

**THE STATE'S RIGHT TO REGULATE:**  
**AS INTERPRETED IN RECENT INVESTOR-STATE AWARDS**

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## Introduction

1. The question is to what extent the State has the right to regulate without being obliged to compensate investors for expropriation that arises out of such regulation.
2. The starting point should be a presumption that the State is not liable to compensate for the exercise of regulatory powers. *See M Sornarajah, The International Law on Foreign Investment* (4th edn Cambridge University Press, 2017) at page 469.
3. This presumption against compensation is strengthened where:
  - (1) the regulation is in areas of environmental protection;
  - (2) the regulation is in relation to cultural preservation;
  - (3) more generally, where the public interests are so dominant as to overwhelm individual interest.
4. On the other hand, the presumption against compensation, is weakened where:
  - (1) there is discrimination that cannot be explained in a legitimate manner; and
  - (2) the exercise is not accompanied by due process and other procedural safeguards that amount to a denial of natural justice in terms of international law.

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Marfin Investment Group Holdings SA & Ors v. Republic of Cyprus [ICSID Case No ARB/13/27  
(Award, 26 July 2018)]

Facts

1. The dispute arises from the BIT between Cyprus and Greece.
2. Article 4 of the Cyprus Greece BIT provides:

Investments by investors of either Contracting Party shall not be expropriated, nationalised, or subjected to any other measure which would be tantamount to expropriation or nationalisation in the territory of the other Contracting Party except under the following conditions:

- (a) the measures are taken in the public interest and under due process of law,
- (b) the measures are clear and non-discriminatory,
- (c) the measures are accompanied by provisions for the payment of prompt, adequate and effective compensation. Such compensation shall be equivalent to the market value of the investment affected immediately before the date on which the measures, mentioned in this paragraph, were taken or made publicly known.

Compensation shall be paid immediately after the completion of legal procedure for expropriation and shall be transferred in freely convertible currency. If the Contracting Party delays payment of compensation, it is liable to pay interest calculated on the basis of the 6-month London Interbank Offered Rate for the relevant currency. The extent or compensation is subject to review under due process of law.

3. The dispute concerns the failure of the second largest bank in Cyprus, Marfin Popular Bank Public Co Ltd, during the Cypriot financial crisis.

4. The Claimants, which include shareholders of Marfin Popular Bank, claimed that the Respondent had expropriated their investment by:<sup>2</sup>
  - (1) the Respondent's response to Private Sector Involvement Plus (PSI+);
  - (2) the removal of the Chief Executive Officer of Marfin Popular Bank; and
  - (3) the dilution of the Claimants' shareholding following Marfin Popular Bank's recapitalization.

### **Decision**

5. The arbitral tribunal considered that the economic harm, consequent to State regulations do not constitute a public taking provided that the regulatory measure:<sup>3</sup>
  - (1) was non-discriminatory and generally applicable;
  - (2) was taken in good faith, in particular, if such measure was adopted in order to protect the public welfare;
  - (3) complied with due process; and
  - (4) was proportionate to the aim sought to be achieved.
6. The arbitral tribunal recognized that Article 4 of the Cyprus Greek BIT is drafted in broad terms and does not include any exception for the exercise of the State's regulatory powers. However, the arbitral tribunal decided that the provisions of the BIT must be interpreted in accordance with customary international law, based on Article 31(3)(c) of the 1969 Vienna Convention on the Law of Treaties. Under customary international law, a State is not liable to compensate a foreign investor for the normal exercise of the State's regulatory powers, where the 4 conditions above are satisfied.<sup>4</sup>

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<sup>2</sup>See *Marfin Investment supra* at paragraph 825.

<sup>3</sup> See *Marfin Investment supra* at paragraph 826, 828, 829.

<sup>4</sup> See *Marfin Investment supra* at paragraphs 827 and 828.

7. The arbitral tribunal found that the Respondent's measures did not constitute a compensable taking.<sup>5</sup>
8. In particular, with respect to the Respondent's response to PSI+, the arbitral tribunal decided that it was not up to an arbitral tribunal constituted under an investment treaty to sit in judgment over difficult political and policy decisions made by the State, particularly where those decisions involved an assessment and weighing of multiple conflicting interests and were made based on continuously developing threats to the safety and soundness of the financial system. Unless the measure at issue is shown to be arbitrary, and unrelated to a rational policy, or manifestly lacking even-handedness, an arbitral tribunal should not intervene.<sup>6</sup>
9. As to the removal of the Chief Executive Officer from the management of Marfin Popular Bank, the arbitral tribunal adopted the position in *Saluka* that a banking regulator's decision to place a bank in forced administration was entitled to some deference. 'In the absence of clear and compelling evidence' that the bank regulator had 'erred or acted otherwise improperly in reaching its decision', an arbitral tribunal must accept the reasons given by the bank regulator for its decision. Therefore, it could not be for the arbitral tribunal to determine whether the Respondent's independent bank regulator's decision to remove the Chief Executive Officer of Marfin Popular Bank was correct or otherwise.<sup>7</sup>
10. The arbitral tribunal found that they should be mindful of the fact that a central bank acts as a regulator of a highly technical and sophisticated economic sector, that it has intimate knowledge of the underlying data, and is best placed to assess whether one course of action is preferable to another. It is not up to the arbitral tribunal to substitute its judgment on the advisability of the measures taken by the Respondent's independent bank regulator, so a certain level of deference to the judgment of the bank regulator must indeed exist.<sup>8</sup>

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<sup>5</sup> See *Marfin Investment supra* at paragraph 830.

<sup>6</sup> See *Marfin Investment supra* at paragraph 870, endorsing the view in *SD Myers Inc v. The Government of Canada*, UNCITRAL (First Partial Award, 13 November 2000) at paragraph 261.

<sup>7</sup> See *Marfin Investment supra* at paragraph 898, endorsing the view in *Saluka Investments BV v. Czech Republic*, UNCITRAL (Partial Award, 17 March 2006) at paragraphs 272 and 273.

<sup>8</sup> See *Marfin Investment supra* at paragraph 899.

11. Nevertheless, the arbitral tribunal considered that such deference must not impede its task to verify whether international law was complied with. If there was any evidence that a decision taken by a regulator was abusive, did not afford due process, or was a pretense of form designed to conceal improper ends, the arbitral tribunal must find a breach of international law.
  
12. The arbitral tribunal found that the removal of the Chief Executive Officer of Marfin Popular Bank was an exercise of regulatory powers:<sup>9</sup>
  - (1) taken in order to protect the public welfare;
  - (2) proportionate;
  - (3) non-discriminatory; and
  - (4) taken in good faith.
  
13. Specifically, on whether the measures were proportionate, the arbitral tribunal decided that, in order to determine whether the removal of management was a legitimate exercise of the State's regulatory powers, the arbitral tribunal must weigh the competing interests at stake; on the one hand, the State's legitimate interest to protect the public welfare and, on the other hand, the investor's legitimate interest to continue managing its investment.<sup>10</sup>
  
14. In this case, the competing interests at stake were:<sup>11</sup>
  - (1) the Respondent's interest in protecting the safety and soundness of its banking sector, the interests of depositors and taxpayers at large against the risk that Marfin Popular Bank, one of the two systemic banks in Cyprus, would be unable to meet its financial commitments and would become bankrupt; and
  - (2) the Claimants' interest to continue to manage Marfin Popular Bank.

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<sup>9</sup> See *Marfin Investment supra* at paragraph 901.

<sup>10</sup> See *Marfin Investment supra* at paragraph 983.

<sup>11</sup> See *Marfin Investment supra* at paragraph 984.

15. The arbitral tribunal found that the removal of the management of Marfin Popular Bank satisfies the condition of proportionality and the Claimants were not made to bear an excessive burden.

Magyar Farming Company Ltd & Ors v. Hungary [ICSID Case No ARB/17/27 (Award, 13 November 2019)]

### **Facts**

1. The dispute arises from the BIT between Hungary and the United Kingdom.
2. Article 6 of the Hungary UK BIT provides:
  1. Neither Contracting Party shall nationalise, expropriate or subject to measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as 'expropriation') the investments of investors of the other Contracting Party in its territory unless the following conditions are complied with:
    - (a) the expropriation is for a public purpose related to the internal needs of that Party and is subject to due process of law;
    - (b) the expropriation is non-discriminatory; and
    - (c) the expropriation is followed by the payment of prompt, adequate and effective compensation.

Such compensation shall amount to the market value of the investment expropriated immediately before the expropriation or impending expropriation became public knowledge, shall include interest at a normal commercial rate until the date of payment, shall be made without delay, be effectively realisable and be freely transferable. The investor shall have a right, under the law of the Contracting Party making the expropriation, to prompt review, by a judicial or other independent authority of that Party, of his or its case and of the valuation of his or its investment in accordance with the principles set out in this paragraph.

2. Where a Contracting Party expropriates the assets of a company which is constituted or incorporated under the law in force in any part of its own territory, and in which investors of the other Contracting Party own shares, it shall ensure that the provisions of paragraph 1 of this Article are applied to the extent necessary to guarantee prompt, adequate and effective compensation in respect of their investment to such investors of the other Contracting Party who are owners of those shares.
3. The dispute arises out of the Respondent's measures regulating possession and disposal of State-owned agricultural land, which, according to the Claimants, resulted in the expropriation of their leasehold rights to 760 hectares of State-owned land.
4. The Claimants contend that:
  - (1) by a Lease Agreement, Inicia Zrt, who is one of the Claimants, had a contractual and a statutory pre-lease right to the Land granted by the Respondent;
  - (2) the Claimants' pre-lease right meant that, if the Respondent intended to lease the Land to a third party upon the expiration of the Lease Agreement in July 2014, the Respondent should inform Inicia of any offer from a third party that the Respondent intended to accept. Inicia was then entitled to 'step in and assume the offer from the third party' and thereby enter into a renewed lease agreement upon the terms of that offer;
  - (3) in 2011, the Respondent amended their land law, and precluded lessees of State-owned agricultural land plots from exercising their statutory pre-lease rights in cases where the National Land Agency (the NLA) leased the land out by way of a tender;
  - (4) the Respondent then orchestrated a rigged tender process. Despite the Claimants' superior bids, the leases were purportedly won by third parties in January 2014;
  - (5) as a result, the Respondent evicted the Claimants from the Land in disregard of the Claimants' pre-lease rights; and
  - (6) the Respondent's measures constitute an unlawful expropriation of the Claimants' leasehold rights to the Land contrary to Article 6 of the Hungary UK BIT.<sup>12</sup>

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<sup>12</sup> See *Magyar Farming supra* at paragraphs 5 to 8.

## Decision

### ❖ Vested Rights

5. The arbitral tribunal decided that the term expropriation used in Article 6 of the Hungary UK BIT should be interpreted, in the light of the doctrine of acquired or vested rights, as mandated by Article 31(3)(c) of the 1969 Vienna Convention.<sup>13</sup>
6. Based on this doctrine, while the State may change general statutes based on its policy decisions, where the statute provided for a possibility of acquiring rights with economic value, and a private party availed itself of this possibility, subsequent regulatory changes must respect that vested right.<sup>14</sup>
7. The arbitral tribunal considered that a distinction should be drawn between a statute conferring mere privileges or powers on a private party and such party's subsequent exercise of these powers by acquiring what can be regarded as a vested right.<sup>15</sup>
8. The 1994 Hungarian Arable Land Act gave any party the power to enter into a lease agreement and thereby acquire a statutory pre-lease right. This power is not itself a vested right or an asset, and therefore the State could in principle change it without compensation. In turn, once a party availed itself of this power and entered into a lease agreement, such party will hold a vested right.<sup>16</sup>
9. The Respondent was at liberty to change its laws and remove provisions allowing a party to enter into a lease agreement and acquire a statutory pre-lease right. However, where a party had previously availed themselves of this power

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<sup>13</sup> See *Magyar Farming supra* at paragraph 344.

<sup>14</sup> See *Magyar Farming supra* at paragraph 344.

<sup>15</sup> See *Magyar Farming supra* at paragraph 348.

<sup>16</sup> See *Magyar Farming supra* at paragraph 349.



by entering into specific lease agreements, such parties had vested rights that ought to have been respected.<sup>17</sup>

❖ Police Powers

10. The arbitral tribunal found that a bona fide exercise of a State's right to regulate is exempt from the duty to provide compensation. However, creating an unqualified exception from the duty of compensation for all regulatory measures would be incompatible with non-expropriation provisions in BITs. *See Magyar Farming supra* at paragraph 364.
11. The arbitral tribunal recognized that there is no comprehensive test to distinguish regulatory expropriation, for which compensation is required, from an exercise of police or regulatory powers, for which no compensation is required.
12. The arbitral tribunal found that State measures annulling rights of an investor may be exempt from a duty of compensation only in a narrow set of circumstances. These circumstances can be categorized in two broad groups:
  - (1) first, the exemption from compensation may apply to generally accepted measures of police powers that aim at enforcing existing regulations against the investor's own wrongdoings, such as criminal, tax and administrative sanctions, or revocation of licenses and concessions; and
  - (2) second, regulatory measures aimed at abating threats that the investor's activities may pose to public health, the environment or public order. This line of case law relates to measures such as the prohibition of harmful substances, tobacco plain packaging, or the imposition of emergency measures in times of political or economic crises.<sup>18</sup>

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<sup>17</sup> *See Magyar Farming supra* at paragraph 350.

<sup>18</sup> *See Magyar Farming supra* at paragraph 366.

13. The arbitral tribunal found that the Respondent's change of its agricultural land holding policy was not within either of these two categories. While the Respondent was fully entitled to change its policies, in doing so it was required to respect vested rights. In other words, it is not immediately apparent why this policy change, which purportedly benefited Hungarian society as a whole, should have been carried out at the expense of the Claimants' vested rights.<sup>19</sup>

## Conclusion

14. In conclusion, the arbitral tribunals, in *Marfin Investment* and *Magyar Farming supra*, recognize the State's right to regulate without being liable to compensate investors provided that such regulations satisfy the four conditions of good faith, non-discrimination, due process and proportionality.
15. The arbitral tribunals, in *Marfin Investment* and *Magyar Farming supra*, do not expressly adopt an analysis that begins with a presumption that the State is entitled to regulate without being liable to compensate investors.
16. However, this presumption may be discerned from the arbitral tribunal's finding, in *Marfin Investment supra*, that an arbitral tribunal would need to give deference to a banking regulator's decision on complex issues on which such regulator would have the relevant data, as this should equally apply to most State regulations.
17. Similarly, the arbitral tribunal, in *Magyar Farming supra*, recognizes that the State was free to change its laws and policies.
18. As mentioned at beginning, the starting point should be a presumption that the State is entitled to regulate without being liable to compensate investors. This presumption may be rebutted when one of the four conditions is proved.

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<sup>19</sup> See *Magyar Farming supra* at paragraph 367.

19. The analysis should not be done in the reverse. That is, that a State is liable to compensate investors unless the four conditions are strictly proved.

