quite to the contrary, the original bargain was that the Sultan would be made whole in exchange for "all revenues of that state . . . and over all minerals in the earth, and over all plants and animals".[377]

274. No reasonable person would assume the risk of entering into an epically imbalanced contract to his own disadvantage. Recall that the parties' agreement on

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[375] *Id.*, ¶¶ 485-486.

[376] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.2.(3)(d).

[377] **Doc. C-14**, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz (text taken from the Authority Letter); **Doc. C-13**, Official Gazette of The Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878.

the sum of 5,000 dollars represented their estimate of 100% of the Sultan's economic benefit from the Leased Territories in 1878.[378]

275. Prof. Brödermann supports this view, adding:

> The traditional agricultural use of the Territory as contemplated in the negotiation (*see* article 4.3 lit. (a)) and the subsequent use of the Territory after contract conclusion by the North Borneo Chartered Company for approximately sixty-five (65) years (*see* article 4.3 lit. (a)), growing boom-and-bust crops over five (5) to ten (10) year cycles may serve as an indication that there was no risk allocation towards the Sultan for the substantial loss of value of his performance as compared to the current value.[379]

276. Finally, the Commentary states that hardship is usually relevant for long-term contracts. As explained in § IV.C above, the 1878 Lease Agreement is a long-term contract under the definition of Article 1.11 of the UNIDROIT Principles.[380]

### (b) The Hardship Doctrine Permits the Sole Arbitrator to Terminate and/or Rebalance the 1878 Lease Agreement

#### (i) Relevant Provision

277. If the requirements for hardship are met, Article 6.2.3 of the UNIDROIT Principles ("effects on hardship") will apply to determine the available remedies.[381] It reads:

> (1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds in which it is based.
>
> (2) The request on renegotiation does not entitle the disadvantaged party to withhold performance.
>
> (3) Upon failure to reach agreement within a reasonable time either party may resort to the court.
>
> (4) If the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed, or (b) adapt the contract with a view to restoring its equilibrium.[382]

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[378] *See* ¶¶ 50-51, *supra*.

[379] Third Brödermann Report, ¶ 489.

[380] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 1.11.

[381] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3.

[382] UNIDROIT Principles of International Commercial Contracts, Article 6.2.3.

278. Claimants seek to terminate the 1878 Lease Agreement, or alternatively, to adapt it with a view to restoring its equilibrium.

### (ii) Procedural Pre-Requisites of Hardship

#### (1) Renegotiation (Article 6.2.3(1))

279. The Commentary states:[383]

> Since hardship consists in a fundamental alteration of the equilibrium of the contract, paragraph (1) of this Article in the first instance entitles the disadvantaged party to request the other party to enter into renegotiation of the original terms of the contract with a view to adapting them to the changed circumstances.[384]

280. The Commentary then provides an illustration of this provision:

> A, a construction company situated in country X, enters into a lump sum contract with B, a governmental agency, for the erection of a plant in country Y. Most of the sophisticated machinery has to be imported from abroad. Due to an unexpected devaluation of the currency of country Y, which is the currency of payment, the cost of the machinery increases dramatically. A is entitled to request B to renegotiate the original contract price so as to adapt it to the changed circumstances.[385]

281. The Commentary also notes that there is an element of good faith inherent in the duty to renegotiate:

> Although nothing is said in this Article to that effect, both the request for renegotiations by the disadvantaged party and the conduct of both parties during the renegotiation process are subject to the general principle of good faith and fair dealing (see Article 1.7) and to the duty of cooperation (see Article 5.1.3). Thus the disadvantaged party must honestly believe that a case of hardship actually exists and not request renegotiations as a purely tactical maneuver. Similarly, once the request has been made, both parties must conduct the renegotiations in a constructive manner, in particular by refraining from any form of obstruction and by providing all the necessary information.[386]

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[383] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3.

[384] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Comment 1.

[385] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Illustration 1.

[386] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Comment 5.

282. Prof. Brödermann highlights the 1996 ICC "***Cubic***" case, in which a duty of good faith directly applied to required renegotiation under Article 6.2.3 of the UNIDROIT Principles.[387] The tribunal in *Cubic* held that the covenant of good faith and fair dealing precluded a party from invoking the binding effect of the contract in the face of hardship.[388]

283. Article 6.2.3 thus permits Claimants here to request renegotiation of the 1878 Lease Agreement in light of the changed circumstances. Claimants have timely done so, on numerous occasions over several decades. The attempts at renegotiation were summarized in § II.N above. Each request was to no avail because Malaysia never responded; nor indeed has Malaysia even acknowledged them.

284. Furthermore, Prof. Kratz describes how the 1878 Lease Agreement contained specific language ordering the parties to renegotiate over time – the 1903 Amendment being a prime example of such obligation.[389] According to him, "the possibility of a revisit of the terms [of the 1878 Lease Agreement] stood expressly in Malay parlance".[390] He explains that it would be strange to characterize the 1903 Amendment as a mere clarification, because it "would not have taken the last years of Sultan Jamal-ul Azam's reign and three more rulers after him, 25 years in all, to sort out" the scope of the Leased Territories.[391]

285. He explains that the 1903 Amendment was "the front for something different and far more substantial",[392] which he describes as an obligation to revisit the economic terms of the bargain as follows:

> The contract states, that the ruler will turn to Overbeck and his successors for help and advice when there were 'difficulties'. This phrase is the key as the word for difficulties kesulitan can imply many things, as can the terms help and advice. But it is unambiguous in stating that it is the other party's contractual obligation to see that the ruler will not run into difficulties and will see him right. Presumably that sentence was the result of a

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[387] Third Brödermann Report, ¶ 380.

[388] **<u>Annex ELO III</u>** - no. 3.35: Bonell, Michael Joachim. "UNIDROIT Principles; A Significant Recognition by a United States District Court." Unif. L. Rev. ns 4 (1999): p. 658.

[389] Kratz Report, ¶¶ 137-141.

[390] *Id.*, ¶ 139.

[391] *Id.*

[392] *Id.*

> compromise introduced by 'Overbeck' who was against any re-entry whereas the ruler considered it a natural part of this perpetually self-renewing contract. . . . This was all rather delicate an issue for Overbeck's heirs and not to be broadcast in that way in the ruler's Declaration. But it is recorded on the actual Declaration, right to the lower left of a datu's signature, countersigned by another so far unidentified Sulu witness and a British official, Alex Cox, 'subject to HE approval'.
>
> This part of the Declaration is probably the most important one to the ruler, because 'Overbeck' had had to accept, that there was a mechanism for reviewing the originally agreed sum of the lease and that there was a case for readjustment and that there was already, twenty five years into the contract, a certain amount of arrears outstanding, which needed to be reimbursed. Apparently, His Excellency did approve.[393]

286. Hence, Malaysia not only has failed to engage in renegotiations pursuant to Article 6.2.3 of the UNIDROIT Principles (and despite Claimants' attempts at renegotiation summarized in § II.N above); it has also failed to abide by the terms of the 1878 Lease Agreement itself. Malaysia's inaction allows Claimants to proceed to arbitration, as explained in § IV.D(b)(ii)(2) immediately below.

#### (2) Right to Resort to Litigation or Arbitration (Article 6.2.3(3))

287. Article 6.2.3(3) permits parties to resort to a court or an arbitrator, as applicable under the relevant contract, if they fail to agree on renegotiation. Here, the Commentary notes:

> If the parties fail to reach agreement on the adaptation of the contract to the changed circumstances within a reasonable time, paragraph (3) of this Article authorises either party to resort to the court. Such a situation may arise either because the non-disadvantaged party completely ignored the request for renegotiations or because the renegotiations, although conducted by both parties in good faith, did not have a positive outcome.[394]

288. We are in the category of "completely ignored" in this case, as evidenced in § II.N above.

289. Over the years, courts and tribunals have confirmed a tribunal's authority to terminate or rebalance a contract under Article 6.2.3(4) of the UNIDROIT Principles.

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[393] *Id.*, ¶¶ 139-140.

[394] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Comment 6 (emphasis added).

290. In 2006, the Argentine Court of Appeals "*Cámara de Apelaciones en lo Civil y Comercial de La Matanza*" analyzed a case concerning a real estate contract in which the purchase price was established in U.S. dollars. The national crisis in Argentina had made the purchase price excessively onerous because the Argentine peso was devalued after the contract was signed but before the sale.

291. The Court of Appeals upheld the lower court's decision ordering the contract's adaptation. The Court referred to Article 6.2.1 of the UNIDROIT Principles and the Commentary in support of the reasoning that hardship can be invoked notwithstanding the requesting party's delayed performance. Despite its reference to Article 6.2.1, the Court's discussion clearly demonstrates that it was analyzing Article 6.2.3.

292. The Court stated:

> *Asimismo, los Principios sobre los Contratos Comerciales Internacionales de UNIDROIT establecen en el art. 6.2.1 (obligatoriedad del contrato). En caso de excesiva onerosidad (hardship), la parte en desventaja puede solicitar la renegociación del contrato. Tal solicitud deberá formularla sin demora injustificada, con indicación de los fundamentos en los que se basa. La solicitud de renegociación no autoriza en si misma a la parte en desventaja a suspender el cumplimiento de sus obligaciones. En caso de no llegarse a un acuerdo en un plazo prudencial, cualquiera de las partes podrá acudir a un tribunal. Si el tribunal determina que se presenta una situación de excesiva onerosidad (hardship), y siempre que lo considere razonable, podrá:*
>
> *(a) dar por terminado el contrato en una fecha determinada y en los términos que al efecto determine, o*
>
> *(b) adaptar el contrato, de modo de restablecer su equilibrio*
>
> *Como se expresa en el "Comentario a los Principios de Unidroit para los Contratos del Comercio Internacional", el elemento básico que puede dar pie a una situación de excesiva onerosidad es que concurran circunstancias que alteren fundamentalmente el equilibrio del contrato. Se parte del supuesto de la existencia de un contrato sinalagmático en el que existe un equilibrio entre las prestaciones que cada parte deba realizar a favor de la otra. Tal equilibrio no significa que se dé una equivalencia absolutamente objetiva en términos económicos. En un contrato de compraventa se puede comprar caro o vender barato, en comparación con los precios de mercado, porque así le interesen cualesquiera sean los motivos para ella. El punto de equilibrio, pues no es algo objetivo, externo y, por lo tanto, extrínseco al contrato. Es, por el*

> *contrario, el punto de convergencia de los intereses en presencia que llevan a cada una de las partes a coincidir y, por tanto, a consentir en los términos en que se celebra el contrato.*[395]

[Claimants' translation]

> Likewise, the Principles of International Commercial Contracts of UNIDROIT establish art. 6.2.1. In case of excessive onerousness (hardship), <u>the disadvantaged party may request the renegotiation of the contract</u>. Such request must be made without undue delay, indicating the basis on which it is based. The request for renegotiation does not in itself authorize the disadvantaged party to suspend the fulfillment of its obligations. If an agreement is not reached within a reasonable period of time, any of the parties may go to court. If the court determines that there is a situation of excessive onerousness (hardship), and whenever it considers it reasonable, it may:
>
> (a) terminate the contract on a specific date and in the terms determined for that purpose, or
>
> (b) adapt the contract, so as to restore its balance.
>
> As expressed in the "Commentary on the UNIDROIT Principles for International Commercial Contracts", <u>the basic element that can give rise to an excessively burdensome situation is that circumstances that so fundamentally alter the balance of the contract concur</u>. It is based on the assumption of the existence of a synallagmatic contract in which there is a balance between the benefits that each party must perform in favor of the other. Such balance does not mean that there is an absolutely objective equivalence in economic terms. In a contract of sale you can buy expensive or sell cheap, compared to market prices, because that way you are interested whatever the reasons for it. The breakeven point is not something objective, external and, therefore, extrinsic to the contract. It is, on the contrary, the point of convergence of interests in the presence that lead each of the parties to coincide and, therefore, to consent in the terms in which the contract is concluded.

293. In a 2006 arbitration under the auspices of the Mexican Arbitration Center (*Centro de Arbitraje de México*), the Arbitral Tribunal confirmed its right to terminate or adapt the contract to restore proper balance when hardship had been established. The Tribunal noted:

[395] **<u>Annex ELO III</u>** - no. 2.29: Cámara de Apelaciones en lo Civil y Comercial de La Matanza, sala II(CCivyComLaMatanza)(SalaII), Ghezzi y Salvini, Adelina E.T y otro c. Suárez, Eduardo R. y otro, 2006, § III(a)(2).

> *Pero la consecuencia jurídica que el artículo 6.2.3 de los Principios Unidroit contemplan para el caso de actualizarse la 'excesiva onerosidad' es que da derecho a la parte en desventaja de iniciar negociaciones con miras a contractualmente solucionar el desequilibrio. Si las mismas no prosperan, se puede, previa solicitud y una vez transcurrido un plazo razonable, acudir a un tribunal y solicitar ya sea (1) la terminación del contrato; o (2) la adaptación del contrato para restaurar el equilibrio.*[396]

[Claimants' translation]

> But the legal consequence that Article 6.2.3 of the Unidroit Principles contemplate in the case of achieving the "excessive onerousness" is that it entitles the disadvantaged party to initiate negotiations with a view to contractually resolving the imbalance. If they do not prosper, they can, upon request and after a reasonable period of time, go to the court and request either (1) the termination of the contract; or (2) the adaptation of the contract to restore the balance.

294. In a 2000 ICC case, the tribunal was faced with a claim under Article 6.2.3 concerning the attempted termination of a shareholders' agreement.[397] The award confirmed both that (1) the disadvantaged party is entitled to request renegotiations in the case of hardship and (2) that if such renegotiations fail, the tribunal is entitled to terminate the agreement or to adapt it.[398]

#### (iii) Termination (Article 6.2.3(4)(b))

295. In relation to the decision-maker's powers (Article 6.2.3(4)), the Commentary states:

> According to paragraph (4) of this Article a court which finds that a hardship situation exists may react in a number of different ways.
>
> A first possibility is for it to terminate the contract. However, since termination in this case does not depend on non-performance by one of the parties, its effects on performance already rendered might be different from those provided for by the rules governing termination in general (See Articles 7.3.1 et seq.). Accordingly, paragraph 4(a) provides that termination shall take place "at a date and on terms to be fixed" by the court.[399]

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[396] **Doc. CL-117**, Centro de Arbitraje de México (CAM), Unknown Case No., 30 November 2006.

[397] **Annex ELO III** - no. 1.75: ICC International Court of Arbitration 10021, 2000, § III(33).

[398] *Id.*

[399] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016),

296. The use of the words “A first possibility” confirms that termination is the primary remedy under Article 6.2.3 of the UNIDROIT Principles.

297. In this respect, Prof. Brödermann notes that the Sole Arbitrator ultimately has discretion as to whether to order termination or adaptation under Article 6.2.3. This discretion is “mitigated by reference to reasonable [in Article 6.2.3(4)]”, and such reasonableness “evokes the principle of good faith and fair dealing which generally underlies the provisions on hardship”.[400]

298. In exercising such discretion, the Sole Arbitrator should take into account (1) the Parties’ post-contractual conduct; (2) Claimants’ preference; and (3) a recent, in-depth comparative study of international instruments on hardship and change of circumstances – all of which illustrate a preference for termination.[401]

299. With respect to the Parties’ conduct, Malaysia has engaged in fundamental non-performance by failing to complete any payments under the 1878 Lease Agreement since 2012.[402] Prof. Brödermann argues that the Sole Arbitrator can take such fundamental non-performance into account “as a special circumstance” when deciding between termination and adaptation.[403] He writes:

> In this context of fundamental non-performance, since 2013 considerations of good faith and fair dealing (article 1.7) would allow to also consider an indication of preference regarding contract termination or adaptation which the lessor expresses during the arbitral proceedings (as the obligee of the rent in the word of article 1.11 4th hyphen).[404]

300. Prof. Brödermann concludes that Claimants’ prior communications left no doubt as to their intentions, and therefore that “[t]he lessee could not have been unaware of the intention of the lessor to thereby achieve an end of the contractual relationship”. Consequently, the Sole Arbitrator may consider Claimants’ preference for termination when making his determination.[405]

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Article 6.2.3, Comment 7 (emphasis added).

[400] Third Brödermann Report, ¶ 520.

[401] *Id.*, ¶¶ 521-524.

[402] *Id.*, ¶ 522.

[403] *Id.*¶ 521.

[404] *Id.*, ¶ 522.

[405] *Id.*

301. Finally, Prof. Brödermann highlights Prof. Thomas Rüfner's observation in the seminal *Commentaries on European Contract Law*. That treatise provides a comparative analysis on change of circumstances/hardship in the Principles of European Contract Law, the UNIDROIT Principles, the Draft Common Frame of Reference for contractual terms, and the Common European Sales Law. The *Commentaries* include historical background and a comparative analysis of national laws and trends. Prof. Rüfner observes:

> Contrary to the widespread conviction that adaptation is the preferred remedy [in the footnote he refers to Vogenauer/ McKendrick, Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC), 2d edition 2015, p. 821 article 6.2.3 no. 7], preferences should be given to the termination of the agreement in most cases where the parties are unable to adapt the agreement themselves".[406]

302. Here, Claimants have requested renegotiation of the contract on numerous occasions. Those attempts were summarized in § II.N above. Malaysia has failed to entertain these requests. Therefore, Article 6.2.3(4)(a) permits Claimants to request the 1878 Lease Agreement's termination.

303. The Sole Arbitrator has wide flexibility to terminate the 1878 Lease Agreement "at a date and on terms to be fixed". In § V.B(e)(i) below, Claimants explain that the 1878 Lease Agreement should be terminated on 1 January 2013 (when Malaysia first began to breach the agreement by failing to pay rent) or, alternatively, on February 2020, which is the closest proxy to the date of the arbitral award where we have an economic valuation (*i.e.*, the Brattle Report).

304. In § V.B below, Claimants explain the restitution value Malaysia should pay upon the 1878 Lease Agreement's termination.

#### (iv) Rebalancing the Contract (Article 6.2.3(4)(b))

305. If the Sole Arbitrator declines to terminate the 1878 Lease Agreement under any of the applicable Articles of the UNIDROIT Principles (other grounds for termination are discussed in §§ IV.E and F below), Claimants seek in the alternative to continue the 1878 Lease Agreement with a proper adaptation or rebalancing of its terms under Article 6.2.3(4)(b).

[406] *Id.*, ¶ 523 (emphasis added).

306. As indicated above, Article 6.2.3(4) provides the Sole Arbitrator with remedies if he finds that there is hardship. As a secondary remedy, Article 6.2.3(4)(b) permits the Sole Arbitrator to "adapt the contract with a view to restoring its equilibrium".[407] The Commentary provides:

> Another possibility would be for a court to adapt the contract with a view to restoring its equilibrium (paragraph (4)(b)). In so doing the court will seek to make a fair distribution of the losses between the parties. This may or may not, depending on the nature of the hardship, involve a price adaptation. However, if it does, the adaptation will not necessarily reflect in full the loss entailed by the change in circumstances, since the court will, for instance, have to consider the extent to which one of the parties has taken a risk and the extent to which the party entitled to receive a performance may still benefit from that performance.[408]

307. The use of "Another possibility" (as opposed to "A first possibility" used for termination) indicates that adaptation is the alternative, or secondary, remedy. The order used in Article 6.2.3(4) (section "a" is termination and section "b" is adaptation) confirms this interpretation.

308. Hence, the Sole Arbitrator may rebalance the 1878 Lease Agreement to restore its equilibrium, given the factual predicates discussed in § II.M above.

### (c) The Result Would be the Same under the Spanish *Rebus Sic Stantibus* Jurisprudence

#### (i) Introduction

309. In Spain, absent a codified provision to enable rebalancing, courts have adopted the doctrine of *rebus sic stantibus*.[409]

310. This venerable legal theory posits that all contracts involving continuous performance include an implied clause binding the parties to their contractual obligations only as long as the circumstances remain the same ("*contractus qui habent tractus sucessivus vel dependentia de future rebus sic stantibus*

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[407] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Comment 7.

[408] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 6.2.3, Comment 7 (emphasis added).

[409] **Doc. CL-68**, Supreme Court Judgment No. 2848/2017, 13 July 2017, FJ 5.

*intelliguntur*").[410] This is why the *rebus sic stantibus* doctrine is often referred to as a "clause".[411]

311. The *rebus sic stantibus* doctrine permits the revision, suspension or termination of a contract when supervening circumstances make it overly burdensome for one of the parties to perform its obligations.

### (ii) The Traditional *Rebus Sic Stantibus* Approach in Spain

312. The Spanish Supreme Court grounded *rebus sic stantibus* – an exception to the otherwise sacred principle of *pacta sunt servanda* – in the principle of good faith and fair dealing.[412] Good faith is a core tenet of Civil Law (article 7 of the Spanish Civil Code),[413] and it acts in this case as a justified exception to party autonomy and the principle of legal certainty.

313. The Supreme Court identified a series of criteria to be met for *rebus sic stantibus* to apply:

> [T]he rigor imposed by the jurisprudence of this Chamber to modify what was agreed by virtue of a change of circumstances demands for such change to be extraordinary, for the balance in the obligations to be obliterated due to an exorbitant disproportion, and for the change of circumstances to have been radically unpredictable, all of which entails an obvious exceptionality, as well as the need for those who seek to modify the agreement to prove all these requirements, in a rationally convenient and decisive manner.[414]

314. The Supreme Court's further jurisprudence on the doctrine shows the need for:[415]

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[410] **Doc. CL-69**, Luis Diez Picazo, FUNDAMENTOS DE DERECHO CIVIL PATRIMONIAL, Vol. II (Thomson Civitas, 2008), p. 1057.

[411] *Id.*

[412] *Id.*, p. 1068. *See e.g.*, **Doc. CL-70**, Supreme Court Judgment No. 65/1997, 10 February 1997, FJ 3.

[413] **Doc. CL-71**, Spanish Civil Code, Article 7.

[414] **Doc. CL-72**, Supreme Court Judgment No. 79/2007, 25 January 2007, FJ 3 ("*[E]l rigor impuesto por la jurisprudencia de esta Sala para modificar lo pactado en virtud de circunstancias sobrevenidas, exigiendo que la alteración sea extraordinaria, que el equilibrio de las prestaciones resulte aniquilado, por darse una desproporción exorbitante, y que las circunstancias sobrevenidas sean radicalmente imprevisibles, todo lo cual entraña una evidente excepcionalidad, así como la necesidad de que, quien pretende la modificación de lo acordado, pruebe todos esos requisitos, en forma racionalmente conveniente y decisiva*". – unofficial translation, emphasis added).

[415] *Id.* ("a) *alteración extraordinaria de las circunstancias en el momento de cumplir el contrato en relación con las concurrentes al tiempo de su celebración; b) una desproporción exorbitante, fuera de todo cálculo, entre las prestaciones de las partes contratantes que verdaderamente derrumben el contrato por aniquilación del equilibrio de las prestaciones; c) que todo ello acontezca por la*

(i) An extraordinary alteration of circumstances between the time the contract is executed and the time it is performed: this clause has been mostly applied to long-term contracts, as they are more exposed to changes in circumstances. They tend to – but need not – be bilateral contracts for continuous performance, exposed to a future event.[416]

(ii) An exorbitant disproportion between the parties' obligations that generates a real contractual imbalance: the Spanish jurisprudence does not require that the contractual obligations become impossible to perform, just that they generate an unjustifiably excessive advantage to one of the parties and fundamentally upset the equilibrium of the contract.[417]

(iii) The change must have occurred due to new circumstances that were unforeseen or unforeseeable: the courts have analyzed whether the parties could reasonably have foreseen the change of circumstances when they signed the agreement.

315. The Supreme Court has often added a fourth prerequisite that the *rebus sic stantibus* doctrine can be applied only when no other remedy is available.[418]

316. As with Article 6.2.3(4) of the UNIDROIT Principles, when applying the *rebus sic stantibus* doctrine, Spanish courts have either terminated the parties' obligations under the contracts or rebalanced them.[419]

317. Lower courts have followed the Supreme Court's guidance on the application of *rebus sic stantibus.* Significantly, those courts have considered the criteria above when reviewing the validity of arbitral awards. These include the Superior Court of Justice of Madrid, which of course has supervisory jurisdiction over this arbitration. Just a few years ago, that court used the Supreme Court criteria when reviewing an arbitral award that applied the *rebus sic stantibus* doctrine.[420] The Provincial Court of Madrid has also validated the *rebus sic stantibus* doctrine in other arbitral awards.[421]

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*sobreveniencia de circunstancias radicalmente imprevisibles*").

[416] **Doc. CL-73**, Luis Diez Picazo, SISTEMA DE DERECHO CIVIL, Vol. II (Tecnos, 2001), p. 251; **Doc. CL-70**, Supreme Court Judgment No. 65/1997, 10 February 1997, FJ 3.

[417] *See e.g.*, **Doc. CL-74**, Supreme Court Judgment No. 344/1994, 20 April 1994, FJ 2.

[418] *See e.g.*, **Doc. CL-75**, Supreme Court Judgment No. 481/2009, 20 November 2009, FJ 4; **Doc. CL-73** Luis Diez Picazo, SISTEMA DE DERECHO CIVIL, Vol. II (Tecnos, 2001), p. 251.

[419] *See e.g.*, **Doc. CL-70**, Supreme Court Judgment No. 65/1997, 10 February 1997, FJ 3; **Doc. CL-76**, Supreme Court Judgment No. 781/2009, 20 November 2009, FJ 4; **Doc. CL-73**, Luis Diez Picazo, SISTEMA DE DERECHO CIVIL, Vol. II (Tecnos, 2001), p. 251.

[420] **Doc. CL-77**, Superior Court of Justice of Madrid, Judgment No. 5/2013, 4 February 2013, FJ 3.

[421] **Doc. CL-78**, Provincial Court of Madrid, Judgment No. 542/2008, 27 October 2008, FJ 7 (note that Provincial Court of Madrid used to have the competence to review the arbitral awards of

### (iii) The New Contours of *Rebus Sic Stantibus* in Spain

318. The financial crisis of 2008 hit Spain with devastating consequences. Agreements signed before the crisis, conceived in a promising economic environment, had to be performed in an utterly different context. This led to highly imbalanced situations between contractual parties which, in turn, resulted in a substantial increase in cases involving the *rebus sic stantibus* doctrine.

319. The Supreme Court was thus forced to consider whether an economic crisis – of the nature and magnitude of the 2008 crisis and its aftermath – was sufficient to trigger the application of the *rebus* clause. Two of the first and most cited Supreme Court judgments in this context were issued on 17 and 18 January 2013.[422] There, the Supreme Court established that the economic crisis "of profound and prolonged effects" could indeed qualify as "a fundamental change of circumstances" capable of developing "an exorbitant and incalculable imbalance in the respective obligations of the parties".[423] In these cases, the Supreme Court hinted at a new trend towards the "normalized application" of *rebus sic stantibus* in Spain.

320. A year later, the Supreme Court confirmed this trend in Judgment No. 333/2014. The Supreme Court openly recognized the importance of adapting the traditional concept of *rebus sic stantibus* to a less restrictive, more objective approach.[424] This new approach acknowledged the need for Spanish jurisprudence to adjust to the evolution of this legal doctrine.[425] Moreover, the Supreme Court mentioned the need to align with international standards regarding contract interpretation (specifically the UNIDROIT Principles and the European Principles of Contract Law). According to the Supreme Court, the UNIDROIT Principles showed

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arbitrations seated in Madrid).

[422] **Doc. CL-79**, Supreme Court Judgment No. 820/2013, 17 January 2013; **Doc. CL-80**, Supreme Court Judgment No. 822/2013, 18 January 2013.

[423] **Doc. CL-79**, Supreme Court Judgment No. 820/2013, 17 January 2013, FJ 3 ("*[U]na recesión económica como la actual, de efectos profundos y prolongados, puede calificarse, si el contrato se hubiera celebrado antes de la manifestación externa de la crisis, como una alteración extraordinaria de las circunstancias, capaz de originar, . . . una desproporción exorbitante y fuera de todo cálculo entre las correspectivas prestaciones de las partes, elementos que la jurisprudencia considera imprescindibles para la aplicación de dicha regla*" – unofficial translation).

[424] **Doc. CL-81**, Supreme Court Judgment No. 333/2014, 30 June 2014, FJ 2.

[425] *Id.* ("*[E]n la línea del necesario ajuste o adaptación de las instituciones a la realidad social del momento y al desenvolvimiento doctrinal consustancial al ámbito jurídico*").

that "the rebalancing of the basic conditions of contracts has been subject to regulation . . . without any kind of exception or singularity, as an additional aspect of the doctrine applicable to a breach of contract".[426]

321. In this sense, the Spanish Supreme Court announced that "more subjective" principles of "equity and justice" should be abandoned in favor of more "objective" grounds – to wit, the rules governing the equilibrium or proportionality of contracts ("*reglas de conmutatividad*") and the principle of good faith.

322. The Supreme Court's analysis established that decision-makers should make the following assessments to determine whether a specific change of circumstances had legal consequences for a contractual relationship:

(i) Determine how the change of circumstances has impacted the economic purpose of the contract and the equilibrium of the parties' benefits. There is ground for the application of *rebus* if (a) the main economic purpose of the contract is obstructed or becomes unattainable; or if (b) the equilibrium of the contract "has practically disappeared or is destroyed". The Supreme Court explained that "what is assessed is the breach of the equilibrium of the contract due to the unjustifiably excessive advantage of the business relationship".[427]

(ii) Compare the change of circumstances with the risks assumed by the parties in the sense that "the change of circumstances, considered as a risk, must be excluded from the normal risk inherent or derived from the contract".[428]

323. The Supreme Court emphasized the concept of "unpredictability" as an integral aspect of the *rebus* clause. It defined it as an element that "should not be analyzed with respect to an abstract possibility of producing the alteration or as a determining circumstance of the change, considered in itself, but in the economic and business context in which it is involved".[429] The Court therefore linked the

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[426] *Id.* ("*[L]a relevancia del cambio o mutación de las condiciones básicas del contrato, ha sido objeto de regulación por estos mismos textos de armonización sin ningún tipo de regulación excepcional o singular al respecto, como un aspecto más de la doctrina de incumplimiento contractual*" – unofficial translation).

[427] *Id.* ("*[S]e valora la ruptura del equilibrio contractual por la onerosidad sobrevenida de la relación negocial celebrada*" – unofficial translation).

[428] *Id.* ("*[E]l cambio o mutación, configurado como riesgo, debe quedar excluido del "riesgo normal" o inherente o derivado del contrato*" – unofficial translation).

[429] *Id.* ("*[L]a nota de imprevisibilidad no debe apreciarse respecto de una abstracta posibilidad de la producción de la alteración o circunstancia determinante del cambio, considerada en sí misma, sino en el contexto económico y negocial en el que incide*" – unofficial translation).

requirement of "unpredictability" to the specific circumstances of the contract and, particularly, to the parties' allocation of risks.

324. Finally, in line with its previous decisions, the Supreme Court concluded that

> [T]he current economic crisis, with the deep and prolonged effects of economic recession, can be openly considered as a phenomenon of the economy capable of generating a serious disruption or mutation of circumstances and, therefore, altering the basis on which the initiation and development of contractual relationships had been established.[430]

325. Shortly after, in a judgment of 15 October 2014, the Supreme Court reaffirmed and elaborated on its new interpretation of "*unpredictability*". The Supreme Court held that unpredictability must be assessed through the lens of "reasonableness" ("*criterios de razonabilidad*"), taking into consideration the specific circumstances, the sphere of control of the disadvantaged party, and the allocation of risks in the contract.[431]

326. These two Supreme Court judgments of 2014 constitute a landmark in the recent history of the *rebus* doctrine in Spain. Several court decisions have followed their reasoning.[432] The Supreme Court has not hesitated to overturn lower courts' decisions for failing to follow its jurisprudential criteria on *rebus sic stantibus*.[433] It likewise has continued to clarify the scope of the *rebus* doctrine's application in specific circumstances.[434] Of notable importance is the Supreme Court's recent Judgment of 6 March 2020, in which the Court restated the status of the law in this regard and confirmed that the change of circumstances necessary to apply the

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[430] *Id.* ("*[L]a actual crisis económica, de efectos profundos y prolongados de recesión económica, puede ser considerada abiertamente como un fenómeno de la economía capaz de generar un grave trastorno o mutación de las circunstancias y, por tanto, alterar las bases sobre las cuales la iniciación y el desarrollo de las relaciones contractuales se habían establecido*" – unofficial translation, emphasis added).

[431] **Doc. CL-82**, Supreme Court Judgment No. 591/2014, 15 October 2014, FJ 3.

[432] *See e.g.*, **Doc. CL-83**, Supreme Court Judgment No. 418/2019, 30 May 2019, FJ 3; **Doc. CL-84**, Provincial Court of Asturias, Judgment No. 278/2016, 30 June 2016, FJ 4, 5, 6.

[433] For instance, in 2019, the Supreme Court issued a judgment in a case concerning a contract regarding the sale of solar energy projects in France where it decided that the *sua sponte* application of the *rebus* clause by the Provincial Court was inappropriate insofar as it had not followed the requirements imposed by the recent jurisprudence. **Doc. CL-85**, Supreme Court Judgment No. 455/2019, 18 July 2019, FJ 2.

[434] *Id.*; FJ 2; **Doc. CL-86**, Supreme Court Judgment No. 19/2019, 15 January 2019, FJ 3; **Doc. CL-87**, Supreme Court Judgment No. 5/2019, 9 January 2019, FJ 2; **Doc. CL-88**, Supreme Court Judgment No. 156/2020, 6 March 2020, FJ 4.

*rebus sic stantibus* clause "is more likely to appear in a long-term contract of continuing performance".[435]

327. Note that, in the previously mentioned judgment of 15 October 2014,[436] the Supreme Court applied the *rebus sic stantibus* doctrine to rebalance a long-term lease agreement which had been affected by the economic crisis. It considered that the overall financial stability of the market and the value of the area in which the property was based were circumstances that the parties had taken into account to conceive and execute the agreement. The Supreme Court decided that the economic crisis had had an enormous impact on the general financial situation and particularly in the hospitality industry, and therefore applied the *rebus sic stantibus* doctrine to rebalance the parties' contractual obligations.

#### (iv) The Concept of *Rebus Sic Stantibus* Developed by the Spanish Jurisprudence is Applicable to the 1878 Lease Agreement

328. If a Spanish court – rather than the Sole Arbitrator – were considering this case under Spanish law, it would surely arrive, through the *rebus* doctrine, at the same conclusion compelled by the UNIDROIT Principles: the change in circumstances in the 1878 Lease Agreement requires that it be terminated or rebalanced. Indeed, the changes are so radical and so utterly unpredictable from the vantage point of 1878 that even the traditional, more conservative *rebus* rules would apply.

329. First. The prerequisite for applying the *rebus* clause (using either the traditional or the new approach) is a change in circumstances of extraordinary or fundamental proportions.

330. As explained in ¶¶ 102-107 above, Sabah was a rustic, largely uncultivated territory best known for its edible birds' nest caves and seed pearl deposits. Today, it boasts a thriving economy, thanks to some of the world's most valuable commodities such as oil, gas, and palm oil. These commodities were unknown in Sabah at the time of the execution of the 1878 Lease Agreement; and even if they

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[435] **Doc. CL-89**, Supreme Court Judgment No. 156/2020, 6 March 2020, FJ 4 ("*[E]s más probable que se dé en un contrato de larga duración, ordinariamente de tracto sucesivo*" – unofficial translation).

[436] **Doc. CL-82**, Supreme Court Judgment No. 591/2014, 15 October 2014, FJ 3.

had been known and found in Sabahan land or waters at the time, no one in 1878 or 1903 would have been able to do anything useful with them.

331. It is difficult to imagine a more profound or exceptional change of circumstances than those in this case. Those radical changes clearly meet the strict standards established by the Supreme Court to apply the *rebus* clause. This is all the more so when the Supreme Court has held that "long and profound effects of an economic crisis" – necessarily temporary, cyclical, and today somewhat predictable – are sufficient to trigger the clause.

332. Second. The change in circumstances must produce a contractual imbalance. The economic purpose of the 1878 Lease Agreement was to lease the territory so that Overbeck and Dent could obtain "all revenues of that state . . . and over all minerals in the earth, and over all plants and animals".[437] That purpose is unchanged – Malaysia's activities still include the acquisition and development of resources found in the Leased Territories.

333. What has changed is the balance of benefits in the Agreement. The Sultan agreed to 5,000 dollars (later updated to 5,300 dollars) as compensation for the lease, reflecting the loss of his annual income in Sabah.[438] Claimants received their 5,300 dollars (Ringgit) a year until 2013.[439] We know that the lease represented a value more than 5,000 dollars for Dent and Overbeck in 1878, but that value was somewhere between five and ten times the annual rental payment.[440] Today, the value of the Leased Territories to Malaysia reflecting its now-discovered hydrocarbon and palm oil wealth is several million times greater than the sum paid to Claimants for leasing the land.

334. In other words, the initial contractual balance has been obliterated. Simply put, there is no way that the Sultan, today, would have executed the 1878 Lease Agreement on the terms he did; the changed circumstances have made the Agreement unrecognizable from its original form.

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[437] **Doc. C-14**, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz (text taken from the Authority Letter); **Doc. C-13**, Official Gazette of The Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878.

[438] *See* ¶¶ 50-51, *supra.* The sum was updated to 5,300 Dollars in 1903 (*see* § II.G, *supra*).

[439] In recent years, Malaysia paid Claimants in the Philippine Peso equivalent of MYR 5,300.

[440] *See* ¶ 52, *supra.*

335. Spanish courts might consider the contractual imbalance in this case to be atypical, insofar as it stems from an – outrageous – *increase* in the benefits for the defending party (as opposed to an unexpected loss for the claiming party). As with the UNIDROIT Principles' position on restoring equilibrium (see § IV.D(a)(ii)(1) above), however, there is no reason why the *rebus* doctrine should not apply here, considering that it meets all the jurisprudential requirements.

336. Third. The fundamental change of circumstances must have been unforeseeable to the parties at the time of the contract's execution, and thus beyond their ability to assume the risk of such change in their agreement.

337. Note, again, that the original parties could not possibly have foreseen or accounted for the existence or value of materials – hydrocarbons and palm oil – that served no useful purpose in 1878 or 1903. Even if oil had gushed out of the ground in the middle of the Company's first trading post, it would have been more a nuisance than a windfall. In any event, it was nearly a century before the oil industry in Sabah took off. Palm oil – used for biofuels as an alternative to oil – developed even later in Sabah, in the 1990s.[441] The Sultan and Overbeck could not have contemplated the existence of these commodities, let alone imagined that they would make Sabah one of the most profitable regions of Malaysia.

338. Fourth. Spanish courts examine whether the contract provides an alternative remedy to rebalance the parties' obligations. The text of the 1878 Lease Agreement, analyzed at length throughout this Statement of Claim, clearly envisages no mechanism to adapt its terms in light of new circumstances – or even in response to the inevitable passage of time. It only included an obligation to renegotiate over time (as explained at ¶¶ 285-286 above).

339. This case would easily qualify for termination or rebalancing under the traditional *rebus sic stantibus* analysis of the Spanish courts. It certainly qualifies under the newer, modified standard. Any such rebalancing or termination accordingly would be in conformity with Spanish law.

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[441] *See* § II.M(d), *supra*.

### E. The 1878 Lease Agreement Should be Terminated Under Article 7.3.1

#### (a) Introduction

340. In its 19 September 2019 letter, Malaysia has plainly recognized it has been in breach of the 1878 Lease Agreement since 2013.[442] Claimants request that the 1878 Lease Agreement be terminated pursuant to Article 7.3.1 of the UNIDROIT Principles due to Malaysia's fundamental breach of the contract for eight straight years.

341. Article 7.3.1 provides:

> (1) A party may terminate the contract where the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance.
>
> (2) In determining whether a failure to perform an obligation amounts to a fundamental non-performance regard shall be had, in particular, to whether:
>
> (a) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result;
>
> (b) strict compliance with the obligation which has not been performed is of essence under the contract;
>
> (c) the non-performance is intentional or reckless;
>
> (d) the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance;
>
> (e) the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated
>
> (3) In the case of delay the aggrieved party may also terminate the contract if the other party fails to perform before the time allowed it under Article 7.5.1 has expired.

342. The above supports terminating the 1878 Lease Agreement, as we explain below.

#### (b) Malaysia's Non-Performance is Fundamental (Article 7.3.1(1))

343. A "fundamental" breach must be material and not merely of minor importance.[443]

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[442] *See* ¶ 94, *supra*.

[443] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016),

344. Here, the years of fundamental non-performance are both readily apparent and obviously fundamental: Malaysia has admitted it has not paid since 2013.[444] Despite that, Malaysia has continued to reap exorbitant revenue from the Leased Territories. Payment, moreover, is Malaysia's *only* obligation under the 1878 Lease Agreement. Failure to make any payments is as "fundamental" as it gets.

#### (c) Malaysia's Non-performance Substantially Deprived Claimants of their Expectations (Article 7.3.1(2)(a))

345. The Commentary describes this factor as being satisfied when "the non-performance is so fundamental that the aggrieved party is substantially deprived of what it was entitled to expect at the time of the conclusion of the contract".[445] It provides the following useful example:

> On 1 May A contracts to deliver standard software before 15 May to B who has requested speedy delivery. If A tenders delivery on 15 June, B may refuse delivery and terminate the contract.[446]

346. The Commentary notes that:

> The aggrieved party cannot terminate the contract if the nonperforming party can show that it did not foresee, and could not reasonably have foreseen, that the non-performance was fundamental for the other party.[447]

347. A further illustration is provided:

> A undertakes to remove waste from B's site within thirty days without specifying the exact date of commencement. B fails to inform A that B has hired excavators at high cost to begin work on the site on 2 January. B cannot terminate its contract with A on the ground that A had not cleared the site on 2 January.[448]

348. In his seminal book, Prof. Brödermann highlights that factors (a) and (b) of Article 7.3.1 "measure fundamental non-performance from the perspective of what

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Article 7.3.1, Comment 2.

[444] *See* ¶¶ 94, 220, *supra*.

[445] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Comment 3.

[446] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Illustration 2.

[447] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Comment 3.

[448] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Illustration 3.

the obligee, deprived from performance, 'was entitled to expect', by comparing the failures of the obligor with its obligations under the contract . . ".[449]

349. Prof. Brödermann adds that the:

> [S]ubstantial deprivation factor . . . (a) requires a general consideration of the seriousness of the non-performance as compared with the rights of 'the aggrieved party' (i.e. the obligee) under the contract and (b) leaves room for an exception considering the obligor's perspective . . . namely, if subject to its proof, the obligor (i.e. a reasonable person in the same situation) did not foresee (i.e. no positive knowledge) and court not reasonably have foreseen (i.e. ignorance which is not due to negligence) at the time of the contract conclusion, such result, i.e, the consequence of the non-performance.[450]

350. It has been argued, Prof. Brödermann notes:

> [T]hat there is no 'substantial deprivation' if, with a view to the contractual agreement and the commercial background, the obligee (i.e. the 'aggrieved party') could make 'any reasonable use' of the goods despite the non-performance in quality or time.[451]

351. Another leading treatise on the UNIDROIT Principles highlights factors to be analyzed when determining whether a breach results in the substantial deprivation highlighted in Article 7.3.1(2).[452] First, one should look at the contractual agreement itself, as this is the "guiding principle" of Article 7.3.1(2).[453] Under this provision, the parties can "expressly or implicitly attach particular weight to certain obligations with the consequence that a breach of such a term is regarded as fundamental".[454]

352. Second, one must address the seriousness of such a breach. This should "primarily be assessed from the perspective of the aggrieved party: how important was that particular obligation for this party on the basis of an objective interpretation of the contract ('was entitled to expect under the contract')?"[455]

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[449] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 219.

[450] *Id.*, pp. 219-220.

[451] *Id.*, p. 220.

[452] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 824.

[453] *Id.*

[454] *Id.*

[455] *Id.*

353. Here, there are no goods. There is nothing at all. Non-performance has completely deprived Claimants for several years of the only thing they were entitled to under the 1878 Lease Agreement – payment. No breach could be more serious or fundamental. Malaysia has not argued – and could never credibly claim – that it did not foresee that failing to pay would be a fundamental breach in Claimants' eyes. Claimants thus have a right to terminate under Article 7.3.2(a) of the UNIDROIT Principles.

#### (d) Malaysia's Non-Performance Was Intentional or Reckless (Article 7.3.1(2)(c))

354. The Commentary notes simply that this factor:

> [D]eals with the situation where the non-performance is intentional or reckless. It may, however, be contrary to good faith (see Article 1.7) to terminate a contract if the non-performance, even though committed intentionally, is insignificant.[456]

355. Prof. Brödermann explains that this provision elevates even minor non-performance, if intentional or reckless, to a termination-worthy scenario:

> [I]f it was 'intentional or reckless' . . . so that, seen in combination with the consequences of the non-performance [factors (a) and (b)], the non-performance must be assessed as 'fundamental'. . . .[457]

356. There is no dispute here that Malaysia's non-performance was intentional. Malaysia has admitted as much. Nor was Malaysia's non-performance in good faith; Malaysia has acknowledged that it stopped making lease payments after a member of the Kiram family – not one of the Claimants – made an ill-advised incursion into Sabah.[458] Malaysia is punishing Claimants for something they did not do; that is the essence of bad faith.

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[456] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Comment 3.

**Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), pp. 221-222.

[458] *See* ¶ 100, *supra.*

### (e) Malaysia's Non-Performance Gives Claimants Good Reason to Believe that They Cannot Rely on Malaysia's Future Performance (Article 7.3.1(2)(d))

357. The Commentary notes under this section that an intentional breach may show that a party cannot be trusted:

> A, the agent of B, who is entitled to reimbursement for expenses, submits false vouchers to B. Although the amounts claimed are insignificant, B may treat A's behaviour as a fundamental non-performance and terminate the agency contract.[459]

358. Prof. Brödermann's commentary notes that this factor is fulfilled if:

> [The] obligor's behaviour (e.g. by a particularly serious case of non-performance . . .), caused the obligee to believe . . . (a) it cannot rely on the obligor's future performance of an instalment contract . . . and (b) to the contrary, the obligee may fear fundamental non-performance in the sense of factors (a) or (b).[460]

359. Here, Malaysia has intentionally, and admittedly (see ¶ 100 above), failed to perform its only obligation under the 1878 Lease Agreement since 2013. After acknowledging its breach, Malaysia failed even to attempt to rectify its actions. In fact, it was not until its nefarious letter of 19 September 2019 – while this arbitration was well under way – that Malaysia offered payment upon the condition that this arbitration be withdrawn.[461] That is plainly unacceptable and once again proves that Malaysia is an unreliable party.

360. All this gives Claimants ample reason to believe that they cannot rely on Malaysia's future performance. In fact, despite Malaysia's unacceptable offer of 19 September 2019, it continues to be in breach.

### (f) Malaysia Will Not Suffer Disproportionate Loss if the Contract is Terminated (Article 7.3.1(2)(3))

361. The Commentary notes that Article 7.3.1(2)(e) of the UNIDROIT Principles:

> [D]eals with situations in which a party who fails to perform has relied on the contract and has prepared or tendered performance. In these cases regard is to be had to the extent to which that party suffers disproportionate loss if the non-

[459] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Illustration 4.

[460] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 222.

[461] **Doc. C-52**, Letter from Respondent to Paul Cohen, 19 September 2019, ¶ 11.

> performance is treated as fundamental. Non-performance is less likely to be treated as fundamental if it occurs late, after the preparation of performance, than if it occurs early before such preparation. Whether a performance tendered or rendered can be of any benefit to the non-performing party if it is refused or has to be returned to that party is also of relevance.[462]

362. The Commentary illustrates this proposition thus:

> On 1 May A undertakes to deliver software which is to be produced specifically for B. It is agreed that delivery shall be made before 31 December. A tenders delivery on 31 January, at which time B still needs the software, which A cannot sell to other users. B may claim damages from A, but cannot terminate the contract.[463]

363. Prof. Brödermann adds that this "disproportionate loss" factor:

> [P]ermits to consider possible disproportionate losses of the defaulting obligor as a result of the preparation of (and investment in) the performance ('reliance of the non-performing party') – or the absence of such losses – as balanced (a) against the interest of the oblige in the termination and/or in the good or service and (b) against the behavioural factors such as recklessness.[464]

364. Here, there is no fear of a disproportionate loss. As discussed in § V.B below, the end result of a termination due to non-performance would merely be Malaysia's payment (*i.e.*, the restitution value) for the rights to the Leased Territories it now occupies and lucratively exploits. No past performance will have gone to waste, since such past performance corresponded with lease rights for those respective years. Termination would thus result in a (completely justified) payment for the Leased Territories' acquisition.

#### (g) Malaysia Has Been Given Notice (Article 7.3.2(1))

365. Once there are grounds for termination, Article 7.3.2(1) of the UNIDROIT Principles provides that "[t]he right of a party to terminate the contract is exercised by notice to the other party".[465]

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[462] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Comment 3.

[463] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.1, Illustration 5.

[464] **Doc. C-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 222.

[465] Article 7.3.2(1)

366. The Commentary observes that this Article:

> [R]eaffirms the principle that the right of a party to terminate the contract is exercised by notice to the other party. The notice requirement will permit the non-performing party to avoid any loss due to uncertainty as to whether the aggrieved party will accept the performance. At the same time it prevents the aggrieved party from speculating on a rise or fall in the value of the performance to the detriment of the non-performing party.[466]

367. Prof. Brödermann opines that Article 7.3.2(1):

> [P]rovides an internationally adequate solution for termination, by requiring mere (unilateral) notice, effective upon receipt, without (i) intervention of a court or, at the other extreme, (ii) without an 'automatic' ipso facto termination, e.g. in case of permanent force majeure.[467]

368. Notice under Article 7.3.2 of the UNIDROIT Principles becomes effective when the non-performing party receives it.[468]

369. As explained in § II.N above, Malaysia was put on notice of Claimants' right and intention to terminate in 1989, when Claimants floated the concept of formally ceding sovereignty to Malaysia by terminating the 1878 Lease Agreement, in exchange for a lump-sum payment. Throughout the years, Claimants continued to revisit the bargain. In their Notice of Arbitration, dated 30 July 2019, Claimants again put Malaysia on notice that they sought to terminate the 1878 Lease Agreement or, alternatively, readjust the annual rent.

370. Malaysia has undoubtedly breached the 1878 Lease Agreement. Its breach meets all the requirements of Article 7.3.1 of the UNIDROIT Principles. Consequently, the Sole Arbitrator should terminate the 1878 Lease Agreement.

### F. The 1878 Lease Agreement Can Also be Terminated as a Contract for An Indefinite Period (Article 5.1.8)

371. Article 5.1.8 of the UNIDROIT Principles reads as follows:

> A contract for an indefinite period may be terminated by either party by giving notice a reasonable time in advance. As to the

[466] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.2, Comment 1.

[467] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 244.

[468] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 7.3.2, Comment 4.

> effects of termination in general, and as to restitution, the provisions in Articles 7.3.5 and 7.3.7 apply.

372. The Commentary states:

> The duration of a contract is often specified by an express provision, or it may be determined from the nature and purpose of the contract (e.g. technical expertise provided in order to assist in performing specialized work). However, there are cases when the duration is neither determined nor determinable. Parties can also stipulate that their contract is concluded for an indefinite period.
>
> The Article provides that in such cases either party may terminate the contractual relationship by giving notice a reasonable time in advance. What a reasonable time in advance will be depends on circumstances such as the period of time the parties have been cooperating, the importance of their relative investments in the relationship, the time needed to find new partners, etc.
>
> The rule can be understood as a gap-filling provision in cases where the parties have failed to specify the duration of their contract. More generally, it also related to the widely recognized principle that contracts may not bind the parties eternally and that they may always opt out of such contracts provided they give notice a reasonable time in advance.[469]

373. Tellingly, the Commentary also notes:

> The fact that, by virtue of termination, the contract is brought to an end does not deprive a party to the contract of its rights to claim damages for any non-performance.[470]

374. Prof. Brödermann provides additional insight into Article 5.1.8, noting, in part, that Article 5.1.8:

> [O]pens a way out of a contract with an indefinite term by advance notice. It thereby (i) serves a risk-management function (against the risk of being bound for an indefinite period of time) and provides a chance to adapt to market developments . . . (ii) Art. 5.1.8 thereby statues an exception to the *pacta sunt servanda* principle . . . (iii) Art. 5.1.8 protects a residual freedom of contract which includes the freedom to revisit the decision on the contract partner and not to be bound indefinitely. (iv) the implicit mandatory rule in Art. 5.1.8 permits the parties to separate in a fair way . . . There are no further special

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[469] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 5.1.8, Comment 1 (emphasis added).

[470] Official Commentary to the UNIDROIT Principles of International Commercial Contracts (2016), Article 5.1.8, Comment 2.

> requirements to exercise a termination under Art. 5.1.8 . . . (v) Art. 5.1.8 is not available to terminate a long-term contract.[471]

375. There is no dispute that the 1878 Lease Agreement is an indefinite contract.

376. Article 5.1.8 provides an explicit means to terminate the 1878 Lease Agreement. As the Commentary and Prof. Brödermann make abundantly clear (at ¶ 374 above), an indefinite contract can be terminated under Article 5.1.8 merely by providing reasonable notice. Prof. Brödermann explicitly states that "[t]here are no further special requirements to exercise a termination under Art. 5.1.8".

377. Thus, the 1878 Lease Agreement must be terminated by virtue of Article 5.1.8 of the UNIDROIT Principles. As explained in § II.N above, Malaysia was put on notice of Claimants' right and intention to terminate in 1989, when Claimants floated the concept of formally ceding sovereignty to Malaysia by terminating the 1878 Lease Agreement, in exchange for a lump-sum payment. In their Notice of Arbitration, dated 30 July 2019, Claimants again put Malaysia on notice of their right and intention to terminate the 1878 Lease Agreement, among other remedies.

# V. QUANTUM

## A. Applicable Parameters for Quantum Calculations

### (a) Hydrocarbons and Palm Oil are the Relevant Industries from which to Calculate Damages

378. We have shown in §§ II.M and IV above that the radically changed circumstances of the 1878 Lease Agreement and Malaysia's shameless abandonment of its contractual obligations carry legal consequences. The remaining question is what form and magnitude those consequences should take. We discuss the issue in this section.

379. Treacher described the financial terms of the 1878 Lease Agreement in his letter to the Earl of Derby, written on the Agreement's execution date:

> His Highness [the Sultan] also consulted me, in a very intelligent manner, on several other points, such as the amount he should ask, &c., and in the advice I ventured to give I endeavoured, so far as possible not to lose sight of His Highness's own interest while not opposing those of the proposed British Company, which already holds from Brunei a concession of the territories in question.

[471] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 133 (emphasis added).

. . . .

> The Sultan assured me that at the present moment he receives annually from this portion of his dominions the sum of 5,000 dollars, namely 300 busings of seed pearls from the Lingabo River alone, which at 10 dollars a busing comes to 3,000 dollars per annum, and about 2,000 dollars from four birds-nest caves in the Kinabatangan River, which are his family possessions.[472]

380. Because of the Sultan's above estimate of his income from the Leased Territories, Overbeck and the Sultan of Sulu agreed to set the payment for their arrangement at 5,000 dollars (updated to 5,300 dollars in 1903). The Sultan was thus made whole for the loss of his ability to extract any further commercial benefit from the Leased Territories.

381. Seed pearls and birds' nest harvesting were the two major industries in the Leased Territories in 1878, or at least the ones that produced the most commercial value for the Sultan at that time. On that basis, we have instructed Brattle to calculate Malaysia's revenues from the two largest industries in the Leased Territories today. As explained in § II.M(b) above, the most profitable and largest industries in the Leased Territories today are hydrocarbons (oil & gas) and palm oil.

382. Brattle first has computed Malaysia's profits from oil, gas and palm oil in the Leased Territories between 2013 (when Malaysia first failed to pay under the 1878 Lease Agreement) and 2020.[473] Brattle has also assessed the profit that Malaysia is likely to obtain from the Leased Territories' ongoing oil and gas, and palm oil production over the foreseeable future.[474] Brattle computes Malaysia's future profit as a 2020 lump-sum amount as of February 2020.[475]

383. Had Brattle included all other major industries operating today in the Lease Territories in its calculations (such as timber, rubber, cacao, fisheries, other types of agriculture, and tourism),[476] it would have revealed that the amount of revenue that Malaysia is receiving (and will receive) from the Leased Territories is much higher. By focusing exclusively on hydrocarbons and palm oil, Claimants have

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[472] **Doc. C-11**, Letter from William H. Treacher to the Earl of Derby, 22 January 1878, in BORNEO, DENT AND OVERBECK CONCESSION 1877-8, The National Archives (United Kingdom), pp. 8-9.

[473] *See* ¶¶ 94, 220, *supra.*

[474] Brattle Report, § ¶ 182; *see also* § II.M(b), *supra.*

[475] Brattle Report, ¶ 8.

[476] *See* § II.M(a), *supra*. *See also* Brattle Report, ¶ 25.

adopted a conservative posture. They have also respected the original bargain, in which the Sultan focused on the two most important industries in the Leased Territories for the purpose of calculating the 1878 Lease Agreement's economic benefits.

### (b) Currency

#### (i) Payments under the 1878 Lease Agreement Were Made in Various Currencies, Culminating in the Malaysian Ringgit

384. The 1878 Lease Agreement provides for a "fee of five thousand dollars per year, to be paid annually",[477] or in the contemporary Spanish translation "*darle cinco mil pesos anuales*".[478] In the 1903 Amendment, the parties agreed to an increase of "300 dollars a year", which resulted in "[a]rrears for past occupation 3,200 dollars".[479] There was no specific reference as to what "peso" or "dollar" the parties were referring to. The original parties presumably were referring to the Filipino "*peso fuerte*", in force in the Philippines and other Spanish East Indies in 1878, replaced by 1903 by the new Filipino peso approved by the United States of America. The new Filipino peso was to have exactly half the gold content of the U.S. dollar.[480]

385. Regardless of what the original currency was, Article 1.9(1) of the UNIDROIT Principles ("Usages and practices") provides that "[t]he parties are bound by any usage to which they have agreed and by any practices which they have established between themselves".[481] Section 2 of the Commentary to Article 1.9 clarifies that "[a] practice established between the parties to a particular contract is automatically binding, except where the parties have expressly excluded its application". Section 6 of the Commentary further provides that, "once they are applicable in a given case", courses of dealing "prevail over conflicting provisions contained in the Principles". The Commentary adds that "[t]he reason for this is that they bind the parties as implied terms of the contract as a whole or of single statements or other conduct on the part of one of the parties". In short, if a practice is established

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[477] **Doc. C-14**, English Translation of the 1878 Lease Agreement and Letter of Authority by Annabel Teh Gallop and Ernst Ulrich Kratz (emphasis added).

[478] **Doc. C-13**, Official Gazette of the Philippines, *Contrato de Arrendo de Sandacan en Borneo, con el Baron de Overbeck*, 13 July 1878 (emphasis added).

[479] **Doc. C-17**, Official Gazette of the Philippines, Confirmatory Deed of 1903, 22 April 1903.

[480] **Doc. C-105**, *History of Philippine Money*, WIKIPEDIA.

[481] Emphasis added.

between the parties, such practice becomes part of the agreement and therefore takes precedence over the UNIDROIT Principles.

386. In our case, since Malaysia introduced the Ringgit in 1967,[482] it has been making all payments under the 1878 Lease Agreement in that currency. The heirs of the Sultan have not disputed the currency; they have instead disputed the quantum of payments, on the basis that they fail to reflect the original bargain. The Parties therefore can be considered to have established the practice of processing payments under the 1878 Lease Agreement in Ringgit.

387. This result is consistent with Article 6.1.10 of the UNIDROIT Principles, which provides that, "[w]here a monetary obligation is not expressed in a particular currency, payment must be made in the currency of the place where payment is to be made". In our case, the Ringgit is the currency of the place where payment is to be made (*i.e.*, the currency in force today where the Sultan originally received payments, and also in force today in the Leased Territories).

388. Thus, whether by practice established by the Parties (Article 1.9(1) of the UNIDROIT Principles), or by application of the default rule for the determination of a contract's currency (Article 6.1.10 of the UNIDROIT Principles), the result is the same: the applicable currency for payments made under the 1878 Lease Agreement is the Malaysian Ringgit.

#### (ii) Nonetheless, the U.S. Dollar is the Relevant Currency to Calculate Damages

389. The fact that the applicable currency for payments made under the 1878 Lease Agreement is the Ringgit does not, however, require that damages must be calculated in Ringgit.

390. Article 7.4.12 of the UNIDROIT Principles provides that "[d]amages are to be assessed either in the currency in which the monetary obligation was expressed or <u>in the currency in which the harm was suffered</u>, whichever is more appropriate".[483] According to the Commentary, Article 7.4.12 "offers a choice between the currency

[482] **<u>Doc. C-106</u>**, *Malaysian Banknotes and Coins: Past Series*, BANK NEGARA MALAYSIA CENTRAL BANK OF MALAYSIA.

[483] Emphasis added.

in which the monetary obligation was expressed and that in which the harm was suffered, whichever is more appropriate in the circumstances".[484]

391. Article 7.4.12 embodies the principle of full compensation (discussed in ¶¶ 441-446 below), as recognized in the Commentary: "**The choice is left to the aggrieved party**, provided that the principle of full compensation is respected".[485] Obviously, the fact that the choice is left to the aggrieved party (here, Claimants) leaves no room for second-guessing by Malaysia or the Sole Arbitrator. Claimants request their compensation in U.S. dollars, which is the appropriate currency under the circumstances. This choice binds the Sole Arbitrator.

392. A specific application of the principle of full compensation is that the currency used to calculate the compensation shall not subject the aggrieved party (here, again, Claimants) to further losses. Regardless of the currency used in a contract, the aggrieved party is entitled to a calculation of the damages in the same currency in which the damages are suffered. Indeed, per the Commentary to Article 7.4.12, "the currency which may be considered the most appropriate is that in which the profit would have been made".[486]

393. Brattle makes its calculations in U.S. dollars because the industries at issue are indexed to U.S. dollars.[487] Moreover, production of oil, gas and palm oil is mainly intended for export, and therefore paid abroad in U.S. dollars. As a result, damages should be calculated in U.S. dollars. Otherwise, the compensation would not capture the full extent of the damages Claimants have suffered, and could also subject Claimants to additional damages in case of fluctuation in the exchange rate between U.S. dollars and Malaysian Ringgit.

394. This is consistent with Section 4 of the Commentary to Article 7.4.2 (discussed in ¶¶ 441-446 below), which provides that "[i]n application of the principle of full compensation regard is to be had to any changes in the harm, including its

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[484] Emphasis added.

[485] Emphasis added. *See also* **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), pp. 259-260.

[486] *See also* **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 918 (noting that "[i]t may also be appropriate to assess damages in the currency in which the aggrieved party would have made a profit" – footnotes omitted, emphasis omitted).

[487] Brattle Report, ¶ 118 (oil and gas) and ¶¶ 141, 147, 149 (palm oil).

expression in monetary terms, which may occur between the time of the non-performance and that of the judgment". This rule is intended to insulate Claimants from currency depreciation.

395. International tribunals have generally ruled that the respondent must take the risk of currency depreciation between the date of the loss and the date of the award. In *Siemens v. Argentina*, the Arbitral Tribunal acknowledged that the non-performing party should bear the currency risk:

> Argentina has argued that the Contract is denominated in pesos and that it had not guaranteed to Siemens the parity of the peso in effect at the time it entered into the Contract. This assertion is correct but it has to be considered in the context of the requirement that the consequences of the illegal act be wiped out. It would be hardly so if the parity of the currency would be added as yet another risk to be taken by the investor after it has been expropriated. In the instant case, the Claimant has pleaded that the Tribunal accept May 18, 2001 as the date of expropriation. . . . On May 18, 2001, the peso was at par with the dollar. If such obligation would have been met, the Claimant would have been compensated in pesos convertible at that rate. Therefore, the Tribunal concludes that compensation shall be paid in dollars.[488]

396. Many other international tribunals have taken the position that the claimant should not be prejudiced by the depreciation of the respondent's currency between the date of the loss and the date of payment. Here are a few examples:

(i) ***Lighthouses Arbitration***: "[T]he injured party has the right to receive the equivalent at the date of the award of the loss suffered as a result of an illegal act and ought not to be prejudiced by the effects of devaluation which took place between the date at which the wrongful act occurred and the determination of the amounts of compensation".[489]

(ii) **U.N. Compensation Commission**: "[N]ormally, the object of a civil money judgment is to restore an injured party to a position as close as possible to that in which he or she would have been had the injury not occurred. Interpreting this principle in the context of currency

[488] **<u>Doc. CL-91</u>**, *Siemens A.G. v. The Argentine Republic*, ICSID Case No. ARB/02/8, Award, 17 June 2007, ¶ 361.

[489] **<u>Doc. CL-92</u>**, *Lighthouses Arbitration (France v. Greece)*, Claim No. 27, 24 July 1956, 10 RIAA 155, p. 248 ("*Ils ne peuvent être retenus, parce que la partie lésée a droit à recevoir l'équivalent à la date de la sentence du préjudice subi à raison d'un acte illégal et ne doit pas supporter les effets d'une dévaluation intervenue entre la date à laquelle l'acte préjudiciable a eu lieu et la fixation de l'indemnité*." – unofficial translation).

conversions, such conversions are to be made at a rate so as to make the injured party whole and to avoid a windfall to the wrongdoer".[490]

(iii) ***McCollough v. Ministry of Post***: "The Tribunal finds that it would be inequitable to oblige the claimant now to suffer the full extent of such [currency] a depreciation when the payments it should have received were delayed as the consequence of breaches of contract by the Respondents".[491]

397. Scholars agree with this principle. For Dr. Borzu Sabahi, "[t]he underlying objective in the choice of a currency . . . must be protecting the aggrieved party against losses arising out of currency devaluation caused by an unlawful act".[492] For Prof. Wöss and others, the award will only place the injured party in a position of full compensation "if made in the currency which most closely reflects the claimant's loss".[493]

398. The above confirms that the appropriate way to calculate the damages suffered is by using the currency in which the damages are suffered. Otherwise, if the contract is expressed in one currency but the damages are suffered in another, the passage of time may exacerbate the damage as a result of currency fluctuation.

399. Finally, the Commentary to Article 7.4.12 states that the question this article deals with "should be kept distinct from that of the currency of payment of the damages addressed in Article 6.1.9", which deals with the "currency of payment".

400. Article 6.1.9(4) of the UNIDROIT Principles provides that, "if the obligor has not paid at the time when payment is due, the obligee may require payment according to the applicable rate of exchange prevailing either when payment is due or at the time of actual payment".[494] This is consistent with Section 4 of the Commentary to Article 7.4.2 ("regard is to be had to any changes in the harm, including its expression in monetary terms, which may occur between the time of

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[490] **Doc. CL-93**, Report and Recommendations Made by the Panel of Commissioners Concerning the First Instalment of Individual Claims for Damages up to US$100,000 (Category "C" Claims), S/AC.26/1994/3, 21 December 1994, pp. 30-31.

[491] **Doc. CL-94**, *McCollough & Company, Inc. v. The Ministry of Post et al.*, 11 Iran-US CTR 3, Award, 22 April 1986, pp. 32-33.

[492] **Doc. CL-95**, Borzu Sabahi, COMPENSATION AND RESTITUTION IN INVESTOR-STATE ARBITRATION: PRINCIPLES AND PRACTICE (Oxford University Press, 2011), p. 154.

[493] **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 7.42.

[494] Section 3 of the Official Commentary to Article 6.1.9 provides in very similar terms that "[i]f, however, the obligor is in default, the obligee is given an option between the rate of exchange prevailing when payment was due or the rate at the time of actual payment".

the non-performance and that of the judgment"). Under Article 6.1.9(4), Malaysia is free to pay Claimants in Ringgit at the prevailing U.S. dollar – Ringgit exchange rate on the day Malaysia makes full payment of the arbitral award, expressed in U.S. dollars. This will prevent Claimants from suffering further damages as a result of the interplay between Malaysia's delay in making payment and the fluctuation of exchange rates.

### (c) The DCF Method is Appropriate to Calculate Future Economic Benefits

401. Brattle has used the Discounted Cash Flow ("**DCF**") method to calculate all future economic benefits to Malaysia from the Leased Territories.

402. The DCF method is based on the premise that *a dollar today is worth more than a dollar tomorrow*, because the dollar today can be invested to start earning interest immediately.[495]

403. The *International Glossary of Business Valuation Terms* defines DCF as a method "whereby the present value of future expected net cash flows is calculated using a discount rate".[496] A DCF analysis seeks to determine the lost net earnings someone will suffer as a result of the legal injury that triggered the dispute. The DCF does so by calculating the aggrieved party's anticipated future stream of net cash flow over a specific period of time, and then discounting that gross amount back to a present-value lump sum. The discount rate is the "rate of return used to convert a future monetary sum into present value".[497]

404. The *Lawyer's Business Valuation Handbook* (edited by the American Bar Association), described by the Delaware Court of Chancery as "the leading non-academic treatise",[498] defines "discount rate" as "the expected *total rate of return* the investor requires to commit funds to the particular investment", which is "market-driven for it represents the expected rates of return available in the market on other

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[495] **Doc. CL-96**, Richard A. Brealey *et al.*, PRINCIPLES OF CORPORATE FINANCE (McGraw Hill, 2008), p. 16.

[496] **Doc. CL-97**, INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (AICPA), "Discounted Cash Flow Method", p. 43.

[497] *Id.*, "Discount Rate". For a more detailed discussion on the DCF method, refer to **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), pp. 195-200; **Doc. CL-57**, Shannon P. Pratt *et al.*, LAWYER'S BUSINESS VALUATION HANDBOOK (American Bar Association, 2010), pp. 45-48.

[498] **Doc. CL-98**, *Delaware Open MRI Radiology Associates, Inc. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006), n. 130.

investments that are comparable in terms of risk".[499] The *Lawyer's Business Valuation Handbook* summarizes the importance of DCF valuations to the financial and business community as follows:

> The income approach is presented first because, in theory, it is the dominant approach in business valuation. . . . The discounted cash flow (DCF) method is the most conceptually correct method because it captures the driving principle of valuation: Value is the present worth of future benefits. . . . Not only is discounted cash flow the most theoretically correct valuation method, it is also the most widely practiced valuation method in the world of corporate finance. Furthermore, the method is increasingly used by valuation experts and increasingly accepted by the courts. In . . . *discounting* . . . we are converting an expected stream of income into a present value. In other words, we are estimating what someone would pay today (or as of the effective valuation date) for an expected stream of future economic income.[500]

405. Several international organizations and associations praise the effectiveness of the DCF method. For example, the *Fédération des Experts Comptables Européens* adopts the approach that earnings capacity is the best measure of a business's value:

> The value of a business is based, under the assumption of purely financial objectives, on the present value of net cash flows from the business to the owner (net receipts of the owner of the business). This means that the value of the business is based solely on its ability to earn business profits for the owner. This value is based on the profits of the business which will be achieved if the business is continued in the future and assuming the disposal of any assets not required for the operations (earnings-based value). Only in the event that the present value of profits which would arise if the entire enterprise were liquidated (liquidation value) exceeds the value of the business as a going concern should the liquidation value to be shown as the business value.[501]

406. The *International Valuation Standards Committee* also recognizes the importance of the DCF valuation method:

> DCF analysis has gained widespread application due in part to the advancement of computer technology. DCF analysis is

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[499] **Doc. CL-57**, Shannon P. Pratt *et al.*, LAWYER'S BUSINESS VALUATION HANDBOOK (American Bar Association, 2010), p. 58 (emphasis in original).

[500] *Id.*, p. 45 (emphasis added).

[501] **Doc. CL-99**, Business Valuation: A Guide for Small and Medium Sized Enterprises, *Fédération des Experts Comptables Européens* (July 2001), p. 6.

> applied in valuations of real property, business and intangible assets; in investment analyses; and as an accounting procedure to estimate value in use. The use of DCF has increased substantially in institutional, investment property and business valuation sectors and is frequently required by clients, underwriters, financial advisers and administrators, and portfolio managers.[502]

407. Several international tribunals have used DCF as a standard method for calculating damages. For instance, the Arbitral Tribunal in *Metalclad v. United States* mentioned that "the fair market value of a going concern which has a history of profitable operation may be based on an estimate of future profits subject to a discounted cash flow analysis".[503] Likewise, in *CMS v. Argentina*, the Arbitral Tribunal held that "DCF techniques have been universally adopted, including by numerous arbitral tribunals, as an appropriate method for valuing business assets".[504] In *Enron v. Argentina*, the Arbitral Tribunal opined that "there is convincing evidence that DCF is a sound tool used internationally to value companies", and added that "[i]t has also been constantly used by tribunals in establishing the fair market value of assets to determine compensation of breaches of international law".[505]

408. In *Lauder v. Czech Republic*, the Arbitral Tribunal praised the DCF method and summarized a long line of prior international cases in which tribunals chose DCF as the most appropriate valuation method:

> International arbitral tribunals have recognized the DCF method's utility in the context of compensation for the destruction or taking of going concerns where no active market of assets exists. The Iran-U.S. Claims Tribunal and ICSID tribunals have utilized the DCF method for calculating the quantum of damages in cases of expropriation, In *Amco Asia Corp. v. Republic of Indonesia*, an ICSID tribunal explained that it had used the DCF method because "while there are several methods of valuation of going concerns, the most appropriate one is to establish the *net present value* of the business, based

[502] **Doc. CL-100**, *International Valuation Guidance Note No. 9, Discounted Cash Flow Analysis for Market and Non-Market Based Valuations*, International Valuation Standards Committee (6th Edition, 2003), ¶ 1.1.

[503] **Doc. CL-101**, *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000, ¶ 119.

[504] **Doc. CL-102**, *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Award, 12 May 2005, ¶ 416.

[505] **Doc. CL-103**, *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, 22 May 2007, ¶ 385.

> on a projection of the foreseeable net cash flow during the period to be considered". *Amco Asia Corp. v Republic of Indonesia*, ICSID Case No. ARB/81/1 (1984), 1 ICSID Rep. 413, 501 (1993). . . . The Iran-U.S. Claims Tribunal also calculated compensation using the DCF method. *Starrett Housing supra*, and *Phillips Petroleum supra*. As the Tribunal explained in *Phillips Petroleum*, "a prospective buyer of the assets would almost certainly undertake [a] DCF analysis to help it determine the price it would be willing to pay and DCF are, therefore, evidence the Tribunal is justified in considering in reaching its decision on value". *Phillips Petroleum*, *supra*, at 123, *Amoco Int'l Finance Corp.*, *supra*, at 258, (DCF method properly employed when *restitution in integrum* equivalent when contemplated by the *Factory at Chorzów* case is appropriate standard of compensation); Brower & Brueschke, *supra*, at 589, ("Where an active market does not exist, the DCF method has proved a valuable tool to approximate fair market value".); *World Bank Guidelines on the Treatment of Foreign Direct Investment*, adopted September 21, 1992, *reprinted in* 31 I.L.M. 1363, 1383 (1992) (compensation for taking of "a going concern with a proven record of profitability" is presumptively reasonable if determined "on the basis of the discounted cash flow value").[506]

409. In sum, abundant authority and precedent exists to justify using the DCF method to calculate future economic benefit from the Leased Territories.

## B. Termination of the 1878 Lease Agreement Requires Payment of Restitution Value

### (a) Introduction

410. Claimants have explained that termination is the appropriate remedy under three separate legal theories: (i) hardship (Article 6.2.3(4) of the UNIDROIT Principles; *see* § IV.D above); (ii) breach of contract (Article 7.3.1 of the UNIDROIT Principles; *see* § IV.E above); and (ii) termination of a contract for an indefinite period (Article 5.1.8 of the UNIDROIT Principles; *see* § IV.F above).

411. In the following sections, Claimants explain the relief sought if the Sole Arbitrator terminates the 1878 Lease Agreement.

### (b) Termination of a Long-Term Contract Implies Restitution

412. Article 7.3.5 of the UNIDROIT Principles provides that:

> (1) Termination of the contract releases both parties from their obligation to effect and to receive future performance.

[506] **Doc. CL-104**, *CME Czech Republic B.V. v. The Czech Republic, Ad Hoc*, Final Award, 14 March 2003, ¶ 161 (emphasis added).

> (2) Termination does not preclude a claim for damages for non-performance.
>
> (3) Termination does not affect any provision in the contract for the settlement of disputes or any other term of the contract which is to operate even after termination.

413. According to Section 1 of the Commentary to Article 7.3.5, "[p]aragraph (1) of this Article states the general rule that termination has effects for the future in that it releases both parties from their duty to effect and to receive future performance".[507] Recall also that the effects of termination under Article 5.1.8 of the UNIDROIT Principles are channeled through Articles 7.3.5 and 7.3.7.[508] As a result, the Official Commentary to Article 5.1.8 of the UNIDROIT Principles, after making a *renvoi* to Article 7.3.5, provides that upon termination "[b]oth parties are released from their obligation to render and to receive future performance".[509]

414. The term "future" refers to "the date when these performances would (have) become due, not to the date when they were (or would have been) effectively made".[510] The release of the future (sometimes referred as "further") performance upon termination of a contract is deeply rooted in international law.[511]

415. This forward-looking rule is consistent with Article 7.3.7 of the UNIDROIT Principles, which specifically deals with "Restitution with respect to long-term contracts",[512] such as the 1878 Lease Agreement:

> (1) On termination of a long-term contract restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible.
>
> (2) As far as restitution has to be made, the provisions of Article 7.3.6 apply.

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[507] Emphasis added.

[508] UNIDROIT Principles, Article 5.1.8 ("A contract for an indefinite period may be terminated by either party by giving notice a reasonable time in advance. As to the effects of termination in general, and as to restitution, the provisions in Articles 7.3.5 and 7.3.7 apply".). *See* § IV.F, *infra.*

[509] Emphasis added.

[510] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 854.

[511] **Doc. CL-105**, *Sapphire International Petroleums Ltd. v. National Iranian Oil Company, Ad-Hoc*, Award, 15 March 1963, p. 185.

[512] The 1878 Lease Agreement is a "long-term contract". *See* § IV.C, *supra.* Note that Prof. Brödermann includes lease agreements under the category of long-term contracts of divisible nature. **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 236.

416. Section 1 of the Commentary to Article 7.3.7 restates that, "on termination of a long-term contract, restitution can only be claimed for the period *after* termination has taken effect, provided the contract is divisible".[513] The Commentary concludes that "termination is a remedy with prospective effect only" and "can, therefore, only be claimed in respect of the period after termination".[514]

417. The same forward-looking perspective permeates the Commentary to Article 5.1.8 .[515] Hence, Claimants claim restitution of the Leased Territories only upon the termination of the 1878 Lease Agreement (*i.e.*, Claimants cannot, and do not, claim restitution prior to the termination of the 1878 Lease Agreement).

418. Restitution upon termination is a well-trodden path in international law. In *International Military Services Ltd v. Islamic Republic of Iran*, available on UNILEX, an arbitral tribunal held that, under Article 7.3.7 of the UNIDROIT Principles, "in case of termination of a contract to be performed over a period of time, the parts already performed should not be affected by the termination".[516] The Supreme Court of the Netherlands confirmed the award. Likewise, in an award issued by an arbitral tribunal seated in Russia, also available on UNILEX, the Arbitral Tribunal ruled that Article 7.3.7(1) of the UNIDROIT Principles "provides that if the performance of the contract is of a continuing nature and is divisible, restitution can only be demanded for the period after termination has taken effect".[517]

419. Paragraph 2 of Article 7.3.7 regulates restitution by means of a *renvoi* to Article 7.3.6, which deals with "Restitution with respect to contracts to be performed at one time". The latter Article states:

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[513] Emphasis added.

[514] *See also* **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 235 (noting the "prospective effect" of termination, concludes that objects and payments "as a matter of performance rendered prior to the termination cannot be claimed back under the restitution principle" – emphasis omitted, internal quotations omitted).

[515] UNIDROIT Principles, Article 5.1.8, Comment 2 ("Restitution can, therefore, be claimed only in respect of the period after termination. This is set out in Article 7.3.7(1), with the consequence that, as far as restitution has to be made, the provisions of Article 7.3.6 apply as set out in Article 7.3.7(2)".).

[516] **Doc. CL-106**, *International Military Services Ltd v. Islamic Republic of Iran*, Hoge Raad Case No. C07/202HR, Decision, 24 April 2009, Abstract.

[517] **Doc. CL-107**, International Arbitration Court of the Chamber of Commerce and Industry of the Russian Federation Case No. 111/2011, Award, 3 February 2012, Abstract.

> (1) On termination of a contract to be performed at one time either party may claim restitution of whatever it has supplied under the contract, provided that such party concurrently makes restitution of whatever it has received under the contract.
>
> (2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.
>
> (3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.
>
> (4) Compensation may be claimed for expenses reasonably required to preserve or maintain the performance received.[518]

420. Section 2 of the Commentary to Article 7.3.6 clarifies that "[p]aragraph (1) of this Article gives each party a right to claim the return of whatever the party has supplied under the contract provided that that [*sic*] party concurrently makes restitution of whatever it has received". Again, Claimants here claim restitution only after – not prior to – the termination of the 1878 Lease Agreement.

421. In ICC Arbitration No. 9797, available on UNILEX, an ICC arbitral tribunal addressing Article 7.3.6(1) of the UNIDROIT Principles concluded that, "[u]nder general principles of law, upon termination of the contract either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received. . . ".[519] Similarly, in ICC Arbitration No. 7365/FMS, also available on UNILEX, the Arbitral Tribunal held that "[t]he obvious and most important effect of a contract termination, be it for the convenience of one party or for other reasons, is that either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received", quoting verbatim Article 7.3.6.[520]

422. In our case, termination of the 1878 Lease Agreement requires that Malaysia return the rights over the Leased Territories to Claimants (namely, the ability to exploit and extract any commercial benefit therefrom).

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[518] Emphasis added.

[519] **Doc. CL-108**, *Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative*, ICC Case No. 9797, Award, 28 July 2000, § V.H.

[520] **Doc. CL-109** *Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Defense Systems, Inc.*, ICC Award No. 7365/FMS, Award, 5 May 1997, Abstract (internal quotation marks omitted).

### (c) Allowance in Money in Lieu of Restitution is Appropriate

423. Claimants acknowledge that restitution of the kind called for above is essentially impossible. Malaysia considers Sabah to be its own by right of sovereign prerogative; it is hardly about to surrender the Leased Territories, or any rights associated therewith, no matter how compelling Claimants' argument that the Sultan never ceded Sabah and that sovereignty therefore remains in his descendants' hands. Failing restitution in kind, Claimants seek a sum of money for the loss of what should be theirs after the 1878 Lease Agreement is over.

424. Article 7.3.6 of the UNIDROIT Principles, applicable by *renvoi* of Article 7.3.7, provides in its second paragraph that, "[i]f restitution in kind is not possible <u>or appropriate</u>, an allowance has to be made in money whenever reasonable".[521] Section 3 of the Commentary to Article 7.3.6 explains that "[r]estitution must normally be made in kind", but there are "instances where instead of restitution in kind, an allowance in money has to be made".

425. The Commentary considers that "restitution in kind would not be appropriate" when "returning the performance in kind would cause unreasonable effort or expense". In other words, restitution is "still possible, [but] may have become so onerous that it would run counter to the general principle of good faith and fair dealing".[522]

426. In our case, Malaysia's hypothetical (and highly unlikely) return of the Leased Territories (or any rights associated therewith) might well cause uprisings, civil war, disturbances or the like in the region.[523] Moreover, if the Sole Arbitrator were to award restitution in kind and Malaysia refused to comply, Claimants lack effective means to enforce any order of restitutionary nature.[524] It is therefore safe to assume

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[521] Emphasis added.

[522] UNIDROIT Principles, Article 7.2.2(b) (Section 2 of the Official Commentary, which is cross-referenced in Section 3 of the Official Commentary to Article 7.3.6).

[523] **<u>Doc. C-107</u>**, Kate McGeown, *How do you solve a problem like Sabah?*, BBCNEWS, 24 February 2013.

[524] **<u>Doc. CL-59</u>**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 57 ("The preference for compensation is also attributable to the difficulties of enforcing arbitral awards against sovereign States. Investors lack effective means to enforce an order of a restitutionary nature, for example, to return expropriated property or contract rights or to annul a piece of legislation. . . . In practice, pecuniary awards are easier to enforce because States have assets abroad that can be seized and sold". – footnotes omitted).

that "restitution in kind is not possible or appropriate" in accordance with Article 7.3.6. In fact, Ripinski and Williams agree that, although "strictly speaking restitution continues to be the primary remedy . . . it is seldom requested" and instead "[c]ompensation is the prevalent remedy".[525] Prof. Brödermann also supports this conclusion, noting:

> The current lessee is a state which uses the Territory to generate substantial income streams, including taxes. This may indicate that it is not "appropriate" to order restitution in kind within the terms which the Sole Arbitrator determines under article 6.2.3 (4). Rather, the circumstances as assumed point towards an allowance in money.[526]

427. Consequently, in accordance with paragraph 2 of Article 7.3.6, "an allowance has to be made in money" by Malaysia to Claimants. Section 3 of the Commentary to Article 7.3.6 clarifies that "[t]he allowance will normally amount to the value of the performance received". Section 4 of the Commentary likewise states that, when restitution in kind is not possible or appropriate, "it imposes a liability on the recipient of the performance to make good the value of that performance".

428. Finally, Section 3 of the Commentary states that "[t]he purpose of specifying that an allowance has to be made in money 'whenever reasonable' is to make it clear that an allowance only has to be made if, and to the extent that, the performance has conferred a benefit on its recipient". Malaysia cannot seriously argue that it obtains no profit from exploiting the natural resources of the Leased Territories. The discussion at § II.M above confirms that Malaysia has obtained – and will continue to obtain – substantial economic benefit from the exploitation of the Leased Territories.

429. The UNILEX database provides the following useful example of the use of Article 7.3.6, reflecting the concept of an allowance in money in lieu of restitution:

> Two Italian companies entered into a works contract for the construction of a water purifying plant. Once completed the plant proved to be seriously defective prompting the owner to bring an action for termination of the contract. The Court, having found that the plant's defects were such as to make it absolutely useless for the purpose for which it had been built, declared the contract terminated in accordance with Article 1455 of the Italian

[525] *Id.*, p. 59.

[526] Third Brödermann Report, ¶ 564.

> Civil Code. Moreover, in accordance with Article 1458 of the Italian Civil Code the Court ordered the parties to return what they had received under the contract. However, <u>since restitution in kind of some parts of the plant was not possible or appropriate because the owner wanted to keep them, the Court granted the contractor an allowance in money corresponding to the value these parts had for the owner</u>. In support of its decision the Court not only pointed out that a similar solution is adopted in both civil law and common law systems but expressly referred to Article 7.3.6 (1) [Art. 7.3.6(2) of the 2010 edition] of the UNIDROIT Principles stating that "[i]f restitution in kind is not possible or appropriate allowance should be made in money whenever reasonable".[527]

430. International practice confirms that "[r]eparation of damage by financial means should generally try to come as closely as possible to the *restitutio in integrum*".[528] The leading international case in this regard is the famed judgment of the Permanent Court of International Justice ("**PCIJ**") in the *Case Concerning the Factory at Chorzów* ("***Chorzów***"). The *Chorzów* case has been described as the "most important judicial decision with respect to international damages law for breach of an international legal standard or obligation", and its dictum is "considered a general principle of international law and even international customary law".[529]

431. In *Chorzów* the PCIJ explained the standard for reparation as follows, placing great emphasis on restitution in kind, and ruling that an allowance in money should be payable in lieu of restitution:

> The essential principle contained in the actual notion of illegal act – a principle which seems to be established by international practice and in particular by decisions of arbitral tribunals – is that the reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed. <u>Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution</u>

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[527] **<u>Doc. CL-110</u>**, *Consorzio Fimedil S.C.A.R.L. v. Tekind S.R.L.*, Tribunale Catania (Italy), Case No. R.G. 8850/05, Decision, 6 February 2009, Abstract (emphasis added).

[528] **<u>Doc. CL-111</u>**, Irmgard Marboe, CALCULATION OF COMPENSATION AND DAMAGES IN INTERNATIONAL INVESTMENT LAW (Oxford University Press, 2009), p. 28.

[529] **<u>Doc. CL-60</u>**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 5.175 (footnotes omitted). *See also* **<u>Doc. CL-111</u>**, Irmgard Marboe, CALCULATION OF COMPENSATION AND DAMAGES IN INTERNATIONAL INVESTMENT LAW (Oxford University Press, 2009), p. 27 ("This general rule is so wide-spread in national legal orders that it can be regarded as a general principle of law" – footnotes omitted); **<u>Doc. CL-59</u>**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 35 ("The dicta of the PCIJ in [*Chorzów*] case have come to be treated by international tribunals as reflecting customary law" – footnotes omitted).

> in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it – such are the principles which should serve to determine the amount of compensation due to an act contrary to international law.[530]

432. The *Chorzów* case is crystal clear that the applicable remedy is "[r]estitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear".[531] Elsewhere, the PCIJ referred to this principle as "the obligation to restore the undertaking and, if this be not possible, to pay its value at the time of the indemnification, which value is designed to take the place of restitution which has become impossible".[532] This is essentially the rule of Article 7.3.6(2) of the UNIDROIT Principles.

### (d) Allowance in Money is Equivalent to Market Value

433. For Prof. Peter Huber, author of one of the seminal commentaries on the UNIDROIT Principles, the "basic rule is that the breach of a restitutionary obligation usually amounts to a non-performance under Art. 7.1.1 [of the UNIDROIT Principles]".[533] In his opinion, the "allowance in money" should "be viewed as a comprehensive rule for whether a monetary claim can be substituted for performance (*i.e.,* restitution) in kind".[534]

434. A party may only be made whole if the restitution value resembles the market value of the asset (here, the rights over the Leased Territories). Indeed, Section 3 of the Commentary to Article 7.3.6 explains that the "allowance will normally amount to the value of the performance received".[535]

435. In his book, Prof. Brödermann believes that determining the reasonableness of the "allowance in money" should "start with the market value at the time when restitution was due".[536] Specifically in this case, Prof. Brödermann notes in his Third Report:

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[530] **Doc. CL-112**, *Case Concerning the Factory at Chorzów*, PCIJ 1928 Ser A, No 17, p. 47 (emphasis added).

[531] **Doc. CL-112**, *Case Concerning the Factory at Chorzów*, PCIJ 1928 Ser A, No 17, p. 47.

[532] *Id.*, p. 48.

[533] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 861.

[534] *Id.,* p. 862.

[535] Emphasis added.

[536] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL

> To determine the quantum, the Sole Arbitrator needs to determine the **market value** of the exploitation of rights over the Territory provided that they have value for the lessee.[537]

436. Likewise, Prof. Huber states that "allowance in money" should "be done in principle by looking at the market value of the performance received".[538] He adds that, when the recipient of the object (here, Malaysia) keeps it, "the recipient's benefit usually equates to the market value of the object".[539]

437. The rule that the allowance in money needs to reflect the market value of the unreturned consideration is also crystallized in international law. As noted in ¶ 432 above, the PCIJ referred in the *Chorzów* case to the principle of *restitutio in integrum* as "the obligation to restore the undertaking and, if this be not possible, to pay its value at the time of the indemnification, which value is designed to take the place of restitution which has become impossible".[540] Without doubt, "value at the time of the indemnification" can refer to nothing else than market value.

438. Authoritative commentaries outside the realm of the UNIDROIT Principles follow the same approach. For Mark Kantor, who has studied damages in international arbitration extensively, "Market Value is the dominant valuation principle for assessing injuries to businesses".[541] For Ripinski and Williams, when "a non-expropriatory violation has produced effects similar to those of an expropriation", "arbitrators have logically chosen to measure the loss, and therefore compensation, by focusing on the market value of the investment lost".[542]

439. The *International Valuation Standards Committee* defines "market value" as the "estimated amount for which an asset or liability should exchange on the

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CONTRACTS (Nomos, 2018), p. 233 (emphasis added).

[537] Third Brödermann Report, ¶ 575 (emphasis original).

[538] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 859 (footnotes omitted).

[539] *Id.* (emphasis added).

[540] **Doc. CL-112**, *Case Concerning the Factory at Chorzów*, PCIJ 1928 Ser A, No 17, p. 48 (emphasis added).

[541] **Doc. CL-58**, Mark Kantor, VALUATION FOR ARBITRATION (Wolters Kluwer, 2008), p. 50.

[542] **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 92. Elsewhere, these authors state that "[f]or the purposes of determining the quantum of damages, the exact obligation breached by the respondent State appears to be irrelevant. The principal question concerns the loss caused to the claimant by the wrongful act: quantification of the loss in monetary terms will give an amount of compensation". *Id.*, p. 90.

valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion".[543] Likewise, the International Glossary of Business Valuation Terms defines fair market value as:

> [T]he price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.[544]

440. These conditions construct an idealized hypothetical market, designed to ensure that the price is determined solely by market forces. Countless international arbitral tribunals have followed the same approach, including *CMS v. Argentina* and *Azurix v. Argentina*,[545] which expressly embraced the above-quoted definition of fair market value from the International Glossary of Business Valuation Terms. In fact, *CMS v. Argentina* described the foregoing as "an internationally recognized definition".[546]

441. Although most provisions on damages should not apply to a claim of restitution because the latter is a self-contained regime,[547] it may be useful to show that the result is the same if we were to apply the UNIDROIT Principles' rules on damages. Under those Principles, any compensation must comply with the notion of "full compensation", embodied in Article 7.4.2:

> (1) <u>The aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance</u>. Such harm includes both any loss which it suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm.

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543 **<u>Doc. CL-113</u>**, International Valuation Standards Council, INTERNATIONAL VALUATION DEFINITIONS, "Market Value".

544 **<u>Doc. CL-114</u>**, INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (AICPA), "Fair Market Value", p. 44.

545 **<u>Doc. CL-102</u>**, *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Award, 12 May 2005, ¶ 402; **<u>Doc. CL-115</u>**, *Azurix Corp. v. The Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006, ¶ 424.

546 **<u>Doc. CL-102</u>**, *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8, Award, 12 May 2005, ¶ 402. *See also* **<u>Doc. CL-104</u>**, *CME Czech Republic B.V. v. The Czech Republic, Ad Hoc*, Final Award, 14 March 2003, ¶ 497 (concluding that customary international law required full compensation equivalent to the fair market value of the expropriated investment).

547 *See* ¶ 433, *supra.*

> (2) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.[548]

442. According to Section 1 of the Commentary to Article 7.4.2, "this Article establishes the principle of the aggrieved party's entitlement to full compensation for the harm it has sustained as a result of the non-performance of the contract". Or, as Prof. Ewan McKendrick explains, full compensation means "making good of losses suffered and compensation for profits lost".[549]

443. According to Section 2 of the Commentary, "the aggrieved party is entitled to compensation in respect not only of loss which it has suffered, but also of any gain of which it has been deprived as a consequence of the non-performance".[550] The distinction is widely referred to as direct damages versus loss of profit. Both need to be understood liberally:

> The notion of loss suffered must be understood in a wide sense. It may cover a reduction in the aggrieved party's assets or an increase in its liabilities which occurs when an obligee, not having been paid by its obligor, must borrow money to meet its commitments. The loss of profit or, as it is sometimes called, consequential loss, is the benefit which would normally have accrued to the aggrieved party if the contract had been properly performed. . . .[551]

444. A simple way to understand this is that compensation must make the aggrieved party (*i.e.*, Claimants) indifferent between financial compensation and restitution (*i.e.*, returning the rights over the Leased Territories) from the moment of termination of the agreement onward.

445. An arbitral tribunal constituted under the auspices of the *Centro de Arbitraje de México* (CAM) concluded that Article 7.4.2 embodies the rule of *restitutio in integrum*, which intends to return the aggrieved party "*en la situación que hubiera*

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[548] Emphasis added. *See also* **Doc. CL-116**, ICC Case No. 11849, Award, 2003, ¶ 76 ("Art. 7.4.2 of the Unidroit principles also provides, as an expression of a generally accepted principle of law, that the harm suffered by the aggrieved party includes any gain of which such party has been deprived".).

[549] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 873 (emphasis omitted).

[550] Emphasis added.

[551] Emphasis added.

*tenido de no haberse presentado el incumplimiento*". In other words, "*la parte agraviada tiene derecho a una reparación integral*".[552]

446. This standard of full compensation is the result of a longstanding line of precedents in international law. Under *Chorzów*, discussed at ¶¶ 431-432 above, the compensation must "wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed".[553] The *Chorzów* case is often referred to as "the measure of damages as applied in international law"; scholars agree that *to wipe out all consequences of the illegal act* "means full reparation or full compensation".[554]

#### (e) Key Criteria to Calculate the Restitution Value of the Leased Territories

##### (i) The 1878 Agreement Should Terminate as of January 2013, or in the alternative, February 2020

447. If the Sole Arbitrator terminates the 1878 Lease Agreement due to hardship,[555] pursuant to Article 6.2.3 of the UNIDROIT Principles, he may do so "at a date and on terms to be fixed". In such a case, the most appropriate date would be 1 January 2013, when Malaysia first breached the 1878 Lease Agreement. The restitution value therefore should be calculated as of that time. The above must be understood in light of the fact that, since at least 1989, Claimants have tabled ending the 1878 Lease Agreement (*see* § II.N above). This undeniably supports its early termination.

448. Prof. Brödermann considers this termination date to be a conservative target, contending that it could legitimately be much earlier. He notes that the Sole Arbitrator may be guided by certain factors when making any such determination. Those factors include: the conduct of the parties, and the nature and purpose of the contract.[556]

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[552] **Doc. CL-117**, Centro de Arbitraje de México (CAM), Unknown Case No., 30 November 2006, ¶ 163.

[553] **Doc. CL-112**, *Case Concerning the Factory at Chorzów*, PCIJ 1928 Ser A, No 17, ¶ 47.

[554] **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 2.06. *See also id.*, ¶ 5.180 ("The reference to 'wipe out all consequences of the illegal act' establishes the full compensation principle for damages in international law.").

[555] *See* § IV.D, *supra.*

[556] Third Brödermann Report, ¶ 548.

449. With respect to party conduct, Prof. Brödermann notes that Claimants reached out to Malaysia for decades, at the latest in 1989, in an attempt to renegotiate. Meanwhile, despite its general duty of cooperation, Malaysia continued to exploit the Leased Territories on its own terms, completely ignoring Claimants' requests for renegotiation.[557] As for the nature and purpose of the contract, Prof. Brödermann notes that the 1878 Lease Agreement governed the exploitation of territorial rights, in which hardship regularly unfolded over decades.[558]

450. Prof. Brödermann concludes:

> To sum up, in the context of a contract in existence since over 140 years and efforts to renegotiate in light of unfolding hardship over decades, at least since April, 1999, the margin of discretion of the Sole Arbitrator to decide upon a reasonable termination date with regard to the principle of good faith and fair dealing (article 1.7) underlying hardship would cover therefore a termination date far earlier than January 2013. In this context, he may also consider the conduct of the lessee if, over decades, the lessee did not abide by its duty of cooperation under article 5.1.3 (also expressing a general principle of law and trade usage) by not reacting and communicating with the lessor about various requests of renegotiation, regardless of their specific form.[559]

451. Accordingly, if the Sole Arbitrator orders termination under Article 6.2.3, 1 January 2013 is an appropriate – indeed, a conservative – date.

452. Even if, instead of hardship, the Sole Arbitrator declares termination for breach of contract (Article 7.3.1 of the UNIDROIT Principles; *see* § IV.E above) or as a contract for an indefinite period (Article 5.1.8 of the UNIDROIT Principles; *see* § IV.F above), the termination date should remain 1 January 2013, and the restitution value should likewise be calculated from then.[560] The termination date should match the date of Malaysia's breach. Malaysia must have been aware of the 1878 Lease Agreement's potential termination at that point, and knew since at least 1989 that Claimants had the Agreement's termination in mind.

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[557] *Id.*

[558] *Id.*

[559] *Id.*, ¶ 549.

[560] **<u>Doc. CL-61</u>**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 232 (noting that, when an obligor has not performed, the "termination with *ex nunc* (prospective) effect would still take place <u>prior to performance by the obligor</u>" – emphasis in original).

453. Alternatively, the Sole Arbitrator should terminate the 1878 Lease Agreement on February 2020 or the date of the arbitral award. February 2020 is an acceptable proxy for the arbitral award and is the date on which the latest data for the calculation of a restitution value became available.[561]

454. Given that termination under the UNIDROIT Principles is a remedy with *prospective* effects only, fixing the termination date here affects the calculation of the restitution value. If the Sole Arbitrator deems the 1878 Lease Agreement terminated from January 2013, all economic benefits from then onward should form part of the restitution value (since Claimants would have collected those economic benefits if Malaysia had tendered restitution upon termination). We explain this in § V.B(f) below. Conversely, if the Sole Arbitrator deems the 1878 Lease Agreement terminated in February 2020 or later, Claimants will have a claim for restitution value as of that date, plus a claim for (rebalanced) unpaid rent from 2013 until termination, under the rubric of non-performance damages. We explain this in § V.B(g) below.

455. Prof. Wöss and others believe that there is no pre-established rule for determining the date of valuation, but the selection of the date must reflect the principle of full compensation:

> There is no pre-established practice as to the determination of a date of valuation of damages, in particular, in the case of complex long-term contracts. However, the date of the valuation has to be the most appropriate in the light of the full compensation principle, which means that the valuation has to restore the financial position that the injured party would have had at the date of the award, as this is the date when the injured party should receive the damages.[562]

456. For Wöss and others, "[f]ull compensation under the Chorzów case means awarding the higher of the value of the [asset] at the moment of breach or at the moment of the award".[563] In other words, according to the *Chorzów* standard, in order to achieve full compensation, an arbitral tribunal must award damages equivalent to the higher valuation of "the undertaking as of the date of the violation

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[561] Brattle Report, ¶ 26.

[562] **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 5.116.

[563] *Id.*, ¶ 5.180.

and the date of the award plus the lost profits between the date of the violation and the date [on which] the award is awarded".[564]

457. As detailed below, termination in 2013 yields a higher monetary amount than termination at a later date. Therefore, the Sole Arbitrator should consider the 2013 termination date first.

#### (ii) Claimants Should Receive Between 10% - 20% of the Leased Territories' Economic Benefits

##### (1) Introduction

458. We have instructed Brattle to account for the fact that Claimants cannot credibly claim 100% of Malaysia's revenues from the Leased Territories for restitutionary purposes. Even though the Sultan bargained for 100% of his economic losses (5,000 dollars) in return for granting the lease, he understood that the lease was worth considerably more to Overbeck and Dent.[565]

459. By the same token, Claimants today could not manage the Leased Territories without a concessionaire or operator. That operator originally was Messrs. Overbeck and Dent, followed by the Company, the Crown Colony of North Borneo, and today Malaysia. Claimants for this purpose consider Malaysia to be like a property manager: the manager invests in the property to make it lucrative and maintains the lion's share of the revenues and profits; the owner is awarded a percentage of these revenues. Here, Claimants seek a reasonable percentage of Malaysia's overall economic benefits for Sabah's oil, gas, and palm oil production.

460. To determine the applicable share due to Claimants, we have analyzed the royalty rates of various countries, the practices and promises of the Federal and State Governments of Malaysia and Sabah with respect to their royalties, and the historical expectations of the Sultanate's revenue stream. As we explain below, Claimants consider a restitution value that reflects 20% (*see* § V.B(e)(ii)(2) below), 15% (*see* § V.B(e)(ii)(3) below) or 10% (*see* § V.B(e)(ii)(4) below) of Malaysia's economic benefit from the Leased Territories to be appropriate. Historical records indicate that the Sultan levied a tax between 10% and 25% on all goods from his

[564] *Id.*, ¶ 5.196.

[565] **Doc. C-62**, Letter from William Treacher to the Earl of Derby, 14 May 1878, in Dent and Overbeck Concession 1877-8, The National Archives (United Kingdom).

subjects outside of Sulu.[566] Claimants' Claim follows this order of preference. We disregard the 25% figure because it is outside the modern mainstream for royalties, and focus instead on the lower figures.

### (2) The Case for 20% Royalties

461. In the 2018 election, the Pakatan Harapan coalition government and Malaysia's Prime Minister Mahathir Mohamad, acknowledging the historic underpayment of royalties to Sabah, promised to quadruple the oil royalty to the Sabah government. The oil royalty therefore was to be increased to 20%.[567] The Malaysian Government's acknowledgment of Sabah's right to a 20% royalty supports applying a 20% share to the economic benefits Malaysia receives from the Leased Territories.

462. The Pakatan Harapan coalition fell apart in early 2020, before any 20% royalty rate was implemented.[568] Given the current state of federal Malaysian politics, it is unclear when or whether the 20% rate will apply. A 20% royalty rate nonetheless is the norm in Algeria, Nigeria (onshore), Venezuela, and Uzbekistan.[569]

### (3) The Case for 15% Royalties

463. An alternative approach is to apply a 15% share to Malaysia's economic benefits. Fifteen percent includes the 10% royalty the Malaysian government levies on the value of all oil and gas produced in Sabah,[570] and the newly imposed 5% sales tax on petroleum products instituted by the Sabah government in April 2020, pursuant to the State Sales Tax Ordinance 1998.[571] Sabah imposed this new sales

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[566] **Doc. C-58**, James F. Warren, TRADE, RAID, SLAVE: THE SOCIO-ECONOMIC PATTERNS OF THE SULU ZONE, 1770-1889 (Australian National University, Canberra 1975), p. 18; *see also* **Doc. C-59**, Nicholas Tarling, SULU AND SABAH, A STUDY OF BRITISH POLICY TOWARDS THE PHILIPPINES AND NORTH BORNEO FROM THE LATE EIGHTEENTH CENTURY (Oxford University Press, 1978), p. 75.

[567] **Doc. C-108**, Natasha Joibi, *Sabah to continue pursuit of 20% oil royalty, but "as a family" and "team"*, THESTAR, 31 July 2018.

[568] **Doc. C-109**, Yen Nee Lee, *Malaysia's Mahathir unexpectedly quit as prime minister – but he could come back*, CNBC, 25 February 2020.

[569] **Doc. C-110**, *Crude Oil Royalty Rates*, LIBRARY OF CONGRESS LAW. The Venezuelan standard royalty is in fact 30%; the 20% rate applies only if the oil field is not otherwise economically exploitable.

[570] Brattle Report, ¶ 66. Five percent royalty goes to Malaysia and 5% royalty goes to Sabah.

[571] **Doc. C-111**, Muguntan Vanar, *Sabah Imposes 5% sales tax on petroleum products*, THESTAR, 7 April 2020; *see also* **Doc. C-112**, Larissa Lumandan, *High Court rules Sabah, Sarawak can impose sales tax on petroleum products*, FMTNEWS, 13 March 2020.

tax after the federal government failed to follow through with its 2018 promise of a 20% royalty to Sabah.[572]

464. An approximate 15% royalty rate is the norm in Kuwait and Libya (16.67%), Chad (14.25%-16.5% crude oil) and is close to the average rate in Colombia (8% - 25%) and Ecuador (12.5% - 18.5%).[573]

### (4) The Case for 10% Royalties

465. A final alternative is to apply a 10% share to Malaysia's economic benefits. This 10% share is equivalent to the 10% royalty levied by Malaysia on the value of all oil and gas produced in Sabah.[574] The 10% is also close to the ratio of the Dent Brothers' estimate of the territory's value,[575] compared with the Sultan's annual lease payments according to their correspondence,[576] as well as the ratio of those annual payments to the Company's annual revenue in its first reported year.[577]

466. A 10% royalty rate is the norm, or close to it, in Argentina (12%), Australia (10% - 12%), India (10% - 12.5%), Nigeria (deepwater), Croatia, Guinea, and Iraq.[578]

467. Malaysia has hugely benefited from the grossly imbalanced state of the 1878 Lease Agreement for more than 50 years, at Claimants' direct expense. Applying a minor portion of Malaysia's real and anticipated gains from the time of its breach of the 1878 Lease Agreement – at most one fifth, at least one tenth – is both equitable and reasonable.

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[572] **Doc. C-111**, Muguntan Vanar, *Sabah Imposes 5% sales tax on petroleum products*, THESTAR, 7 April 2020; *see also* **Doc. C-112**, Larissa Lumandan, *High Court rules Sabah, Sarawak can impose sales tax on petroleum products*, FMTNEWS, 13 March 2020.

[573] **Doc. C-110**, *Crude Oil Royalty Rates*, LIBRARY OF CONGRESS LAW; *see also* **Doc. C-113**, Global Oil and gas tax guide 2019, EYREPORT (2019).

[574] Brattle Report, ¶¶ 56, 66(a).

[575] *See* ¶ 52, *supra.*

[576] **Doc. C-63**, Letter from Alfred Dent to Edward Dent, 18 February 1878, in CO 874/180, The National Archives (United Kingdom), p. 9.

[577] **Doc. C-69**, British North Borneo Company Books, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom), pp. 268-269.

[578] **Doc. C-110**, *Crude Oil Royalty Rates*, LIBRARY OF CONGRESS Law; *see also* **Doc. C-113** *Global Oil and gas tax guide 2019*, EYREPORT (2019).

### (f) The Sole Arbitrator Should Terminate the 1878 Lease Agreement as of January 2013 and Award Full Restitution

#### (i) Introduction

468. If the 1878 Lease Agreement is terminated as of 1 January 2013, the restitution value – which is the measure of Claimants' compensation – must comprise:

(i) a lump-sum amount to Claimants for the stream of economic benefits that they would have received if they had leased the Leased Territories since 1 January 2013 to Malaysia or someone else according to the current measure of economic benefits obtained by the lessee; plus

(ii) a lump-sum amount to Claimants for the going-forward stream of economic benefits that they would expect to receive if they were to lease the Leased Territories to Malaysia or someone else according to the current measure of economic benefits obtained by the lessee.

469. Brattle has calculated: (i) the backwards-looking or historical value of the rights over the Leased Territories from 2013 (when Malaysia stopped paying rent) through February 2020 (see § V.B(f)(ii) below); (ii) the present value of the rights over the Leased Territories as of February 2020 (see § V.B(f)(iii)(1) below); and (iii) an equitable value of the rights over the Leased Territories for post-2044 oil and gas income, where no reliable forecasts exist (see § V.B(f)(iii)(2) below).

#### (ii) The Quantum of Claimants' Right to Past Economic Benefits

470. Malaysia has received substantial economic benefits from the Leased Territories since 1 January 2013. Therefore, if the 1878 Lease Agreement is terminated as of 1 January 2013, the restitution value shall constitute a lump-sum amount to Claimants in return for the stream of economic benefits that they would otherwise have received from the Leased Territories, had they regained the rights over them on that termination date.

##### (1) The Sole Arbitrator Can Use Retrospective Information when Assessing Damages

471. Manuel A. Abdala, Pablo T. Spiller and Sebastian Zuccon believe that "the use of *ex-post* information has its own advantages" because "*ex-post* information on the evolution of [crucial damage drivers] may turn out to be the most reasonable

assumption about the parties' *ex-ante* information, and thus of the quantum of damages".[579]

472. In our case, fixing the termination date in January 2013 does not deprive the Sole Arbitrator of hindsight data to ascertain the restitution value of the Leased Territories as of that date. This is because at the time of termination in January 2013 all subsequent events, known today, had a degree of uncertainty. Using expectations from January 2013 without accounting for the realities from then until the present may end up under-compensating (or over-compensating) Claimants. We need not apply oil, gas and palm oil price forecasts from January 2013 about the price from 2013-2020; we know what the prices were. The principle of "full compensation" implies that historical losses should be treated as they are – using hindsight – rather than as they might have been from Claimants' perspective in January 2013.

473. Conversely, discounting historical losses to the date of termination in January 2013 and then bringing them forward to the date of the award runs the risk of what Manuel A. Abdala, Palo D. Lopez Zadicoff and Pablo T. Spiller call the "Invalid Round Trip". By discounting cashflows at a risk-adjusted interest rate to bring them forward to the date of the award, the Sole Arbitrator may order compensation for award for historical losses at a value which, as of the date of the award, could be lower than the value of the historical loss at the time it occurred.[580] As of the date of the award, the Sole Arbitrator can ascertain going-forward damages with a much higher degree of certainty than using only information available in January 2013. The reason is simple: the Sole Arbitrator need not forecast the (now) historical losses as of 1 January 2013. Why gaze into a crystal ball when you already know the answer? Other authors agree from a legal perspective that "[p]ast losses are generally brought to their present-day values by adding interest, while future losses are discounted".[581]

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[579] **Doc. CL-118**, Manuel A. Abdala *et al.*, *Chorzów's Compensation Standard as Applied in ADC v. Hungary*, 4(3) TDM (2007), pp. 3-4.

[580] **Doc. CL-119**, Manuel A. Abdala, Pablo D. López Zadicoff and Pablo T. Spiller, *Invalid Round Trips in Setting Pre-Judgment Interest in International* Arbitration, 5(1) WORLD ARBITRATION AND MEDIATION REVIEW (2011), pp. 1-21. *See also* **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶¶ 6.61, 6.109-6.113.

[581] **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW

474. This is precisely the approach taken by the U.S. Supreme Court in its seminal decision in *Sinclair Refining Co. v. Jenkins Petroleum Process Co.* of 1933:

> The law will make the best appraisal that it can, summoning to its service whatever aids it can command. . . . At times the only evidence available may be that supplied by testimony of experts as to the state of the art, the character of the improvement, and the probable increase of efficiency or saving of expense. . . . But a different situation is presented if years have gone by before the evidence is offered. Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within. . . . To correct uncertain prophecies [for a breach of contract or a tort claim] is not to charge the offender with elements of value nonexistent at the time of his offense. It is to bring out and expose of light the elements of value that were there from the beginning.[582]

475. The European Court of Human Rights (the "**ECHR**") has considered post-expropriation events in valuing expropriated property under the European Convention of Human Rights.[583] Notable in this respect is *Scordino v. Italy*, where the ECHR analyzed a long line of ECHR jurisprudence based on the PCIJ's *Chorzów* case, in which the ECHR consistently valued land in accordance with its current value (*i.e.*, taking into account information after the occupation by the authorities).[584] The ECHR summarized its position as follows:

> An analysis of the three above-mentioned cases, which all concern cases of inherently unlawful dispossession, shows that, in order to fully compensate the loss incurred, the Court has awarded amounts taking account of the current value of land in the light of today's property market. It has also sought to compensate loss not covered by payment of that amount, by taking account of the potential of the land in question, calculated, if applicable, on the basis of the construction costs of buildings put up by the expropriating authority. Taking account of the foregoing considerations, the Court believes that in the present case, the nature of the violation found in the principal judgment enables it to adopt the principle of restitutio

(British Institute of International and Comparative Law, 2008), p. 115.

582 **Doc. CL-120**, *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 289 US 689 (1933), p. 698 (internal citations omitted).

583 **Doc. CL-121**, Irmgard Marboe, *Compensation and Damages in International Law – "The Limits of Fair Market Value"*, 7 JOURNAL OF WORLD INVESTMENT & TRADE 723 (2006), p. 752 (*citing* **Doc. CL-122**, *Belvedere Alberghiera Srl v. Italy*, ECHR No. 31524/96, 30 October 2003, ¶¶ 32-36; **Doc. CL-123**, *Motais de Narbonne v. France*, ECHR No. 48161/99, 27 May 2003, ¶ 19; and **Doc. CL-Doc. CL-124**, *Terazzi v. Italy*, ECHR No. 27265/95, 26 October 2004, ¶ 37).

584 **Doc. CL-124**, *Scordino v. Italy*, ECHR No. 43662/98, 6 March 2007, ¶¶ 31-35.

> in integrum. Consequently, the Court considers that the return of the land in issue ... would put the applicants as far as possible in a situation equivalent to the one in which they would have been if there had not been a breach of Article 1 of Protocol No. 1; the award of the existing buildings would then fully compensate them for the consequences of the alleged loss of enjoyment. . . . If such restitution is not made, the Court considers that the compensation to be awarded to the applicants is not limited to the value of their property on the date of occupation. It decides that the State should pay to the parties concerned a sum corresponding to the current value of the land (EUR 1,329,840), from which must be deducted the compensation obtained by the applicants at national level (namely, ITL 264,284,339 in 1982, see paragraph 25 of the principal judgment) and updated (that is, approximately EUR 436,000). To this amount will be added an amount for appreciation brought about by the presence of buildings – which in the present case has been estimated at the same level as the construction costs – and which is also capable of compensating the applicants for any other loss they have incurred.[585]

476. Similarly, in *Belvedere Alberghiera Srl v. Italy*, the ECHR found that any compensation must take into account all circumstances surrounding the land since its illegal occupation:

> As it is the inherent unlawfulness of the expropriation which was at the origin of the breach found, the compensation must necessarily reflect the full value of the property. With regard to pecuniary damage, the Court therefore holds that the compensation to be awarded to the applicant is not limited to the value of the property when it was occupied. For that reason, it requested the expert to estimate also the current value of the land in issue and the other heads of damage. The Court decides that the State shall pay the applicant the current value of the land. To that amount shall be added a sum for loss of enjoyment of the land since the authorities took possession of it in 1987 and for the depreciation of the property. Furthermore, in the absence of comments from the Government on the expert report, an amount shall be awarded for loss of income from the hotel activity.[586]

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[585] *Id.*, ¶¶ 36-38 (emphasis added).

[586] **Doc. CL-122**, *Belvedere Alberghiera Srl v. Italy*, ECHR No. 31524/96, 30 October 2003, ¶¶ 34-36 ("*Comme c'est l'illégalité intrinsèque de la mainmise, qui a été à l'origine de la violation constatée, l'indemnisation doit nécessairement refléter la valeur pleine et entière des biens. S'agissant du dommage matériel, la Cour estime par conséquent que l'indemnité à accorder à la requérante ne se limite pas à la valeur qu'avait sa propriété à la date de l'occupation. Pour cette raison, elle a invité l'expert à estimer aussi la valeur actuelle du terrain litigieux et les autres préjudices. La Cour décide que l'Etat devra verser à l'intéressée la valeur actuelle du terrain. A ce montant s'ajoutera une somme pour la non-jouissance du terrain depuis que les autorités on pris possession du terrain en 1987 et pour la dépréciation de l'immeuble. En outre, à défaut de commentaires du Gouvernement*

477. All estimates have a degree of uncertainty. But if good evidence subsequent to the injury event does exist, a court or an arbitrator may reasonably conclude that that evidence should be taken into account. If the Sole Arbitrator concludes that the 1878 Lease Agreement ended on 1 January 2013, he should consider the known information of the Leased Territories' worth from 2013-2020 to ascertain the restitution value as of that termination date.

#### (2) Calculation of Past Restitution Value

478. As noted above, Brattle has calculated that Malaysia made US$ 25.75 billion from hydrocarbons (see ¶¶ 134-137 above) and a further US$ 2.58 billion from palm oil (see ¶ 160-161 above) in the Leased Territories between 1 January 2013 and February 2020.

479. Brattle has calculated that the applicable pre-award interest rate is 3.96% per annum.[587] This interest rate has been calculated in accordance with Articles 7.4.9 and 7.4.12 of the UNIDROIT Principles, as we explain in § V.D(c) below.

480. Applying the above interest rate to past restitution value calculated as if Malaysia had returned the Leased Territories on 1 January 2013, Brattle concludes that the historical restitution value payable to Claimants since 1 January 2013 is **US$ 6.50 billion** (applying a 20% share), **US$ 4.87 billion** (applying a 15% share) or **US$ 3.25 billion** (applying a 10% share).[588] Table 23 below (taken from the Brattle Report) summarizes the various sources of economic benefits, applying the corresponding shares that Claimants should have obtained:

*sur l'expertise, il y a lieu d'octroyer une somme pour le manque à gagner dans l'activité hôtelière."* – unofficial translation).

[587] Brattle Report, ¶¶ 196-197.

[588] *Id.*, ¶ 218.

Table 23: Restitution Value 2013-2020

| | | |
|---|---|---|
| Valuation date | [1] See note | 01/02/20 |
| MYR to USD Rate MYR/USD | [2] See note | 4.16 |
| **Historical Benefits, USD** | | |
| Oil and Gas USD bln | [3] See note | 29.49 |
| Palm Oil USD bln | [4] See note | 2.99 |
| Total USD bln | [5] [3]+[4] | 32.49 |
| **Claimant's Share, USD** | | |
| 10% Share USD bln | [6] [5]x10% | 3.25 |
| 15% Share USD bln | [7] [5]x15% | 4.87 |
| 20% Share USD bln | [8] [5]x20% | 6.50 |
| **Claimant's Share, MYR** | | |
| 10% Share MYR bln | [9] [2]x[6] | 13.52 |
| 15% Share MYR bln | [10] [2]x[7] | 20.28 |
| 20% Share MYR bln | [11] [2]x[8] | 27.04 |

Notes and sources:
[1], [3], and [4]: Brattle Workpapers B, Rebalancing the Lease.
[2]: MYR to USD exchange rate as of Feb. 1st, 2020.

### (iii) The Quantum of Claimants' Right to Future Economic Benefits

#### (1) Forward-Looking Restitution Value

481. Brattle forecasted the economic benefits to Malaysia from (i) continued oil and gas development in the Leased Territories from 2020 out to 2044 (the last year in which there are reliable forecasts) (*see* § II.M(c)(v) above); and (ii) the ongoing cultivation of oil palms in the Leased Territories out to perpetuity (*see* § II.M(d)(iii) above).[589] Table 24 (taken from the Brattle Report) indicates the present values and applies the 20%, 15% and 10% sharing factors:

[589] As opposed to oil and gas, oil palms may be replanted and regenerated. *Id.*, ¶ 146.

Table 24: Post-2020 Restitution Value

| | | | |
|---|---|---|---|
| Valuation date | [1] | See note | 01/02/20 |
| MYR to USD Rate MYR/USD | [2] | See note | 4.16 |
| **Forecasted Benefits, USD** | | | |
| Oil and Gas USD bln | [3] | See note | 57.88 |
| Palm Oil USD bln | [4] | See note | 9.12 |
| Total USD bln | [5] | [3]+[4] | 66.99 |
| **Claimant's Share, USD** | | | |
| 10% Share USD bln | [6] | [5]x10% | 6.70 |
| 15% Share USD bln | [7] | [5]x15% | 10.05 |
| 20% Share USD bln | [8] | [5]x20% | 13.40 |
| **Claimant's Share, MYR** | | | |
| 10% Share MYR bln | [9] | [2]x[6] | 27.89 |
| 15% Share MYR bln | [10] | [2]x[7] | 41.83 |
| 20% Share MYR bln | [11] | [2]x[8] | 55.77 |

Notes and sources:
[1], [3], and [4]: Brattle Workpapers B, Rebalancing the Lease.
[2]: MYR to USD exchange rate as of Feb. 1st, 2020.

482. Brattle concludes that the present value of forward-looking restitution for the Leased Territories is **US$ 13.40 billion** (applying a 20% share), **US$ 10.05 billion** (applying a 15% share) or **US$ 6.70 billion** (applying a 10% share).[590]

483. Note that Brattle forecasted benefits relating only to existing oil and gas fields. Brattle did not consider the potential for new drilling campaigns in existing oil and gas fields, or exploration of new areas that would result in increased production and benefits for Malaysia.[591] Therefore, the potential economic benefits arising from these streams are excluded from the calculation in ¶ 481 above.

### (2) Restitution Value for Post-2044 Oil and Gas Economic Benefits

484. In addition to the already-developed oil and gas fields, which Brattle has only valued through 2044, the Malaysian Sabah basin contains a further 83 contingent oil and gas fields, with a total of 434 million barrels in oil reserves and 561 million barrels of oil equivalent in gas reserves.[592] The Malaysian Sandakan basin has seen several undeveloped oil and gas discoveries, and there could be future discoveries in the Malaysian side of the Tarakan basin.[593] Each basin is within the remit of the

[590] *Id.*, ¶¶ 220-221.
[591] *Id.*, ¶ 222 and n. 187.
[592] *Id.*, ¶ 44.
[593] *Id.*, ¶ 45.

Leased Territories. Contingent fields have not yet been developed, but may be in the future, depending on access to infrastructure, technology improvements, price levels, and new fiscal terms. Malaysia will obviously continue to benefit from these after 2044.

485. If these future economic benefits are not included within the restitution value to be paid to Claimants, they would obviously be undercompensated. According to Article 7.4.3 of the UNIDROIT Principles, future damages are included within the scope of the principle of full compensation, which is the standard for compensation under those Principles:

> (1) Compensation is due only for harm, including future harm, that is established with a reasonable degree of certainty.
>
> (2) Compensation may be due for the loss of a chance in proportion to the probability of its occurrence.
>
> (3) Where the amount of damages cannot be established with a sufficient degree of certainty, the assessment is at the discretion of the court.[594]

486. Section 1 of the Commentary to Article 7.4.3 states: "[p]aragraph (1) permits the compensation also of future harm, i.e. harm which has not yet occurred, provided that it is sufficiently certain". The test of certainty is "balance of probabilities".[595]

487. This Claim meets those criteria. Claimants seek the economic benefits that they would otherwise obtain by leasing the Leased Territories in the future market. The Leased Territories indubitably exist, produce revenue and will continue producing revenue from oil and gas in the future. Anyone considering leasing the Leased Territories today would take into account that they will continue to yield revenue after 2044. Malaysia's failure to return the rights over the Leased Territories will prevent Claimants from obtaining future economic benefit from them, despite the absolute certainty that Malaysia will profit. Future economic benefits beyond 2044 cannot be precisely quantified. They can nonetheless be estimated, and damages can be awarded for them on a discretionary and equitable basis.

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[594] Emphasis added.

[595] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 242.

488. Paragraph 1 of Article 7.4.3 of the UNIDROIT Principles expressly includes "future harm" as a head of damages under the full compensation principle.[596] Paragraph 3 provides that, "[w]here the amount of damages cannot be established with a sufficient degree of certainty, the assessment is at the discretion of the court". This Article clearly provides both that future damages must be compensated, and that the arbitrator has full discretion to assess future damages when they "cannot be established with a sufficient degree of certainty". The Commentary confirms the arbitrator's discretion in these situations: "According to paragraph (3), where the amount of damages cannot be established with a sufficient degree of certainty then, rather than refuse any compensation or award nominal damages, the court is empowered to make an equitable quantification of the harm sustained".[597]

489. According to Prof. Brödermann, if damages exist but cannot be calculated with a reasonable degree of certainty, paragraph 3 of Article 7.4.3 "grants discretion to the court for an equitable quantification of the harm sustained".[598] Prof. John Y. Gotanda has written that "under the UNIDROIT Principles and under some laws, where the amount of damages cannot be established with sufficient degree of certainty, the assessment is at the discretion of the tribunals".[599] He believes that the amount of damages "does not need to be established concretely or with certainty", because that "would place an almost unsurmountable burden on the claimant while benefiting the party who caused the damage. . .".[600] According to Mark Kantor, "[n]ational laws and international law do not require that future revenues, expenses or profits be proved with absolute certainty", and "the absence of express party authorization to resolve a valuation issue equitably may not prove an impenetrable barrier to an arbitrator's employment of equitable principles".[601] For Robert L. Dunn, "[w]hile the proof of the *fact* of damages must be certain, proof of

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[596] *See* ¶¶ 441-446, *supra.*

[597] Emphasis added.

[598] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 243 (emphasis omitted, internal quotation marks omitted).

[599] **Doc. CL-125**, John Y. Gotanda, *Assessing Damages in International Commercial Arbitration: A Comparison with Investment Treaty Disputes*, 4(6) TDM (November 2007), p. 3.

[600] *Id.*, p. 5.

[601] **Doc. CL-58**, Mark Kantor, VALUATION FOR ARBITRATION (Wolters Kluwer, 2008), pp. 71, 117 (footnotes omitted).

the *amount* may be an estimate, uncertain or inexact".[602] Richard H. Kreindler, a well-known international arbitration practitioner, believes that "arbitrators can evaluate the damages by an *appréciation souveraine* or by invoking equity in order to make an overall judgment of various damages when they are not precisely identified, but when it is proven that damages have been suffered".[603]

490. Arbitral tribunals have adopted the same approach when dealing with Article 7.4.3 of the UNIDROIT Principles. In an arbitration under the auspices of the *Centro de Arbitraje de México (CAM)*, the Arbitral Tribunal held that "*[e]l artículo 7.4.3 de los Principios Unidroit otorgan la facultad al Tribunal de cuantificar la indemnización por daños y perjuicios cuando los mismos no puedan establecerse con suficiente grado de certeza*".[604] Similarly, in ICC Case No. 10422, the Arbitral Tribunal held that lost profit should be calculated on net, rather than gross, margins on sales forecasts. Since the claimant did not provide any information to calculate the net margin, however, the Arbitral Tribunal quantified the lost profit on an equitable basis, under Article 7.4.3(3) of the UNIDROIT Principles.[605]

491. The Eritrea-Ethiopia Claims Commission, established in connection with those countries' 1998-2000 conflict, admitted when determining the appropriate compensation for each of the established violations that in most cases it could only make "the best estimat[e] possible on the basis of the available evidence".[606] In support of this approach, the Commission (comprising 5 well-known international practitioners) pointed out that awarding damages for uncertain losses on the basis of mere estimation, or even guesswork, was generally acceptable at both domestic and international levels, and – with respect to the latter – expressly referred to in Article 7.4.3(3) of the UNIDROIT Principles.

492. The U.N. Compensation Commission was created by the U.N. Security Council to adjudicate compensation for losses arising out of Iraq's invasion and

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[602] *Id.*, p. 73 (emphasis in original).

[603] **Doc. CL-126**, Yves Derains and Richard H. Kreindler, EVALUATION OF DAMAGES IN INTERNATIONAL ARBITRATION (ICC Institute of World Business Law, 2006), p. 19.

[604] *See also* **Doc. CL-117**, Centro de Arbitraje de México (CAM), Unknown Case No., 30 November 2006, ¶ 177.

[605] **Doc. CL-127**, ICC Case No. 10422, Award, 2001.

[606] **Doc. CL-128**, *The State of Eritrea v. The Federal Democratic Republic of Ethiopia*, Eritrea-Ethiopia Claims Commission, Award, 17 August 2009, ¶ 37.

occupation of Kuwait. In its Recommendation S/AC.26, 23 September 1997, the Commission noted that many of the claims produced insufficient evidence to demonstrate the amount of the loss with a reasonable degree of certainty. The Commission decided, "in conformity with general principles of law", to exercise its discretion in assessing the amount of compensation that should be awarded. In support of its decision the Commission referred, among others, to Article 7.4.3(3) of the UNIDROIT Principles.[607]

493. The *Gemplus v. Mexico* ICSID Arbitral Tribunal clarified that Article 7.4.3(1) of the UNIDROIT Principles "does not depend upon the tribunal or court acting *ex aequo et bono*".[608] It described the wide powers of an arbitral tribunal in ascertaining future damages:

> [T]he Tribunal rejects any argument that because the quantification of loss or damage in the form of lost future profits is uncertain or difficult, that the Claimants should be treated in this case as having failed to prove an essential element of their claims in respect of lost future profits, with the result that their claims for compensation should be dismissed. The Tribunal considers that this approach is not required by the terms of either BIT or international law; and that it would also produce a harsh and unfair result in this case. The Tribunal emphasises that it is here addressing contingent future events and not actual past events; it is seeking to determine not what did or did not happen as past facts but what could have happened in the future. This exercise necessarily involves the Tribunal in assessing whether such future events would have occurred and in quantifying that assessment in money terms, as compensation. It is not always possible for a claimant to prove that a future event could or could not happen with certainty; and a tribunal can only evaluate the chances of such a future event happening. That is not therefore an exercise in certainty, as such; but it is, in the circumstances, an exercise in "sufficient certainty", as indicated by the ILC's Commentary cited above.[609]

494. Arbitral tribunals have followed these rules even when the UNIDROIT Principles did not apply, consistently invoking equitable principles when damages exist (or will exist) but cannot be quantified with a degree of certainty:

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[607] **Doc. CL-129**, Panel of the Commissioners, Panel F1, U.N. Compensation Commission, Recommendation S/AC.26, 23 September 1997, § III.B, abstract.

[608] **Doc. CL-130**, *Gemplus S.A., SLP S.A., Gemplus Industrial S.A. de C.V. v. The United Mexican States*, ICSID Case No. ARB(AF)/04/3, Award, 16 June 2010, ¶ 13-88.

[609] *Id.*, ¶ 13-91.

(i) ***Tecmed v. Mexico***: "[T]he Arbitral Tribunal may consider general equitable principles when setting the compensation owed to the Claimant, without thereby assuming the role of an arbitrator *ex aequo et bono. . . .*".[610]

(ii) ***AMT v. Zaire***: "For practical reasons founded on equitable principles, the Tribunal finds that the Republic of Zaire which is responsible in international law, is under a duty to compensate AMT for the very losses which have been caused by the acts of violence and looting".[611]

(iii) ***LIAMCO v. Libya***: the umpire acknowledge the acceptance of "equitable compensation" under international law by expressing that "[o]ne of these general principles of law is Equity, which is commonly and unanimously recognized as a supplementary source of . . . international law . . . . Taking Equity into consideration, it would be reasonable and just to adopt the formula of 'equitable compensation' as a measure for the estimation of damages in the present dispute".[612]

(iv) ***Santa Elena v. Costa Rica***: "[T]he determination of value by a tribunal must take into account all relevant circumstances, including equitable considerations. . . . [T]he 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".[613]

(v) ***Himpurna v. PLN***: "In this case as in so many others, it is impossible to establish damages as a matter of scientific certainty. This does not, however, impede the course of justice. . . . Moreover, considerations of fairness enter into the picture, to be assessed – inevitably – by reference to particular circumstances. The fact that the Arbitral Tribunal is influenced in this respect by equitable factors does not mean that it shirks the discipline of deciding on the basis of legal obligations".[614]

(vi) ***Companía de Aguas del Aconquija et al. v. Argentine Republic***: "[I]t is well settled that the fact that damages cannot be fixed with certainty is no reason not to award damages when a loss has been incurred. . . . In such cases, approximations are inevitable; the settling of damages is not an exact science".[615]

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[610] **Doc. CL-131**, *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States*, ICSID Case No. ARB (AF)/00/2, Award, 29 May 2003, ¶ 190 (emphasis added).

[611] **Doc. CL-132**, *American Manufacturing & Trading, Inc. v. Republic of Zaire*, ICSID Case No. ARB/93/1, Award, 21 February 1997, ¶ 7.16 (emphasis added).

[612] **Doc. CL-16**, *Libyan American Oil Company (LIAMCO) v. The Libyan Arab Republic, Ad Hoc*, Award, 12 April 1977, p. 150 (emphasis added).

[613] **Doc. CL-133**, *Compañia del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, ¶¶ 92, 103 (quoting **Doc. CL-137**, *Phillips Petroleum Company Iran v. The Islamic Republic of Iran*, *The National Iranian Oil Company*, 21 IRAN-US CTR 79, Award, 29 June 1989, ¶¶ 122-123).

[614] **Doc. CL-134**, *Himpurna California Energy Ltd. v. PT. (Persero) Perusahaan Listruik Negara, Ad Hoc*, Award, 4 May 1999, *printed in* Albert Jan van den Berg (ed.), XXV YEARBOOK COMMERCIAL ARBITRATION 13 (2000), ¶ 237 (emphasis added).

[615] **Doc. CL-135**, *Companía de Aguas del Aconquija S.A. and Vivendi Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/97/3, Award, 20 August 2007, ¶ 8.3.16 (footnotes omitted, emphasis

(vii) ***SPP v. Egypt***: "[I]t is well settled that the fact that damages cannot be assessed with certainty is no reason not to award damages when a loss has been incurred".[616]

(viii) ***Azurix v. Argentina****:* an ICSID Arbitral Tribunal found that there is a general principle of international law in which, in the absence of any express provision in the applicable legal instrument dealing with assessment of damages, the tribunal will have "considerable discretion in fashioning what they believ[e] to be reasonable approaches to damages".[617]

495. Equitable considerations have also played an important role in the Iran-US Claims Tribunal's determination of compensation.[618]

496. Given the lack of forecasts beyond 2044, a restitution value for economic benefits for that period cannot "be established with a sufficient degree of certainty". "[R]ather than refus[ing] any compensation or award nominal damages", the Sole Arbitrator should use a proxy "to make an equitable quantification of the harm sustained".

497. There can be little question that the Leased Territories will continue to yield profit after 2044, but Brattle's oil and gas forecast does not extend beyond then, and considers only production from existing oil and gas fields.[619] The forecast also

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added).

[616] **Doc. CL-136**, *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/84/3, Award, 20 May 1992, ¶ 215.

[617] **Doc. CL-115**, *Azurix Corp. v. The Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006, ¶ 421.

[618] *See e.g.*, **Doc. CL-137**, *Phillips Petroleum Company Iran v. The Islamic Republic of Iran*, *The National Iranian Oil Company*, 21 IRAN-US CTR 79, Award, 29 June 1989, ¶ 112 ("The need for some adjustments is understandable, as the determination of value by a tribunal must take into account all relevant circumstances, including equitable considerations". – emphasis added); **Doc. CL-138**, *Amoco International Finance Corporation v. The Government of the Islamic Republic of Iran et al.*, 12 IRAN-US CTR 189, Partial Award, 14 July 1987, ¶ 220 ("The choice between all the available methods [of valuation] must rather be made in view of the purpose to be attained, in order to avoid arbitrary results and to arrive at an equitable compensation in conformity with the applicable legal standards". – emphasis added); **Doc. CL-139**, *Starrett Housing Corporation, Starrett Systems Inc., et al. v. The Government of the Islamic Republic of Iran et al.*, 16 IRAN-US CTR 112, Award, 14 August 1987, ¶ 339 (the Tribunal awarded less compensation than the Tribunal's expert had recommended, and justified this reduction on the basis of its discretion to "determine equitably" the amount involved); **Doc. CL-140**, *Shahin Shaine Ebrahimi v. Iran*, 30 IRAN-US CTR 170, Award, 12 October 1994, ¶¶ 40-52, 104 (the Tribunal stated that once the full value of the property has been properly evaluated, the compensation to be awarded must be appropriate to reflect the pertinent facts and circumstances of each case); **Doc. CL-141**, *Eastman Kodak Company v. The Government of Iran*, 27 IRAN-US CTR 3, Award, 1 July 1991, ¶ 54 (compensation awarded was based on promissory notes the expropriated subsidiary had issued to the claimant. A 50 per cent downward adjustment of the value of these promissory notes, owing to uncertainty as to whether the subsidiary would ever have been able to repay them in full, was considered "equitable in all the circumstances" – emphasis added).

[619] Brattle Report, ¶ 222.

does not account for additional production from new drilling campaigns in existing oil and gas fields, or for production in undrilled areas. Given the extent of available information, Brattle cannot assess with any certainty whether new drilling campaigns will in fact arise or if new discoveries will be made that lead to continued production beyond 2044.[620]

498. In this regard, according to Prof. Wöss and others, "[h]istorical data will be relevant if it is proven with reasonable certainty that the income would continue. . . ".[621] In the absence of certain data, Brattle has estimated an "equitable amount" of post-2044 oil and gas based on the rebalanced 1878 Lease Agreement amount under the hypothetical scenario that its terms continue in the future.[622] To compute an equitable amount, Brattle assumes that the rebalanced fixed annual amount in relation to oil and gas would continue unchanged from 2044 out to perpetuity, and computes the February 2020 present value of the resulting delayed perpetuity. Brattle's calculations are summarized in Table 25 below (taken from the Brattle Report):

Table 25: Derivation of Equitable Amount (Post-2044 Oil and Gas)

| | | | Fixed Annual Payment | Present Value in 2044 | Equitable Amount |
|---|---|---|---|---|---|
| Valuation date | [1] | See note | | 01/02/20 | |
| Long-term Discount Rate | [2] | See note | | 2.70% | |
| 2044 Discount Factor | [3] | See note | | 0.50 | |
| | | | [A] | [B] | [C] |
| | | | Table 22 | [A] / [2] | [B] x [3] |
| **Claiman'ts Share, USD bln** | | | | | |
| 10% Share | | | 0.33 | 12.19 | 6.15 |
| 15% Share | | | 0.49 | 18.29 | 9.23 |
| 20% Share | | | 0.66 | 24.39 | 12.31 |

Notes and sources:
[1] and [3]: Brattle Workpapers B, Rebalancing the Lease.
[2]: 2.70% rate represents the long-term LIBOR rate + the Malaysian sovereign spread.

499. Brattle therefore concludes that the equitable value of the post-2044 oil and gas economic benefits from the Leased Territories is **US$ 12.31 billion** (applying a

620 *Id.*

621 **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 5.134.

622 Brattle Report, ¶¶ 222-223.

20% share), **US$ 9.23 billion** (applying a 15% share) or **US$ 6.15 billion** (applying a 10% share).

#### (iv) Conclusion

500. The restitution value of the Leased Territories with a termination date of January 2013 is as follows:

| Category | Amount in US$ Billion | Discussion |
|---|---|---|
| Backwards-looking or historical value of the rights over the Leased Territories from 1 January 2013 (when Malaysia stopped paying rent) through February 2020 | US$ 6.50 (20% share)<br>US$ 4.87 (15% share)<br>US$ 3.25 (10% share) | § V.B(f)(ii)(2), *supra* |
| Forward-looking value of the rights over the Leased Territories from February 2020 | US$ 13.40 (20% share)<br>US$ 10.05 (15% share)<br>US$ 6.70 (10% share) | § V.B(f)(iii)(1), *supra* |
| Equitable value of the rights over the Leased Territories for post-2044 oil and gas economic benefits | US$ 12.31 (20% share)<br>US$ 9.23 (15% share)<br>US$ 6.15 (10% share) | § V.B(f)(iii)(2), *supra* |
| **Total:** | **US$ 32.20 (20% share)**<br>**US$ 24.15 (15% share)**<br>**US$ 16.10 (10% share)** | |

501. Malaysia should pay Claimants the restitution value from the applicable sharing factor.

### (g) The Sole Arbitrator Should Alternatively Terminate the 1878 Lease Agreement as of February 2020 and Award the Restitution Value from that Time, Plus Non-Performance Damages from 2013 to February 2020

#### (i) Introduction

502. If the Sole Arbitrator decides to terminate the 1878 Lease Agreement as of February 2020 or later, Brattle's calculations for going-forward restitution value will be the same as above (*see* § V.B(f)(iii) above).

503. However, given that restitution value has to be computed with prospective effects only (*ex nunc*), a February 2020 termination date will not entitle Claimants to compute any historical value as *restitution value*. Nonetheless, in addition to the going-forward restitution value, Claimants *will* be able to claim the unpaid rent from 1 January 2013 through the termination date, in the form of non-performance damages. Our calculation of non-performance damages follows the rules set forth in Chapter 7 of the UNIDROIT Principles.

### (ii) Claimants May Maintain Both a Claim for Restitution and Damages for Non-Performance

504. Article 7.3.7(1) of the UNIDROIT Principles provides that, "[o]n termination of a long-term contract restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible". But Section 1 of the Commentary clarifies that, "[s]ince contracts are terminated only for the future, any outstanding payments for past performance can still be claimed", concluding that Article 7.3.7 "does not prevent a claim for damages being brought".

505. The rule is the same under Article 5.1.8 of the UNIDROIT Principles for the termination of contracts for an indefinite period, which makes a *renvoi* to Article 7.3.7.[623] Therefore, if the 1878 Lease Agreement is terminated in February 2020 or later, Claimants are entitled to claim the restitution value as of that date, <u>plus</u> all unpaid rent since 2013 in the form of non-performance damages.[624]

506. Article 7.3.5 likewise provides that "[t]ermination does not preclude a claim for damages for non-performance".[625] Section 2 of the Commentary to that Article states that "[t]he fact that, by virtue of termination, the contract is brought to an end, does not deprive the aggrieved party of its right to claim damages for non-performance in accordance with the rules laid down in Section 4 of this Chapter".[626] Claimants therefore invoke Chapter 7, Section 4, of the UNIDROIT Principles to calculate non-performance damages.

507. Article 7.4.1 provides that "[a]ny non-performance gives the aggrieved party a right to damages either exclusively or <u>in conjunction with any other remedies</u> except

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[623] Article 5.1.8, Comment 2 ("The fact that, by virtue of termination, the contract is brought to an end does not deprive a party to the contract of its right to claim damages for any non-performance".).

[624] Section 2 of the Official Commentary to Article 7.3.7 of the UNIDROIT Principles ends the discussion by stating that "[t]his Article is a special rule which, for long-term contracts, excludes restitution for <u>performance made</u> in the past". Emphasis added. In our case, Malaysia continued to make payments under the 1878 Lease Agreement until 2013, year in which it first failed to make payment (or, in other words, failed to perform) until today. Therefore, rents due from 2013 through 2020 are not "performance made in the past" because they remain outstanding or, in other words, have been not performed.

[625] **<u>Doc. CL-90</u>**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 855 ("The fact that the contract has been terminated does not deny a damages claim for breach of contract". – footnotes omitted).

[626] *See also* **<u>Doc. CL-60</u>**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 4.398 ("Termination does not preclude a claim for damages for non-performance, according to paragraph 2 of Article 7.3.5 [UNIDROIT Principles]. . .".).

where the non-performance is excused under these Principles".[627] Obviously, a claimant can combine the right to terminate a contract with the right to claim non-performance damages.[628]

508. An ICC arbitral tribunal described Article 7.4.1 of the UNIDROIT Principles as the "general principle of the right to damages for breach of contract".[629] The Arbitrazh Court of Kaliningrad region believes that this Article "reflects the most modern international approach[ ] on the matter".[630] An arbitral tribunal operating under the auspices of the *Centro de Arbitraje de México* (CAM) concluded that Article 7.4.1 is considered "*el derecho más aceptado*", and "*el derecho a ser indemnizado (resarcimiento) es aditivo a no exclusivo de otras sanciones que apliquen por ley o por contrato*".[631]

509. Section 1 of the Commentary clarifies that Article 7.4.1 "recalls that the right to damages, like other remedies, arises from the sole fact of non-performance".[632] Consequently, "[i]t is enough for the aggrieved party simply to prove the non-performance, i.e. that it has not received what it was promised" and "it is not necessary in addition to prove that the non-performance was due to the fault of the non-performing party".[633] Nor is there an obligation to notify the other party of any default as a pre-condition to the right to recover damages.[634]

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[627] Emphasis added.

[628] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 869; **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 239.

[629] **Doc. CL-142**, ICC Case No. 12193, Award, June 2004, abstract.

[630] **Doc. CL-143**, Arbitrazh Court of Kaliningrad region, Case No. A21-6939/2009, Decision, 15 December 2011, Abstract.

[631] **Doc. CL-117**, Centro de Arbitraje de México (CAM), Unknown Case No., 30 November 2006, ¶¶ 160-161.

[632] *See* **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 238.

[633] *See also* **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 867 ("There is no requirement that the aggrieved party prove that the non-performance was attributable to the fault of the other party to the contract".). *See also* **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 4.387 ("Fault is not a prerequisite for the availability of damages under [the UNIDROIT Principles]".); **Doc. CL-144**, John Y. Gotanda, *Recovering Lost Profits In International Disputes*, 36(1) GEORGETOWN JOURNAL OF INTERNATIONAL LAW 61 (2004), p. 87 ("[T]he UNIDROIT Principles do not limit lost profits to only instances involving a willful or negligent breach".).

[634] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT

510. In our case, Malaysia concedes that it has failed to pay the annual rent on the 1878 Lease Agreement since 2013.[635] Per Article 7.4.1 of the UNIDROIT Principles and its Commentary, it is irrelevant whether Malaysia was at fault in its failure to do so. Nor did Claimants need to notify Malaysia that it was in breach. All that is needed is a showing that Malaysia *in fact* failed to pay rent since 2013. Hence, Claimants can seek compensation for non-performance damages.

#### (iii) This Claim Meets the Legal Standard for Non-Performance Damages

511. Article 7.4.2 of the UNIDROIT Principles enshrines the full compensation standard, as explained in ¶¶ 441-446 above. International tribunals have used the same standard when applying international law. For instance, in *Sapphire International Petroleums Ltd. v. National Iranian Oil Company*, the arbitrator explained that, "[a]ccording to the generally held view, the object of damages is to place the party to whom they are awarded in the same pecuniary position that they would have been in if the contract had been performed in the manner provided for by the parties at the time of its conclusion".[636] One cannot help noticing the similarity of the *Sapphire* formulation with that in the *Chorzów* case, where the PCIJ held that reparation must "re-establish the situation which would, in all probability, have existed if that [illegal] act had not been committed".[637] Notably, the Arbitral Tribunal in *Amco v. Indonesia II*, a case that involved an interference with contract rights in violation of international law, referred to both *Sapphire* and *Chorzów* as authorities in support of the meaning of full compensation.[638]

512. The general objective of full compensation thus applies regardless of whether a loss has been suffered as a result of a breach of contract or a breach of international law.

513. Understanding the *but-for* premise is critical for non-performance damages.[639] The aggrieved party suffers a loss by a breach of contract when such aggrieved

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PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 867.

[635] *See* ¶¶ 94, 220, *supra*.

[636] **Doc. CL-105**, *Sapphire International Petroleums Ltd. v. National Iranian Oil Company, Ad-Hoc*, Award, 15 March 1963, pp. 185-186.

[637] **Doc. CL-112**, *Case Concerning the Factory at Chorzów*, PCIJ 1928 Ser A, No 17, p. 47.

[638] **Doc. CL-145**, *Amco Asia Corporation and others v. The Republic of Indonesia*, ICSID Case No. ARB/81/1, Award, 31 May 1990, ¶¶ 183-186.

[639] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL

party would have been in a better position but for the breach.[640] The *but-for* premise starts by establishing the hypothetical performance of the contract, absent the breach; it determines in financial terms the difference between the hypothetical and actual situation (in which non-performance exists). That difference is the "loss" or the "expectation interest" under the differential hypothesis or *but-for* premise. The "ultimate test" is the "comparison between the claimant's hypothetical performance and the actual performance over a certain period of time".[641] In short, the ultimate question is: what would have happened if there had been no breach?

514. Here, if the Sole Arbitrator terminates the 1878 Lease Agreement as of February 2020 or later, Claimants are claiming the unpaid rent from 2013 through the date of termination. This is the "loss which [Claimants] suffered" set forth in Article 7.4.2. Obviously, comparing the hypothetical scenario in which Malaysia had paid the (updated) rent under the 1878 Lease Agreement with Malaysia's actual non-performance, Claimants have suffered a loss.

515. Section 3 of the Commentary to Article 7.4.3, explains that Article 7.4.2(1), which refers to the harm sustained "as a result of the non-performance", "presupposes a sufficient causal link between the nonperformance and the harm". Some private authors understand that "[c]ausality is based on the concept of natural causality in form of the *conditio sine qua non* or the *but-for* test", which "means that the injured party would not have suffered the harm but for the defendant's breach".[642] The relevant question is: would the claimant be in the same position without the breach? If the answer is no and the loss is attributed to the breach, then the non-performing party must pay damages.

516. There is no doubt that, if the 1878 Lease Agreement were terminated in February 2020 or later, the non-performance damages sought in this arbitration

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CONTRACTS (Nomos, 2018), p. 240 (acknowledging the application of the *but-for* test under Article 7.4.2. to ascertain damages under the UNIDROIT Principles); **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 879 (referring to the *but-for* test as the appropriate standard to analyze the causal link for damages).

[640] **Doc. CL-60**, Herfried Wöss *et al.*, DAMAGES IN INTERNATIONAL ARBITRATION UNDER COMPLEX LONG-TERM CONTRACTS (Oxford University Press, 2014), ¶ 5.34.

[641] *Id.*, ¶ 5.35.

[642] *Id.*, ¶ 4.396. *See also id.*, ¶ 5.128 ("Evidence must prove that the claimant would have been in a better economic situation in the absence of breach of the contract".).

would be a direct consequence of Malaysia's failure to pay rent since 2013. The unpaid rents to be taken into consideration for the purpose of calculating the total compensation are all those from then until the 1878 Lease Agreement is terminated.

#### (iv) Calculation of Non-Performance Damages from 2013-2020

517. As noted, Claimants are entitled to terminate the 1878 Lease Agreement and claim the restitution value as of the termination date (as calculated at § V.B(f) above) plus all unpaid rents from 2013 as non-performance damages. Section 1 of the Commentary to Article 7.3.7 provides an instructive example:

> Company A leases equipment to company B for three years at a rental of EUR 10,000 a month. B pays punctually for the first two months but then fails to make any further payments despite repeated requests by A. After a lapse of five months A terminates the lease. A is entitled to retain the EUR 20,000 already received (see Article 7.3.7(1)) and to recover the EUR 50,000 accrued due (on the basis of the contract of lease which is terminated only for the future), together with whatever damages for breach it has sustained (see Article 7.3.5(2)).

518. In very similar terms, Prof. Huber provides the following example: "if in a 5-year service contract, the supplier terminates the contract after the second year because the other party has not made a single payment, the supplier is still able to claim the sums in arrears as they had become due before termination took effect".[643]

519. In order to comply with the principle of full compensation, the most appropriate approach to non-performance damages is to apply the rebalanced unpaid rent since 1 January 2013, as will be explained in § V.C below, up to the termination of the 1878 Lease Agreement. According to Brattle, the total rebalanced rent amount depends on Claimants' percentage entitlement as follows:[644]

| Share | Amount Per Annum |
|---|---|
| 20% | US$ 714 million |
| 15% | US$ 535 million |
| 10% | US$ 357 million |

520. In other words, a rebalanced rent payment of US$ 357 to 714 million provides Claimants with the appropriate share of the post-2013 economic benefits that

[643] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), pp. 854-855 (footnotes omitted).

[644] Brattle Report, ¶¶ 206-208.

Malaysia obtained from Sabah. According to Brattle, adding interest to February 2020 to the seven rebalanced payments that are outstanding (rent for years 2013-2019), depending on the percentage factor attributable to Claimants, there is an overdue balance of:[645]

| Share | Amount |
|---|---|
| 20% | US$ 5.72 billion |
| 15% | US$ 4.29 billion |
| 10% | US$ 2.86 billion |

521. Malaysia has to pay compensation to Claimants for non-performance damages in the amount corresponding to the applicable share.

### (h) Conclusion

522. The restitution value of the Leased Territories with a termination date of February 2020 is as follows:

| Category | Amount in US$ Billion | Discussion |
|---|---|---|
| Forward-looking value of the rights over the Leased Territories from February 2020 | US$ 13.40 (20% share)<br>US$ 10.05 (15% share)<br>US$ 6.70 (10% share) | § V.B(f)(iii)(1), *supra* |
| Equitable value of the rights over the Leased Territories for post-2044 oil and gas economic benefits | US$ 12.31 (20% share)<br>US$ 9.23 (15% share)<br>US$ 6.15 (10% share) | § V.B(f)(iii)(2), *supra* |
| **Total:** | **US$ 26.71 (20% share)**<br>**US$ 19.28 (15% share)**<br>**US$ 12.85 (10% share)** | |

523. In addition, Malaysia must compensate Claimants for unpaid (rebalanced) rent from 2013 through the termination date in the form of non-performance damages, which amounts to (including interest) (*see* ¶¶ 519-520 above):[646]

| Share | Amount |
|---|---|
| 20% | US$ 5.72 billion |
| 15% | US$ 4.29 billion |
| 10% | US$ 2.86 billion |

524. Claimants claim the sum of the two amounts (restitution value as of February 2020 plus non-performance damages regarding the unpaid rent for years 2013 to 2019, plus interest).

[645] *Id.*, ¶ 210.

[646] *Id.*

### C. Rebalancing the Annual Rent is Appropriate in the Event that the 1878 Lease Agreement is not Terminated

525. If the Sole Arbitrator decides that termination of the 1878 Lease Agreement is not appropriate, he should adapt or rebalance it with a view to restoring equilibrium. The legal justification allowing the Sole Arbitrator to adapt or rebalance the 1878 Lease Agreement was explained at length in §§ II.M and IV.D above.

526. Article 6.2.3(4) of the UNIDROIT Principles provides that, "[i]f the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed, or (b) adapt the contract with a view to restoring its equilibrium".[647] Sub-section (b) thus explains the ground for rebalancing the 1878 Lease Agreement "with a view to restoring its equilibrium" if the Sole Arbitrator decides that it is not appropriate to terminate it.

527. According to Section 7 of the Commentary to Article 6.2.3, if the Sole Arbitrator were to "adapt the contract with a view to restoring its equilibrium", he must "seek to make a fair distribution of the losses between the parties". Depending on the nature of the hardship, this may "involve a price adaptation".[648]

528. When adapting a price to restore equilibrium, Prof. Brödermann observes:

> Applying the reasonableness-test under article 6.2.3 (4) (a) to the terms other than the date with an eye to adjusting the equilibrium would therefore require to start with considering the market value of the consideration received by the lessee.
>
> To start the determination of terms with regard to the actual market value
>
> - is not only consistent with the market driven fundamental alteration of the equilibrium; and
> - it is in line with the principle of **good faith and fair dealing** (article 1.7) underlying hardship and thereby settles the issue in accordance with an underlying general principle, in line with the rules on autonomous interpretation in article 1.6 (2).[649]

529. Claimants request a price adaptation of the 1878 Lease Agreement's annual rent if it is not terminated.

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[647] Emphasis added.

[648] Emphasis added.

[649] Third Brödermann Report, ¶¶ 588-589 (emphasis original).

530. Brattle has calculated the appropriate annual rent in light of the economic benefit that Malaysia obtains under the 1878 Lease Agreement. Brattle has made calculations assuming that the 1878 Lease Agreement would remain in force, but that the annual lease payment would be increased to reflect the magnitude of the economic benefits that Malaysia reaps from the Leased Territories.[650] The rebalanced lease payments would attempt to ensure that Claimants obtain an annual stream of income consistent with the economic benefits that Malaysia receives from the Leased Territories.

531. With this in mind, Brattle applies a factor of 10%, 15% or 20% to the February 2020 economic benefits from the Leased territories, to determine the share of the economic benefits attributable to Claimants.[651]

532. Brattle derives a fixed annual lease amount that should have applied from 2013 and that should continue to apply out into the future. Brattle performs the relevant calculations in two parts, before summing the results to obtain the rebalanced lease amount:[652]

(i) First, Brattle derives a fixed annual payment in relation to oil and gas covering the period 2013 to 2044. In effect, Brattle derives the fixed annual payment from 2013 to 2044 that would generate a stream of annual payments with the same February 2020 present value as Claimants' share of the stream of economic benefits from oil and gas, when adding pre-award interest to fixed annual amounts assumed to arise prior to February 2020, and discounting back to February 2020 fixed annual amounts assumed to arise after February 2020.

(ii) Second, Brattle repeats the same exercise for palm oil, but under the assumed application of a fixed annual amount from 2013 out to perpetuity.

533. Ultimately, the rebalanced rent amount equates to the sum of the fixed annual amounts computed separately for oil and gas, and then palm oil. Brattle derives a total rebalanced rent amount depending on Claimants' percentage entitlement as follows:[653]

[650] Brattle Report, § VI.

[651] *Id.*, ¶¶ 185, 190.

[652] *Id.*, ¶¶ 191-194.

[653] *Id.*, ¶¶ 206-208.

| Share | Amount |
|---|---|
| 20% | US$ 714 million |
| 15% | US$ 535 million |
| 10% | US$ 357 million |

534. In other words, a rebalanced rent payment of US$ 357 to 714 million provides Claimants with the appropriate share of the post-2013 economic benefits that Malaysia reaps from the Leased Territories.

535. Note that the rebalanced annual payment should also be applied retrospectively to outstanding rents from 2013. Section 4 of the Commentary to Article 6.2.2 states:

> By its very nature hardship can only become of relevance with respect to performances still to be rendered: once a party has performed, it is no longer entitled to invoke a substantial increase in the costs of its performance or a substantial decrease in the value of the performance it receives as a consequence of a change in circumstances which occurs after such performance.
>
> If the fundamental alteration in the equilibrium of the contract occurs at a time when performance has been only partially rendered, hardship can be of relevance only to the parts of the performance still to be rendered.[654]

536. Malaysia's performance since 2013 is "still to be rendered". The 1878 Lease Agreement therefore can be retroactively rebalanced as far back as the time of Malaysia's non-performance.

537. According to Brattle, adding interest to February 2020 to the seven rebalanced payments that are outstanding (rent for years 2013-2019), depending on the percentage factor attributable to Claimants, there is an overdue balance of:[655]

| Share | Amount |
|---|---|
| 20% | US$ 5.72 billion |
| 15% | US$ 4.29 billion |
| 10% | US$ 2.86 billion |

## D. Malaysia Should Pay Interest on Any Sum Awarded to Claimants

### (a) Introduction

538. The claim for restitution (*see* § V.B(f) above) and the claim for restitution plus non-performing damages (*see* § V.B(g) above) are for lump-sums of money. The

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654 Emphasis added.

655 *Id.*, ¶ 210.

claim for a rebalanced annual rent (*see* § V.C above) is for a lump-sum with respect to past non-performance.

539. Article 7.4.9 of the UNIDROIT Principles provides the rule for calculating "*interest for failure to pay money*" as follows:

> (1) If a party does not pay a sum of money when it falls due the aggrieved party is entitled to interest upon that sum from the time when payment is due to the time of payment whether or not the non-payment is excused.
>
> (2) The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment.
>
> (3) The aggrieved party is entitled to additional damages if the non-payment caused it a greater harm.

540. Article 7.4.9 distills a few important concepts:

### (b) Interest is Payable from the Time when Payment is Due to the Time when Payment is Made

541. According to paragraph 1 of Article 7.4.9, "[i]f a party does not pay a sum of money when it falls due the aggrieved party is entitled to interest upon that sum from the time when payment is due to the time of payment whether or not the non-payment is excused". Section 1 of the Commentary explains that "[t]his Article reaffirms the widely accepted rule according to which the harm resulting from delay in the payment of a sum of money is subject to a special regime and is calculated by a lump sum corresponding to the interest accruing between the time when payment of the money was due and the time of actual payment".[656] As noted by an international tribunal, "interest is part of 'full' reparation to which the Claimants are entitled to assure that they are made whole".[657]

542. In our case, the situation varies depending on the heads of claim:

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[656] Emphasis added.

[657] **Doc. CL-146**, *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v. Argentine Republic*, ICSID Case No. ARB/02/1, Award, 25 July 2007, ¶ 55.

(i) Claim for Restitution: Malaysia shall pay interest on the restitution value from the date of termination of the 1878 Lease Agreement until the time of actual payment of the Arbitral Award.[658]

(ii) Unpaid Rebalanced Rent: Malaysia shall pay pre-award and post-award interest from the time due under the 1878 Lease Agreement until paid.

543. The above accords with Section 1 of the Commentary to Article 7.4.9, which clarifies that "[i]nterest is payable whenever the delay in payment is attributable to the non-performing party, and this as from the time when payment was due, without any need for the aggrieved party to give notice of the default".[659]

544. The Arbitral Tribunal in ICC Case No. 7365/FMS cited to Article 7.4.9 to stress that "[t]here is a tendency in international commercial law to award interest from the time when the payment has become due without any need for the aggrieved party to give notice of the default".[660] In the same vein, in ICC Case No. 11051, the Arbitral Tribunal ordered the defendants to pay interest on the amounts due from the time they were due to the claimant. In support of its ruling, the Arbitral Tribunal referred to the relevant provision of the Italian Civil Code, adding that "[s]uch solution is consistent with the relevant custom of international trade, of which the UNIDROIT principles are an expression" (quoting Article 7.4.9).[661]

545. Claimants were never – and will continue not to be – under an obligation to inform Malaysia of any default in order to start the accrual of interest. Consequently, interest will start accruing from when any monetary obligation becomes due and until Malaysia makes payment.

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[658] **Doc. CL-90**, Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 862 (noting that Article 7.4.9 of the UNIDROIT Principles "should be applied to monetary obligations of restitution").

[659] *See also* **Doc. CL-90** Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 908 (noting that "[t]here is no need for the aggrieved party to give notice of the default in order to start the clock ticking: the right [to receive interest] arises when payment falls due irrespective of whether or not a notice of default has been given" – footnotes omitted, emphasis omitted).

[660] **Doc. CL-109**, *Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Defense Systems, Inc.*, ICC Award No. 7365/FMS, Award, 5 May 1997, Abstract.

[661] **Doc. CL-147**, ICC Case No. 11051, Award, July 2001.

### (c) Interest Rate

546. In our case, the relevant currency for the calculation of damages is U.S. dollars,[662] and the place of payment is Malaysia.[663] The Commentary to Article 7.4.12 provides that a party is "entitled to interest . . . in the same currency as that in which the main obligation is expressed".

547. International tribunals have applied the above solution (*i.e.*, awarding interest in the currency in which the damages are suffered) outside the UNIDROIT context. In *S.D. Myers, Inc. v. Canada*, the arbitrators awarded compensation in Canadian dollars (CAD). The Arbitral Tribunal was then faced with the question of whether to order interest at the prevailing CAD rate or, because the claimant (SDMI) would have converted its CAD revenues immediately to U.S. dollars in the ordinary course of its business, at a prevailing U.S. dollar rate. The Arbitral Tribunal chose to employ the CAD rate, because it was the currency of both the lost revenue stream and the award:

> The rate of interest to be applied is closely connected with the question of the currency of account in which the award of compensation is made. On the one hand, the currency in which SDMI operated was US$ and no doubt all income received into SDMI's bank account in Ohio would have been converted into that currency. On the other hand, based on the bids made to potential Canadian customers (and the revenue from the seven completed contracts), the currency of account of the transactions between SDMI/MYERS Canada and their Canadian customers was (or was to be) CAN$. On balance, the Tribunal considers that the currency of account of the lost income stream is more closely connected with the loss and damage suffered by SDMI than the working currency of SDMI in Ohio. Accordingly, the Tribunal determines that the currency of the compensation awarded in this Second Partial Award should be CAN$. It follows that the interest rate to be applied should be related to the standard Canadian prime rates applicable from time to time during the relevant period. The relevant period shall be the date of the Notice of Arbitration to the date of payment of the Award. Such interest shall be compounded annually.[664]

548. *S.D. Myers v. Canada* thus makes the case for computing the interest rate here in U.S. dollars. The question remains, what is the applicable rate? Paragraph

[662] *See* § V.A(b)(ii), *supra.*

[663] *See* ¶¶ 387-388, *supra.*

[664] **Doc. CL-148**, *S.D. Myers, Inc. v. Government of Canada, Ad Hoc*-UNCITRAL, Second Partial Award, 21 October 2002, ¶¶ 304-306 (emphasis added).

2 of Article 7.4.9 of the UNIDROIT Principles provides a set of default rules for establishing the applicable interest rate:

(i) the rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or

(ii) where no such rate exists at that place, then the same rate in the State of the currency of payment; or

(iii) in the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment.

549. Section 2 of the Commentary explains that "[t]his solution seems to be that best suited to the needs of international trade and most appropriate to ensure an adequate compensation of the harm sustained", because "[t]he rate in question is the rate at which the aggrieved party will normally borrow the money which it has not received from the non-performing party".

550. To Claimants' knowledge, there is no average bank short-term lending rate to prime borrowers prevailing for the currency of payment (*i.e.*, U.S. dollars) at the place for payment (*i.e.*, Malaysia). As a result, the second proviso of Article 7.4.9 should apply: the rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing in the State of the currency of payment (*i.e.*, the United States of America).

551. This result is consistent with Section 2 of the Commentary to Article 7.4.9, which provides the following useful example:

> No such rate may however exist for the currency of payment at the place for payment. In such cases, reference is made in the first instance to the average prime rate in the State of the currency of payment. <u>For instance, if a loan is made in pounds sterling payable in country X and there is no rate for loans in pounds on country X financial market, reference will be made to the rate in the United Kingdom</u>.[665]

552. Very similarly, UNILEX provides two precedents, which resulted in the same outcome as the example from the Official Commentary:

[665] Emphasis added.

| Payment in Indian Rupees in Russia | Payment in USD in Sweden |
|---|---|
| "[S]ince in the Russian Federation, i.e. the place where the creditor was located, there is no rate of bank interest for Indian currency, the Arbitration Court decided to apply the international trade practice adopted in such cases as reflected in the UNIDROIT Principles of International Commercial Contracts. And since Article 7.4.9 (paragraph 2) of the UNIDROIT Principles provides that the rate of interest shall be the average bank short–term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment, the Arbitration Court applied the corresponding rate of interest used by the Reserve Bank of India".[666] | "In another ICC Award, the arbitral tribunal referred to article 7.4.9 of the Principles to determine the rate of interest applicable to an interest claim that the [claimant] had under the law applicable to the contract. The amount payable was due in U.S. dollars, but payable in Sweden. Following the guideline of the first alternative of article 7.4.9(2), the arbitrators first tried to ascertain the prime rate for U.S. dollar credits in Sweden as the place for payment. The Swedish banks informed the tribunal that no such rates exist in Sweden as credits are granted by Swedish banks in Swedish currency only and a kind of 'Eurodollar' credit rate for U.S. dollar credits in Sweden was not ascertainable".[667] |

553. Brattle calculates that the average bank short-term lending rate to prime borrowers prevailing in the United States of America is 3.96% per annum.[668] The Sole Arbitrator should apply this rate to all amounts awarded to Claimants.

### (d) Malaysia Should Pay Compound Interest

554. The UNIDROIT Principles are silent on whether interest on payments should be simple or compound.[669] Scholars agree that this issue is to be determined by the otherwise applicable law.[670] As explained in § IV.A above, Claimants understand that the first layer of applicable *lex causæ* to this arbitration is the UNIDROIT Principles, but any matter not regulated by the UNIDROIT Principles should be

[666] **Doc. CL-149**, International Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation Case No. 100/2002, Award, 19 May 2004, Abstract.

[667] **Doc. CL-150**, Klaus P. Berger, *The lex mercatoria doctrine and the Unidroit Principles of International Commercial Contracts*, 28 LAW AND POLICY IN INTERNATIONAL BUSINESS (1997), p. 983.

[668] Brattle Report, ¶ 196.

[669] **Doc. CL-61**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 256; **Doc. CL-90** Stefan Vogenauer and Jan Kleinheisterkamp, COMMENTARY ON THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Oxford University Press, 2009), p. 910.

[670] *See* n. 669, *supra*.

analyzed through the lens of the second layer of *lex causæ*, here "general principles of international law".

555. General principles of international law and international practice overall favor compound (as opposed to simple) interest.

556. Academic commentary on the subject has been "unified in its criticism of the simple interest rule".[671] Sergey Ripinsky and Kevin Williams explain the criticism as follows:

> [C]onsidering the compensatory function of interest, compounding is the appropriate mode of interest calculation. This is particularly so in commercial and investment disputes because they involve harm to investors who operate in a financial reality where compound interest is the norm.[672]

557. These authors conclude that "there has been a reversal of the presumption of simple interest: a significant number of recent tribunal decisions provide a strong indication that compound interest has come to be treated as the default solution".[673] In his seminal article, FA Mann looked at modern economic conditions, the function of damages and the rationale for prevailing practices and concluded that "on the basis of compelling evidence compound interest may be and, in the absence of special circumstances, should be awarded to the claimant as damages by international tribunals".[674] Prof. Gotanda, who has written widely on the subject, observed that "almost all financing and investment vehicles involve compound interest" and that "it is neither logical nor equitable to award a claimant only simple interest when the respondent's failure to perform its obligations in a timely manner caused the claimant either to incur finance charges that included compound interest or to forego opportunities that would have had a compounding effect on its investment".[675]

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[671] **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 383 (citing several authors to support this assertion).

[672] *Id.* (emphasis added).

[673] *Id.*, p. 387 (emphasis added).

[674] **Doc. CL-151**, FA Mann, *Compound Interest as an Item of Damage in International Law*, 21 UC DAVIS L REVIEW (1988), p. 586.

[675] **Doc. CL-153**, John Y. Gotanda, *Compound Interest in International Disputes*, OXFORD U COMPARATIVE L FORUM (July 2004).

558. Since 2000, international tribunals have predominantly awarded compound interest.[676] A study in 2006 of 45 international arbitrations resulting in 14 awards of compensation demonstrates that, of the latter, 8 ordered compound interest, 3 simple interest, and 1 no interest (the remaining 2 did not disclose whether they awarded compound or simple interest).[677]

559. In *Santa Elena v. Costa Rica*, the Arbitral Tribunal affirmed that in the instance where a claimant had lost the value of its asset but had not received its monetary equivalent, the award should reflect – at least in part – what the investor would have earned if he had invested his money at the prevailing rates of interest.[678] The norm in the finance industry is compound interest.[679] Commenting on the function of compound interest, the Arbitral Tribunal in *Santa Elena v. Costa Rica* concluded that "it is a mechanism to ensure that the compensation awarded the Claimant is appropriate in the circumstances".[680]

560. Confirming the purely compensatory nature of compound interest, the Arbitral Tribunal in *Metalclad v. Mexico* stated that interest should be compounded in order to "restore the Claimant to a reasonable approximation of the position in which it would have been if the wrongful act had not taken place".[681] This approach was followed in *Wena Hotels v. Egypt*, which, after quoting *Metalclad v. Mexico* and citing Prof. Gotanda, commented that "the claimant could have received compound interest merely by placing its money in a readily available and commonly used investment vehicle".[682] The Arbitral Tribunal also cited FA Mann to say that

[676] **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 384.

[677] **Doc. CL-153**, James Gray, Jason Cain and Wayne Wilson, *ICSID Arbitration Awards and Cost*, 3(5) TDM (December 2006).

[678] **Doc. CL-133**, *Compañia del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, ¶ 104.

[679] **Doc. CL-58**, Mark Kantor, VALUATION FOR ARBITRATION (Wolters Kluwer, 2008), p. 275; **Doc. CL-Doc. CL-154**, Jeffrey M. Colon and Michael S. Knoll, *Prejudgment Interest in International Arbitration*, 4(6) TDM (November 2007), p. 18.

[680] **Doc. CL-133-**, *Compañia del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award, 17 February 2000, ¶ 104.

[681] **Doc. CL-101**, *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000, ¶ 128.

[682] **Doc. CL-155**, *Wena Hotels Ltd. v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, Award, 8 December 2000, ¶ 129.

international tribunals should award compound interest in the absence of special circumstances.[683]

561. In *Azurix v. Argentina*, the Arbitral Tribunal awarded compound interest because it “reflect[ed] the reality of financial transactions, and best approximate[d] the value lost by an investor”.[684] The same justification was subsequently adopted in *MTD v. Chile* and *LG&E v. Argentina*.[685] In that case, the Arbitral Tribunal explained that the phrase “the reality of financial transactions” referred to the possibility for the claimant to have earned compound interest on the amount of compensation, had it been paid in time. The Arbitral Tribunals in *Siemens v. Argentina* and *BG v. Argentina* reasoned similarly.[686] The Arbitral Tribunal in *Vivendi v. Argentina*, awarding compound interest, relied on its own survey (as of 2007), showing a line of 7 international precedents applying compound interest.[687]

562. The line of decisions favoring compound interest has continued.[688] Of notable importance is the award in *Suez v. Argentina*, which explained the state of the issue as follows:

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[683] *Id.*

[684] **Doc. CL-115**, *Azurix Corp. v. The Argentine Republic*, ICSID Case No. ARB/01/12, Award, 14 July 2006, ¶ 440.

[685] **Doc. CL-156**, *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award, 25 May 2004, ¶ 251; **Doc. CL-146**, *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc. v. Argentine Republic*, ICSID Case No. ARB/02/1, Award, 25 July 2007, ¶¶ 54-57.

[686] **Doc. CL-157**, *Siemens A.G. v. The Argentine Republic*, ICSID Case No. ARB/02/8, Award, 6 February 2007, ¶ 399 (“[T]he question is not . . . whether Siemens had paid compound interest on borrowed funds during the relevant period but whether, had compensation been paid following the expropriation, Siemens would have earned interest on interest paid on the amount of compensation. It is in this sense that tribunals have ruled that compound interest is a closer measure of the actual value lost by an investor. . .”.); **Doc. CL-158**, *BG Group Plc. v. The Republic of Argentina*, *Ad Hoc*-UNCITRAL, Award, 24 December 2007, ¶ 456 (“The Tribunal notes in particular that the standard of ‘full reparation’ . . . would not be achieved if the award were to deprive Claimant of compound interest. If invested [immediately after the breach], the sums awarded would have earned compound interest”.).

[687] **Doc. CL-135**, *Companía de Aguas del Aconquija S.A. and Vivendi Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/97/3, Award, 20 August 2007, n. 423.

[688] *See e.g.,* **Doc. CL-159**, *Pope & Talbot Inc. v. Government of Canada*, *Ad Hoc*-UNCITRAL, Award, 31 May 2002, ¶ 89; **Doc. CL-103**, *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, 22 May 2007, ¶ 452; **Doc. CL-160**, *PSEG Global, Inc., The North American Coal Corporation, and Konya Ingin Electrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey*, ICSID Case No. ARB/02/5, Award, 19 January 2007, ¶ 348; **Doc. CL-161**, *Sempra Energy International v. The Argentine Republic*, ICSID Case No. ARB/02/16, Award, 28 September 2007, ¶ 486; **Doc. CL-162**, *National Grid plc v. The Argentine Republic*, *Ad Hoc*-UNCITRAL, Award, 3 November 2008, ¶ 294 and n. 121; **Doc. CL-163**, *EDF International S.A., SAUR International S.A. and León Participaciones Argentinas S.A. v. Argentine Republic*, ICSID Case No. ARB/03/23, Award, 11 June 2012, ¶¶ 1337, 1340; **Doc. CL-164**, *Continental Casualty*

> It is to be noted that Argentina did not specifically contest the use of compound interest in Dr. Deep's calculations. The Tribunal believes that strong reasons, both economic and legal, justify the application of compound interest. First the goal of international law on compensation for violations of international obligations is to place the injured party in the position that such party would currently have been if the injury had never taken place. Compound interest is more effective at achieving that result than is simple interest. Second, international tribunals manifest a growing tendency to apply compound rather than simple interest in damage calculations. Third, it is standard practice in business and finance when calculating financial returns and losses to apply compound interest precisely because financial and economic experts believe it more accurately reflects economic reality than simple interest.[689]

563. In light of the foregoing, compound interest is appropriate in the circumstances for all amounts awarded to Claimants.

564. The practice on choosing an appropriate period of compounding has not been uniform. Precedents range from one year to one month.[690] Brattle uses monthly compounding in its calculations, and explains its decision as follows:

> We assume monthly compounding so as to track fluctuations in interest rates over the course of the year. However, other than permitting the use of different monthly interest rates over the course of a given year, the assumed compounding frequency itself has no impact on our calculation. We first derive monthly pre-award interest rates from the annualised prime rates reported in each month. We derive the monthly rates from the reported annualised figures assuming monthly compounding. We then compute interest over the year by applying the series of monthly interest rates and assuming monthly compounding. The end result would be the same as applying the single annualised rate if interest rates remained constant through the year. Converting annualised interest rates to monthly

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*Company v. The Argentine Republic*, ICSID Case No. ARB/03/9, Award, 5 September 2008, ¶ 309; **Doc. CL-165** *Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/03/19, Award, 9 April 2015, ¶ 65; **Doc. CL-166**, *El Paso Energy International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15, Award, 31 October 2011, ¶ 746; **Doc. CL-167**, *Total S.A. v. Argentine Republic*, ICSID Case ARB/04/1, Award, 27 November 2013, ¶ 261.

[689] **Doc. CL-165**, *Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/03/19, Award, 9 April 2015, ¶ 65 (footnotes omitted, emphasis added).

[690] **Doc. CL-59**, Sergey Ripinsky and Kevin Williams, DAMAGES IN INTERNATIONAL INVESTMENT LAW (British Institute of International and Comparative Law, 2008), p. 387. *See also* **Doc. CL-58**, Mark Kantor, VALUATION FOR ARBITRATION (Wolters Kluwer, 2008), p. 275; **Doc. CL-168**, Jeffrey M. Colón and Michael S. Knoll, *Prejudgment Interest in International Arbitration*, 4(6) TDM (November 2007), p. 18.

> equivalents permits the calculation to track the evolution of interest rates during the course of each year.[691]

565. Pre-award and post award interest should be compounded on a monthly basis on any amount the Sole Arbitrator awards to Claimants.

## E. Apportionment of Proceeds Among Claimants

566. Article 11.2.1 of the UNIDROIT Principles governs how multiple obligees (here, Claimants) can apportion performance:

> When several obligees can claim performance of the same obligation from an obligor:
>
> (a) the claims are separate when each obligee can only claim its share;
>
> (b) the claims are joint and several when each obligee can claim the whole performance;
>
> (c) the claims are joint when all obliges have to claim performance together.[692]

567. Since the parties here did not make an explicit contractual choice, Chapter 4 of the UNIDROIT Principles will govern apportionment of the Claim.[693] The original bargain was for a single rent unit (not divided in any manner).[694] Claimants' rights are joint and several. Consequently, each Claimant may claim the whole performance of Malaysia's payment obligation. Notwithstanding the above, this is irrelevant in our case because Claimants consist of <u>all the obligees under the 1878 Lease Agreement</u>. The Sole Arbitrator need only award the full amount to Claimants, and thereafter Claimants can distribute the proceeds among themselves.

568. That said, should the Sole Arbitrator prefer to specify the percentages payable to each Claimant, we detail the current ownership breakdown below.

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[691] Brattle Report, n. 190.

[692] Section 4 of the Commentary explains that, "when it comes to determining to which of the three types defined in this Article claims by plural obligees belong, the Principles do not provide any presumption". It further explains that "[t]he reason is that none of these types seems to be dominant in practice; choices vary considerably, mainly depending on the operation concerned".

[693] *See* UNIDROIT Principles, Article 11.2.1 (Section 4 of the Official Commentary); **<u>Doc. CL-61</u>**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), pp. 397-398.

[694] **<u>Doc. CL-61</u>**, Eckart J. Brödermann, UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (Nomos, 2018), p. 398 (noting that it should be considered to be joint and several claims when "the parties have agreed that the obligor has to pay to one or the other of the obligees").

569. Malaysia has made much of the Macaskie Decision of 1939 in its various attempts to deny the validity of, or derail, this arbitration proceeding. As the Sole Arbitrator confirmed in his Preliminary Award,[695] the Macaskie Decision served only, by way of Interpleader, to establish who the legal successors to the Sultan of Sulu were at that time for payments under the 1878 Lease Agreement.[696]

570. Since then, the appropriate courts in the Philippines have ruled that the legal administrators/administratrixes for the original heirs of the Sultan of Sulu are:

(i) **Nurhima Kiram Fornan**, who is entitled to receive a share of 3/16 of the payments under the 1878 Lease Agreement;[697]

(ii) **Fuad A. Kiram**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement;[698]

(iii) **Sheramar T. Kiram**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement;[699]

(iv) **Permaisuli Kiram-Guerzon**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement;[700]

(v) **Taj-Mahal Kiram-Tarsum Nuqui**, who is entitled to receive a share of 9/16 of the payments under the 1878 Lease Agreement;[701]

(vi) **Ahmad Narzad Kiram Sampang**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement;[702]

(vii) **Jenny K.A. Sampang**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement;[703] and

(viii) **Widz-Raunda Kiram Sampang**, who is entitled to receive a share of 1/24 of the payments under the 1878 Lease Agreement.[704]

571. The shares stated in ¶ 570 above amount to 100% of the Sultan's successors' right to payment under the 1878 Lease Agreement.

[695] Preliminary Award, ¶ 103.

[696] *See also* § II.I, *supra*; Notice of Arbitration § III.F; Counter-memorial on Jurisdiction and Applicable Law, § III.E.

[697] **Doc. C-104**, Letters of Administration of the intestate estate of Princess Sakinur-in Kiram.

[698] *Id.*, Letters of Administration of the intestate estate of Fuad A.Kiram.

[699] *Id.*, Letters of Administration of the intestate estate of Datu Punjungan Kiram.

[700] *Id.*, Letters of Administration of the intestate estate of Sitti Mariam Kiram.

[701] *Id.*, Letters of Administration of the intestate estate of Dayang-Dayang Hadji Piandao Kiram; Letters of Administration of the intestate estate of Putli Tarhata Kiram.

[702] *Id.*, Letters of Administration of the intestate estate of Mora Napsa.

[703] *Id.*, Letters of Administration of the intestate estate of Sitti Putli Jahara Kiram.

[704] *Id.*, Letters of Administration of the intestate estate of Sitti Rada Kiram.

## F. Summary of Applicable Remedy

572. The applicable remedy turns on two issues, namely (i) whether the Sole Arbitrator decides to terminate the 1878 Lease Agreement; and (ii) if so, when he fixes that date (*i.e.*, on 1 January 2013 or February 2020). The following chart summarizes the discussions and calculations made in the foregoing sections. The remedies Claimants seek are in the order reflected in the chart below:

| Relief Sought | Relevant Date | Description of the Relief Sought | Amount of Relief Sought | Interest Accrues From | Discussion |
|---|---|---|---|---|---|
| **Termination of the 1878 Lease Agreement** | Termination as of 1 January 2013 | Payment of restitution value ("allowance in money"), which is the sum of (i) historical value (2013 to February 2020); (ii) future certain value; and (iii) an equitable remedy for future post-2044 oil and gas value | US$ 32.20 billion (20% share)<br>US$ 24.15 billion (15% share)<br>US$ 16.10 billion (10% share) | 1 January 2013 | § V.B(f), *supra* |
| | Termination as of February 2020 or later | Payment of restitution value ("allowance in money"), which is the sum of (i) future certain value; and (ii) an equitable remedy for future post-2044 oil and gas value<br><br>**PLUS**<br><br>non-performance damages for the (rebalanced) unpaid rent from 2013 to the date of termination of the 1878 Lease Agreement | **Restitution Value of:**<br>US$ 26.71 billion (20% share)<br>US$ 19.28 billion (15% share)<br>US$ 12.85 billion (10% share)<br><br>**PLUS**<br><br>**Unpaid Rent:**<br>US$ 5.72 billion (20% share)<br>US$ 4.29 billion (15% share)<br>US$ 2.86 billion (10% share) | **Restitution Value:** 1 February 2020<br><br>**Unpaid Rent:** since each installment was due and payable at year's end | § V.B(g), *supra* |
| **No Termination of the 1878 Lease Agreement, but Adjusting or Rebalancing the 1878 Lease Agreement** | Breach on 1 January 2013 | Adjustment or rebalancing of the 1878 Lease Agreement to reflect the rebalanced rent, and consequently (i) payment of a lump sum for the (rebalanced) unpaid rent from 2013 to the date of the arbitral award; and (ii) an order that all future annual rent payments be made in the rebalanced amount | **Unpaid Rent:**<br>US$ 5.72 billion (20% share)<br>US$ 4.29 billion (15% share)<br>US$ 2.86 billion (10% share)<br><br>**PLUS**<br><br>an order that all future annual rent be rebalanced to the amount of<br>US$ 714 million (20% share)<br>US$ 535 million (15% share)<br>US$ 357 million (10% share) | **Unpaid Rent:** since each installment was due and payable at year's end | § V.C, *supra* |

## VI. MALAYSIA MUST PAY ALL COSTS OF THIS ARBITRATION

573. This is an *ad hoc* arbitration in which the arbitration clause is silent on costs. The Sole Arbitrator's ability to award costs is governed by the procedural law of the arbitration. In this case, Article 37(6) of the SAA grants the Sole Arbitrator power to make such a decision:

> Subject to agreement by the parties, the award will include the arbitrators' decision on arbitration costs, which will include their own fees and expenses, and, as appropriate, the fees and expenses of the parties' defence or representatives, the cost of the service rendered by the institution conducting the arbitration and all other expenses incurred in the arbitral proceedings.[705]

574. But the law governing the substantive standards for awarding legal costs is not necessarily the same as that governing the tribunal's authority to make an award on costs. The better view is that the standards governing awards of legal costs should be international standards, developed in light of the particular nature and needs of international arbitration. Prof. Gary Born believes so:

> [D]omestic rules regarding legal costs are designed with domestic litigation systems and legal professions in mind; these rules have little direct relevance to the international arbitral process, involving *sui generis* procedures, specialized objectives and lawyers from different jurisdictions. Rather, arbitral tribunals should develop international standards, appropriate to the commercial arbitration context, to ensure that parties are fully compensated for all reasonable costs of successfully vindicating their rights and that efficient, cooperative conduct in the dispute resolution process is rewarded.[706]

575. Most institutional rules include a provision regarding awards on costs. These generally grant arbitral tribunals broad discretionary powers to make these decisions.[707] In exercising their discretion, international arbitral tribunals have often used the "costs follow the event" rule, whereby the defeated party is ordered to bear the costs of the arbitration. Claimants submit that, following the principle of "costs follow the event", Malaysia should bear the costs of this arbitration.

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[705] **Doc. CL-1**, Spanish Law 60/2003, of 23 December, on Arbitration, Article 37(6) (emphasis added).

[706] **Doc. CL-169**, Gary B. Born, INTERNATIONAL COMMERCIAL ARBITRATION (Wolters Kluwers, 2009), p. 2495.

[707] This is the case, for instance, of the ICC Rules (article 37) and the UNCITRAL Rules (article 40).

576. International tribunals have also applied other criteria, such as the parties' conduct in the proceedings, when deciding on the allocation of costs:

> "The [1998 ICC] Rules do not contain any rules or criteria for the decision that the Tribunal must take [regarding costs]. The decision is left to the discretion of the arbitrator. Nevertheless, the results of the arbitration play a predominant role in the exercise of this discretion by the arbitrator. A party who loses his case is, in principle, ordered to pay the costs of the arbitration. However, <u>other criteria can be taken into account, and notably the manner in which the case was conducted, and the costs caused by reckless or abusive requests or delaying tactics</u>".[708]

577. The above is in line with the ICC's official stand on "Techniques for Controlling Time and Costs in Arbitration", which provides that:

> The allocation of costs can provide a useful tool to encourage efficient behaviour and discourage unreasonable behaviour. Pursuant to Article 38(5) of the Rules, the arbitral tribunal has discretion to award costs in such a manner as it considers appropriate.[709]

578. The Sole Arbitrator should take Malaysia's obstructive behavior into account when making a decision on costs. Malaysia's egregious conduct includes the following:

(i) Claimants repeatedly, but unsuccessfully, sought to avoid the submission of this dispute to an arbitrator by attempting to engage in negotiations of the 1878 Lease Agreement.[710] Malaysia failed even to reply to Claimants' repeated requests.[711] Therefore, Malaysia breached its duty to engage in renegotiations under both the 1878 Lease Agreement and Article 6.2.3(3) of the UNIDROIT Principles.[712] Prof. Brödermann confirms that Malaysia's evasive behavior is a violation of said provision of the UNIDROIT Principles.[713]

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[708] **<u>Doc. CL-169</u>**, Gary B. Born, INTERNATIONAL COMMERCIAL ARBITRATION (Wolters Kluwer, 2009), pp. 2499-2500 (emphasis added).

[709] **<u>Doc. CL-170</u>**, *Techniques for Controlling Time and Costs in Arbitration* (ICC COMMISSION REPORT 2018), ¶ 82.

[710] *See* § II.N, *supra*; Preliminary Award, ¶ 69.

[711] Preliminary Award, ¶ 85 ("Respondent had voluntarily chosen not to be involved into the present procedure from the beginning of the case, thus showing its reluctance to settle disputes under the Deed by resorting to the Arbitration Agreement".).

[712] *See* § IV.D(b)(ii)(1), *supra.*

[713] Third Brödermann Report, ¶¶ 603 (noting that "[i]t is sensible to include within these damages [*i.e.*, damages arising from the failure to engage in renegotiations] the legal costs of an arbitration to terminate or rebalance the agreement").

(ii) During the arbitration, Malaysia has refused to take part in the proceedings by failing to appoint legal counsel and to respond to the Sole Arbitrator's instructions.[714] Out of nowhere, Malaysia appointed the law firm Herbert Smith Freehills ("**HSF**") mere hours after the first preliminary conference. HSF participated in the proceeding for a few weeks and then renounced its representation. This stunt caused substantial unnecessary delay and work, also affecting the merits part of this arbitration, which would otherwise be considerably more advanced by now.[715]

(iii) Malaysia has failed to pay its portion of the deposits for this arbitration, forcing Claimants to pay all such deposits.[716]

(iv) Despite its official non-appearance in the proceedings, Malaysia has systematically sent intimidatory communications addressed to Claimants and the Sole Arbitrator, often containing threats.[717]

(v) Malaysia has self-servingly sought an anti-suit injunction in the courts of its own territory, which has led to further intimidatory and coercive visits to, and *ex parte* communications with, the Sole Arbitrator.[718]

(vi) Malaysia's conduct has substantially increased the costs of the proceedings by forcing Claimants to serve Malaysia hard copies of their submissions at no fewer than 5 different addresses to ensure safe receipt.[719]

579. For more than two years, beginning with Claimants' notice of intent to commence arbitration dated 2 November 2017,[720] Malaysia's tactics have ranged from obstinate silence, to overt defiance of the Court's and the Sole Arbitrator's jurisdiction, to disingenuous delay tactics, and ultimately to illegal attempts to intimidate the Sole Arbitrator. Despite these tactics, the Sole Arbitrator generously offered Malaysia every opportunity to participate in the arbitral process and put forward its position. Malaysia has snubbed the Sole Arbitrator at every turn, either with aggressive threats of contempt of court, or with stubborn silence. All this is plain bad faith, at the very least.

580. Scholars and precedents reveal that it is usual practice to penalize a party by an adverse award on costs when it has not arbitrated in good faith or used tactics to delay and/or increase the costs of the proceeding. As Colin YC Ong and Michael

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714 Preliminary Award, ¶¶ 8, 55, 85, 106, 120.

715 *Id.*, ¶¶ 55-59; Letter of Paul H. Cohen to the Sole Arbitrator, 2 October 2019.

716 Preliminary Award, ¶¶ 151-152.

717 *Id.*, ¶ 77.

718 *Id.* (noting that the content of these communications "was intimidatory and coercive and their terms intolerable under any circumstance").

719 Notice of Arbitration, ¶¶ 22-24.

720 Preliminary Award, ¶ 9.

P. O'Reilly explain, "[w]hen parties agree to submit their disputes to arbitration, it by no means follows that they have consented to suffer their opponents' delaying and diversionary tactics which prevent the matter being dealt . . . quickly, effectively and fairly".[721] This is why "[w]here a party acts unreasonably the tribunal will have a broad discretion to decide whether or not and to what extent this conduct may lead to an adjustment of the costs".[722]

581. International tribunals have previously used the allocation of costs to sanction parties that have used dilatory or otherwise obstructive tactics during the proceedings. In the context of ICSID investor-State arbitration, Prof. Christoph Schreuer opines that, "[i]n a number of cases, tribunals awarded costs against parties as a sanction against what they saw as dilatory or otherwise improper conduct in the proceedings".[723] This was the case, for instance, in *Generation Ukraine v. Ukraine.*[724]

582. Similarly, the late Prof. David Caron's commentary to the provision on the allocation of costs in the UNCITRAL Rules states that one of the factors that tribunals must take into account when allocating the costs is the parties' conduct:

> Tribunals, for example, have awarded costs to a party as 'estimated compensation' for expenses incurred as a direct result of another party's conduct that was frivolous, in bad faith, or unnecessarily burdensome.[725]

583. The Iran-US Claims Tribunal, conducted under a version of the 1976 UNCITRAL Rules, has also applied this standard. For instance, in *International Schools Services, Inc. v. Iran,* the Tribunal stated that it had "previously taken into account a Party's conduct during the arbitral proceedings in determining the

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[721] **Doc. CL-171**, YC Ong and Michael P. O'Reilly, COSTS IN INTERNATIONAL ARBITRATION (LexisNexis, 2013), p. 75.

[722] *Id.*

[723] **Doc. CL-172**, Christoph Schreuer *et al.*, THE ICSID CONVENTION: A COMMENTARY (Cambridge University Press, 2009), p. 1230.

[724] **Doc. CL-173**, *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award dated 16 September 2003, ¶¶ 24.2-24.8.

[725] **Doc. CL-89**, David D. Caron, Lee M. Caplan and Matti Pellonpää, THE UNCITRAL ARBITRATION RULES: A COMMENTARY (Oxford University Press, 2006), p. 952.

appropriate amount of costs to award".[726] And in *Dadras International v. Iran*, the tribunal stated:

> In determining the appropriate amount of costs to award, the Tribunal has on several previous occasions taken into account a party's conduct during the arbitral proceedings. Specifically, the Tribunal has held that a party is entitled to the reimbursement of extra costs that it was forced to bear because of the other party's inappropriate conduct.[727]

584. Similar decisions have been taken in ICC cases. In case No. 12745 the Arbitral Tribunal considered that the conduct displayed by one of the parties was enough to justify an award on costs:

> A common method is to award costs to the party having won the arbitration or, where there is no clear winner, to allocate costs in proportion to the outcome of the parties' claims ('costs follow the event'). Another criteria [*sic*] adopted by arbitral tribunals under the ICC Rules is the general conduct of a party and the more or less serious nature of the case it has defended. . . .[728]

585. In ICC Case No. 8486, although the respondent's arguments had prevailed in most of the issues, the Tribunal decided to make an award on costs against it because it had not acted in good faith during the proceedings.[729] Among the dilatory tactics, the Tribunal identified failure to make the requested deposits, failure to appear at many points of the proceeding and a sudden change in its representation, (all of which apply to Malaysia here). The Tribunal concluded that, in accordance with the international principles of law, when allocating the costs, tribunals should consider not only the outcome of the proceedings but also the parties' behavior during them.[730]

586. Finally, in a petition to set aside an arbitral award in which one of the parties was awarded costs, the U.S. Court of Appeals for the Second Circuit ruled that:

> A broad arbitration clause, such as the one in this case [and in the 1878 Lease Agreement] . . . confers inherent authority on

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[726] **Doc. CL-75**, *International Schools Services, Inc. v. Islamic Republic of Iran and others*, 14 IRAN-US CTR 65, Award, 29 January 1987, ¶ 49.

[727] **Doc. CL-64**, *Dadras International and others v. Islamic Republic of Iran and others*, 31 IRAN-US CTR 127, Award, 7 November 1995, ¶ 280.

[728] **Doc. CL-65**, ICC Case No. 12745, Final Award, *printed in* Albert Jan van den Berg (ed.), XXXV YEARBOOK COMMERCIAL ARBITRATION 40 (2010), ¶ 274.

[729] **Doc. CL-66**, ICC Case No. 8486, Final Award, 1996, *printed in* Albert Jan van den Berg (ed.), XXIVA YEARBOOK COMMERCIAL ARBITRATION 162 (1999), ¶ 26.

[730] *Id.*

> arbitrators to sanction a party that participates in the arbitration in bad faith and that such a sanction may include an award of attorney's or arbitrator's fees.[731]

587. In light of the above, Claimants submit that, in the (we hope unlikely) event that the Sole Arbitrator dismisses their claims in whole or in part, Malaysia nonetheless should bear all costs in the arbitration, due to the manifest bad faith it has repeatedly displayed.

## VII. RESERVATION OF RIGHTS

588. Claimants reserve their rights to submit new arguments and/or evidence in light of any arguments and/or evidence that Malaysia may submit, as well as to respond to any arguments or evidence that Malaysia may submit. Claimants also reserve their right to supplement, modify or amend their arguments.

589. This Statement of Claim shall not be understood as a waiver by Claimants of any right arising from any applicable contractual document, law or treaty.

## VIII. CONCLUSION AND PRAYER FOR RELIEF

590. Claimants had hoped to settle this dispute amicably; they tried for decades to negotiate in good faith for a change in the terms of the 1878 Lease Agreement. It was to no avail. Claimants nonetheless anticipate dedicating a substantial portion of any monies received to a fund for the enrichment of the region that spanned the old Sultanate of Sulu – a region that, despite its wealth in natural resources, has found itself impoverished from colonial times to this day.

591. Claimants, in sum, seek redress for the manifest unfairness of the situation into which the Malaysian Government has placed them. They pray that they can find it through this proceeding. And they hope for the realization of the words of Martin Luther King:

*"The moral arc of the universe is long, but it bends toward justice"*.

[731] **Doc. CL-67**, *ReliaStar Life Ins. Co. of N.Y. v. EMC Nat. Life Co.*, 564 F.3d 81 (2d Cir. 2009), p. 86.

592. Claimants accordingly request that the Sole Arbitrator issue an award:

(i) **declaring** that the 1878 Lease Agreement is a lease;

(ii) **declaring** Malaysia in breach of the 1878 Lease Agreement;

(iii) **declaring** the 1878 Lease Agreement terminated, and:

a. if terminated as of 1 January 2013, **ordering** Malaysia to pay Claimants the restitution value of the rights over the Leased Territories as of that day, reflected at § V.F above; or

b. if terminated as of February 2020 or later, **ordering** Malaysia to pay Claimants the restitution value of the rights over the Leased Territories as of that termination date, reflected at § V.F above, plus non-performance damages for the (adapted or rebalanced) unpaid rent from 2013 to the date of termination of the 1878 Lease Agreement, reflected at § V.F above (currently for seven years);

(iv) alternatively, if the Sole Arbitrator does not terminate the 1878 Lease Agreement, **ordering** Malaysia to pay Claimants:

a. a lump sum for the (adapted or rebalanced) unpaid rent from 2013 to the date of the arbitral award, reflected at § V.F above (currently for seven years); and

b. all future annual rent payments in the adapted or rebalanced amount reflected at § V.F above;

(v) **ordering** Malaysia to pay all Claimants' costs in this arbitration;

(vi) **ordering** Malaysia to pay pre-award and post-award interest on any and all amounts awarded to Claimants, except for the award on costs, which should accrue post-award interest only; and

(vii) **ordering** any and all other relief that the Sole Arbitrator deems appropriate.

* * *

Respectfully submitted,

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Madrid, on 20 June 2020

## APPENDIX 1

**List of Fact Exhibits Submitted Herewith**

| Reference | Document Description |
|---|---|
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| Doc. C-56 | South China Morning Post, *Manhathir: 'I'm pro-Malaysia, not anti-Singapore'*, BANGKOK POST, 8 March 2019 |
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| Doc. C-58 | James F. Warren, TRADE, RAID, SLAVE: THE SOCIOECONOMIC PATTERNS OF THE SULU ZONE, 1770-1898 (Australian National University, 1975) |
| Doc. C-59 | Nicholas Tarling, SULU AND SABAH, A STUDY OF BRITISH POLICY TOWARDS THE PHILIPPINES AND NORTH BORNEO FROM THE LATE EIGHTEENTH CENTURY (Oxford University Press, 1978) |
| Doc. C-60 | *White Rajahs*, WIKIPEDIA |
| Doc. C-61 | Letter No. 1 from William H. Treacher to the Earl of Derby, 2 January 1878, in BORNEO, BRITISH NORTH BORNEO COMPANY 1903, The National Archives (United Kingdom) |
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| Doc. C-70 | Hansard's Parliamentary Debates, Third Series: Commencing with the Accession of William IV, Volume CCCIII, Second Volume of the Session (Cornelious Buck & Son, 1886) |
| Doc. C-71 | THE STATESMAN'S YEAR-BOOK: STATISTICAL AND HISTORICAL ANNUAL OF THE STATES OF THE WORLD FOR THE YEAR 1908 (MacMillan and Co., 1908) |
| Doc. C-72 | Ian Donald Black, NATIVE ADMINISTRATION BY THE BRITISH NORTH BORNEO CHARTERED COMPANY, 1878-1915 (Australian National University, 1970) |
| Doc. C-73 | K.G. Tregonning, *The Mat Salleh Revolt (1894-1905)*, JOURNAL OF THE MALAYAN BRANCH OF THE ROYAL ASIATIC SOCIETY Vol. 29, N. 1 (173) (May 1956) |
| Doc. C-74 | D.S. Ranjit Singh, *The Mat Salleh Uprisings, 1895-1903*, 4(4) SEJARAH: JOURNAL OF THE DEPARTMENT OF HISTORY (November 2017) |
| Doc. C-75 | Grant of Kinarut and Dinawan, The National Archives (United Kingdom), 14 May 1897 |

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| Doc. C-76 | Letter from Sir Ernest Woodford Birch, Governor of the British North Borneo Company to Charles Prestwood Lucas, Colonial Office, 21 June 1903, The National Archives (United Kingdom) |
| Doc. C-77 | Kaur Amajarit, ECONOMIC CHANGE IN EAST MALAYSIA- SABAH AND SARAWAK SINCE 1850 (Palgrave Macmillan, 1998) |
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| Doc. C-79 | Regina Lim, FEDERAL-STATE RELATIONS IN SABAH, MALAYSIA: THE BERJAYA ADMINISTRATION, 1976-85 (Institute of Southeast Asian Studies, 2008) |
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| Doc. C-92 | Thomas Fuller, *Oil Price Plunge Confounds Malaysia*, NEWYORKTIMES, 8 July 1998 |
| Doc. C-93 | Letter from Paul H. Cohen, on behalf of the Claimants, to Hasnan Zahedi bin Ahmad Zakaria, advisor of the Prime Minister of Malaysia, 15 November 2016 |
| Doc. C-94 | Letter from Paul H. Cohen, on behalf of the Claimants, to the Prime Minster of Malaysia, 28 April 2017 |
| Doc. C-95 | Letter from Paul H. Cohen, on behalf of the Claimants, to the Prime Minister of Malaysia, 2 July 2018 |
| Doc. C-96 | Letter from The Marquis of Salisbury to Mr. Stuart, 24 November 1879, British and Foreign State Papers, Volume 73, Foreign and Commonwealth Office, H.M. Stationery Office, 1889 |
| Doc. C-97 | 11 April 1878 letter, Alfred Dent to Edward Dent, The National Archives (United Kingdom) |

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| Doc. C-98 | Letter from William H. Treacher to Lord Salisbury, 22 June 1878, in Borneo, British North Borneo Company 1903, The National Archives (United Kingdom) |
| Doc. C-99 | *1819 Singapore Treaty*, SINGAPOREINFOPEDIA, 15 May 2014 |
| Doc. C-100 | Sir Edward Hertslet, K.C.B, THE MAP OF AFRICA BY TREATY VOL.1 (Printed for her Majesty's Stationery Office by Harrison and sons, St. Martin's Lane, 1894) |
| Doc. C-101 | U.K. House of Commons, Statements by Sir Edward Grey, Undersecretary of State for Foreign Affairs, June 13, 1895, in *Hansard*, Ser. 4, Vol. 34 (London, 1895) |
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## APPENDIX 2

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| Doc. CL-66 | ICC Case No. 8486, Final Award, 1996, *printed in* Albert Jan van den Berg (ed.), XXIVA YEARBOOK COMMERCIAL ARBITRATION 162 (1999) |
| Doc. CL-67 | *ReliaStar Life Ins. Co. of N.Y. v. EMC Nat. Life Co.*, 564 F.3d 81 (2d Cir. 2009) |

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| Doc. CL-68 | Supreme Court Judgment No. 2848/2017, 13 July 2017, FJ 5 |
| Doc. CL-69 | Luis Diez Picazo, FUNDAMENTOS DE DERECHO CIVIL PATRIMONIAL, Vol. II (Thomson Civitas, 2008) |
| Doc. CL-70 | Supreme Court Judgment No. 65/1997, 10 February 1997, FJ 3 |
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| Doc. CL-104 | *CME Czech Republic B.V. v. The Czech Republic, Ad Hoc*, Final Award, 14 March 2003 |
| Doc. CL-105 | *Sapphire International Petroleums Ltd. v. National Iranian Oil Company, Ad-Hoc*, Award, 15 March 1963 |

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| Doc. CL-156 | *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, Award, 25 May 2004 |
| Doc. CL-157 | *Siemens A.G. v. The Argentine Republic*, ICSID Case No. ARB/02/8, Award, 6 February 2007 |
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| | Case No. ARB/02/16, Award, 28 September 2007 |
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| Doc. CL-165 | *Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A. v. Argentine Republic*, ICSID Case No. ARB/03/19, Award, 9 April 2015 |
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| Doc. CL-171 | YC Ong and Michael P. O'Reilly, COSTS IN INTERNATIONAL ARBITRATION (LexisNexis, 2013) |
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| Doc. CL-173 | *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003 |
| Doc. CL-174 | *Scordino v. Italy*, ECHR No. 43662/98, 6 March 2007 |

## Appendix 3

**List of Media Files Submitted Herewith**

| Reference | Document Description |
|---|---|
| Doc. CER-2 | *Malaysian Prime Minister says he is not anti-Singapore*, YOUTUBE, 8 March 2019 |