

## KEY POINTS

- Bail-ins in Cyprus and EU legislation raise questions about compliance with international investment protection obligations regarding compensation for expropriation, as well as other treaty standards of fairness and non-discrimination.
- An investment treaty claim against Cyprus alleging that bail-ins constitute compensable expropriation would raise non-trivial questions of jurisdiction and admissibility, but would be likely to be considered on merits.
- The substantive aspects of the claim might include:
  - Whether direct or indirect expropriation has occurred.
  - Whether Cyprus (or a similarly placed State) could validly invoke necessity, at least to suspend, and at most to preclude, the obligation to make good the loss.
  - What compensation is to be paid. States are entitled to expropriate lawfully under certain conditions, but only against the payment of compensation; if these conditions are not met, there is an obligation to restore the property or pay damages for its loss. In the present case, where money is what is taken, the distinction may be less obvious.

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# Bail-ins and the international investment law of expropriation: in and beyond Cyprus

It would be unfair to say that there is no international law of money. There is. But international financial law is relatively undeveloped in comparison to international trade and investment law, particularly as far as rules providing for formalised dispute settlement go. This article considers the legal issues which may arise from bail-ins of depositors of banks from the perspective of international investment treaty law. The focus is consciously narrow: it may be the case that, in addition to bail-ins of depositors, other measures are applied to depositors, bondholders, shareholders, or banks, raising further questions not only under investment law, but also the law of the European Union and the European Convention of Human Rights. However, these issues are outside the scope of this contribution.

## INTRODUCTION

Bailing-out a State or institution means bringing in money from the outside to assist it, in particular to avoid insolvency. “Bail-in” is essentially the opposite technique, though with a similar objective. Deposits are converted, against the depositors’ will, into equity, recapitalising the failing bank without the use of public money. In recent months, the bail-in tool has achieved particular prominence in a number of ways. It has been included in proposed amendments to the relevant Directives of the European Union (EU), with the particular provisions intended to be applied from 1 January 2018<sup>1</sup>. The amendments define bail-ins as the power of the relevant authorities to write down the claims of unsecured creditors of a failing institution and convert debt claims into equity, also setting out a detailed hierarchy of claims. The recitals explain that bail-ins

achieve the purpose of minimising the costs of resolution of failing institutions to taxpayers by ensuring that shareholders and creditors suffer appropriate losses. The proposals were approved by the Council of the EU at the end of June. (Bail-in is already available under US law in certain circumstances, pursuant to the recent Dodd-Frank financial reform Act.)

Conversion of deposits into shares was an important and controversial element of the response to the banking crisis in Cyprus. In late March 2013, the Central Bank of Cyprus intervened in the two largest banks of Cyprus, the Bank of Cyprus (BoC) and the Cyprus Popular Bank (also known as the Laiki Bank), applying a range of measures to their restructuring. These measures left deposits subject to the standard EU Government guarantee of €100,000 untouched, but provided for conversion of 37.5% of uninsured deposits of BoC into shares, and the freezing

of a further 22.5% with the possibility of a further bail-in after an independent valuation of BoC assets. On 29 July, it was reported that an additional 10% of the frozen deposits would be bailed-in, bringing the total bail-in to 47.5%. According to news sources, foreign, and particularly Russian, depositors have been particularly hard-hit by the bail-in, in view of their substantial deposits. Consequently, a depositor of €1m would have €100,000 covered by deposit insurance, 37.5% of €900,000 would have been bailed in initially (€337,500), and an additional 10% will be subject to further bail-in (€90,000). The International Monetary Fund (IMF) praised Cyprus for having taken “bold steps to address the crisis, including the upfront resolution and restructuring of the two largest and insolvent banks at no fiscal cost, while protecting insured depositors”.

But how far are measures of this type consistent with investment protection law? This legal regime is mainly embodied in international treaties, largely bilateral investment protection treaties (BITs) (around 3,000 at the end of 2012), but also some important multilateral treaties (eg, the North American Free Trade Agreement and the Energy Charter Treaty). These treaties provide substantive and procedural protection to foreign “investors” regarding the treatment of “investments”, as defined in each particular agreement. The boilerplate

substantive standards set out in the investment treaties include compensation for expropriation, fair and equitable treatment, freedom of transfers, and non-discrimination, whether by comparison with the host State's nationals ("the national treatment standard") or by comparison with nationals of other States ("the most-favoured-nation (MFN) standard"). However, the particular importance of investment treaties lies in the procedural rights that are usually granted to investors: they are entitled to bring a direct arbitral claim against the State in which the investment has been made ("the host State"), regarding breaches of investment treaties, and without having to procure specific consent or exhaust local remedies. In most treaties, investors are offered a choice between arbitration under the auspices of the International Centre for the Settlement of

differ from case to case. The Cyprus bail-ins provide a good case study for analysing the conditions for the application of investment protection law, particularly in view of the controversial application of bail-in to all uninsured depositors, and the apparent consensus – even if articulated with different degrees of elegance – that depositors and bondholders from Russia were particularly heavily hit by these measures (rightly so, according to those who maintain that the funds were in many cases the result of money-laundering and other dubious conduct). Could foreign depositors rely on investment protection law to challenge the measures of Cyprus? In answering this question, one must first separate two types of preliminary legal issue: matters of jurisdiction, and obstacles to admissibility of a claim. These issues will be addressed in turn.

Convention on Human Rights; but BITs speak in terms of "investments", which is arguably a narrower concept. Most treaties define "investments" in broad and non-exhaustive terms, often explicitly mentioning bonds and claims to money. While one might expect that to be the end of the matter, there has been some disagreement between Tribunals about the general contours of the definition of "investment": in particular, whether a putative investment has to satisfy only the definition provided in the particular treaty, or also certain additional criteria regarding commitment of funds, duration, profit, risk, and contribution to development. Some have argued that these additional criteria are inherent in the notion of "investment" in the ICSID Convention (which contains no definition of the concept); others disagree. Debate centres on whether such criteria are jurisdictional requirements or merely typical features of investments; and whether these criteria would apply to investment treaty claims brought in arbitral fora other than ICSID. There has also been some disagreement between arbitrators, sitting in recent cases brought against Argentina, as to whether governmental bonds qualify as investments made within the territory of the particular State – a discussion that could throw some light, by careful analogy, on the "investment" status of deposits. While a number of investment treaty arbitrations have dealt with claims relating to alleged mistreatment of banks, the narrower question of whether deposits qualify as investments does not seem to have been properly dealt with. A definition of "investment" focusing on the language of BITs, or applying more general criteria in a flexible manner would be easy to satisfy, while a strict reading of requirements of eg, duration of contribution may exclude at least short- to medium-term deposits.

## The applicability of, and the degree of protection provided by investment protection law to depositors subject to bail-ins may differ from case to case.

Investment Disputes ("ICSID", an affiliate of the World Bank) and under other rules of arbitration – the Arbitration Rules of the UN Commission for International Trade Law (UNCITRAL) being the most common alternative option. Cyprus has concluded 27 BITs, of which 20 are in force, and is a party to the ICSID Convention. The next sections will consider whether investment protection rules, particularly the right to compensation for expropriation, can be relied on by foreign investors affected by bail-ins, considering in turn certain preliminary issues of applicability of investment treaties, then focusing on legal and factual aspects of expropriation and bail-ins, and finally giving a brief overview of the possible relevance of other investment protection obligations.

### WHEN IN CYPRUS: SETTING THE SCENE FOR INVESTMENT PROTECTION LAW

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### Jurisdiction: "investors" and "investments"

Investment protection law gives investors procedural rights to bring arbitral claims against States regarding investments; "an investor" and "an investment" are therefore necessary jurisdictional requirements for such a claim.

The first jurisdictional aspect may be disposed of relatively briefly: the relevant question is whether the definition of "an investor" in an international treaty binding upon Cyprus is satisfied. Whilst a BIT between Cyprus and Russia is not in force, and investments by Russian nationals would therefore not be directly covered, investments by Russian-controlled companies incorporated in States which do have binding BITs with Cyprus would normally qualify (as well as, of course, other, non-Russian-controlled, companies and natural persons of the particular States that have BITs with Cyprus).

Deposits are undoubtedly "possessions" and "property" under eg, the European

### Bails-ins (of depositors) and bail-outs (of Cyprus)

The case of Cyprus also raises a challenge that is simultaneously obvious and atypical: should any significance be attached to the broader context within which the bail-ins took place, when Cyprus was apparently

nudged in the direction of applying bail-ins to a broad category of depositors by the so-called Troika (IMF, European Commission (EC), and European Central Bank (ECB))? This fact might be significant in three ways.

- In factual terms, an arbitral Tribunal will be aware that the particular conduct reflects not merely the policy of Cyprus, but also the shared preference of the IMF, EC, and ECB; accordingly, it might be less inclined to view it as arbitrary, capricious, or unreasonable in a way that breaches eg, the standard of fair and equitable treatment or the requirements for lawful expropriation.
- Secondly, in legal terms, there may be some uncertainty about the manner in which the legal order of the post-Lisbon Treaty EU, which now possesses competence over direct investments, fits together with pre-existing investment protection treaties between member states (Cyprus is a member state of the EU, as are some of the States of nationality of direct investors, or subsidiaries of non-EU (eg, Russian) investors). The EC has tended to take a critical view about different aspects of the competence of investment treaty tribunals to rule on disputes raising matters of EU law and practice; again, one imagines that some such arguments might be made in this case.

### Admissibility and third parties

Finally, the question might arise in terms of admissibility: Cyprus might invoke precedents from the International Court of Justice and assert that it is impermissible to decide a case in the absence of necessary and proper third parties. The question of the admissibility of a claim before an international tribunal against a State whose conduct was required in order to fulfil a condition for, or at least closely connected with, measures for obtaining credit in a memorandum of understanding with third international organisations raises a whole host of further complicated issues. This latter point may provide the best frame of reference under international law for capturing possible uneasiness about this case, in which the scope

and manner of application of bail-in tools by a particular State may be causally linked to the position of international organisations providing credit. There can be no certainty as to how Tribunals will react.

### BAIL-INS AND EXPROPRIATION

If the hurdles of jurisdiction and admissibility can be overcome, the question arises whether the relevant BIT's provisions on expropriation have been breached. This analysis may be divided into three parts: the international legal standards relating to expropriation; application of these standards to bail-ins; and the consequences.

### Law of expropriation

Investment protection treaties almost invariably contain rules on expropriation that, while differing at the level of small print, would usually define expropriation (as both direct and indirect); formulate criteria of lawfulness of expropriation (legitimate public purpose, non-discrimination, compensation, and sometimes also due process); and spell out certain elements in more detail (the criteria for calculation of compensation, conditions of transfer of compensation, rights of review under due process, additional assurances of non-discriminatory treatment etc).

Determination of whether direct expropriation has occurred should be fairly straightforward: the title to property is taken away from its private owner by a public act (and either vested in the State or another person). Nationalisations of the last century were mostly clear-cut cases of direct expropriation, with the debate mainly focusing on compensation. Indirect expropriation is more challenging to define. One might draw a distinction between cases that focus on the effect of measures on the investments, and those that take the character of the public measures as the starting point; two awards dealing with alleged mistreatment of banks may illustrate the difference.

According to the *Deutsche Bank AG v Sri Lanka* Tribunal:

“many tribunals in other cases have tested governmental conduct in the context of

indirect expropriation claims by reference to the effect of relevant acts [e.g. of major unilateral increases in royalties], rather than the intention behind them. In general terms, a substantial deprivation of rights, for at least a meaningful period of time, is required” (*Deutsche Bank AG v Sri Lanka*, ICSID Case no ARB/09/02, Award, 31 October 2012, para 503).

Conversely, the *Saluka v Czech Republic* Tribunal suggested that:

“It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare” (*Saluka Investment BV v Czech Republic*, UNCITRAL Arbitration, Partial Award, 17 March 2006, para 255).

Each strand of the law of expropriation would thus formulate the definitional question in different terms. For direct expropriation, one would ask whether the title to the investment has been lost. For the *Deutsche Bank* version of indirect expropriation, one would ask whether, despite the title not being lost, the substantial and temporal effect on property has reached the level of direct expropriation. On the *Saluka* approach, one might ask whether the regulations, whatever their effect might be, have been non-discriminatory, aimed at public welfare, and adopted in a non-arbitrary manner in accordance with due process. Finally, an intermediate position might take into account all considerations by articulating an inquiry in terms of proportionality, considering the effect, purpose, and formal and procedural quality of the measures.

### Applying the law of expropriation to bail-ins

The legal inquiry may be conducted in two steps: first, has expropriation taken place? Secondly, if it has, have the criteria of lawfulness been fulfilled? There is considerable force in the argument for

viewing bail-ins as direct expropriations. It is uncontroversial that taking assets of a company or shares in a company would be a direct expropriation of the particular assets or shares. Why should one reach a different conclusion if it is title to deposits in a company that is lost, even if the former depositors get shares in return for their loss; even if a part of the deposits remains untaken; and even if, furthermore, some of the deposits may be returned in due course (as the memoranda of Cyprus suggested regarding future bail-ins)? The broader structure of the deposit-for-share swap (even with the possible consequence, perhaps not entirely appreciated initially, that former depositors may gain control of the bank as shareholders) does not affect the initial proposition that deposits are, in fact, lost. One might plausibly be cautious about characterising partial

formulated and applied in a formally even-handed manner? If they have not, are the distinctions (eg, exempting insured deposits, deposits below or above certain amount, or deposits by particular types of depositors) justifiable by reference to legitimate purposes? (In the case of Cyprus, the IMF acknowledged the concern, “*caution[ing] against exemptions from conversions into equity, which could lead to unequal treatment among uninsured depositors*.” Similarly, the possible provision of compensation for measures affecting pension funds may raise questions of the justifiability of distinctions between different types of depositor). In any event, even if *de jure* non-discriminatory, are the bail-ins *de facto* discriminatory, disproportionately affecting a particular group of depositors (eg, foreign depositors as a whole, or depositors from a particular State

deprivation of rights, very important public interests, and the form and procedure through which the measures have been formulated and implemented. A possible criticism of this approach, however, is that it uses criteria for determination whether indirect expropriation has taken place similar to those applicable in determination whether the expropriation has been lawful, as we are about to see.

### Substantive legal consequences

If expropriation is held to have occurred, it may have been lawful or unlawful. As previously indicated, expropriation is not unlawful if it is carried out with due legal process, for a legitimate public purpose, and in a non-discriminatory manner, providing also that compensation is paid – as to which see more below. If these criteria are not met, then the taking is unlawful and the property has either to be returned or damages paid for its taking – which will also be discussed shortly.

Cyprus might try to rely on the defence of necessity, and argue that this meant that what would otherwise be illegal, was not. Under general international law, necessity can preclude wrongfulness, even if not expressly provided for in the treaty. The defence is, however, intended to apply only in narrow circumstances when essential interests of States have to be safeguarded against grave and imminent peril. The invocation of necessity in the disputes arising out of the Argentine crisis of the early 2000s has somewhat muddied the waters, and one might point to arbitral or doctrinal authority for nearly every imaginable construction of necessity in investment treaties or the general international law of State responsibility. Still, in the absence of particular treaty exceptions on the point, necessity has never been recognised as precluding wrongfulness for breaches of investment obligations. Arguably, though, the crisis of Cyprus may provide a stronger case for applying the doctrine. Cyprus was perceived as being not very far from a sovereign default, with grave implications for itself, the Euro and the EU as a whole, and the particular solution was found most appropriate (or perhaps even suggested) by the EU and IMF.

## The application of bail-in tools may also be characterised as indirect expropriation...

*indirect* taking or destruction of a business as an expropriation for the purposes of investment law; but a direct expropriation of a clearly identifiable part of an investment, such as a part of a deposit, would probably still be treated as an expropriation.

The application of bail-in tools may also be characterised as indirect expropriation, resulting from a regulatory process regarding (bank) restructuring and insolvencies. The *Deutsche Bank* standard would consider the permanence of bail-ins, and the degree to which they deprive depositors of their rights. (In particular cases other measures depriving investors of their rights eg, taxation or exchange controls, may be applied in parallel, making the argument for expropriation on the basis of effect even stronger.)

The *Saluka* standard would ask questions of a different nature. The proposition that measures aimed at the recovery of banks, particularly in circumstances of severe financial crisis, are designed for the general welfare would seem fairly uncontroversial. But whether the measures were discriminatory would require an examination of particular factual circumstances: have the bail-ins been

or a State that is not a member of a particular international organisation)? If the origin of capital in particular States and its allegedly dubious nature have been explicitly used in the policy discussion about the scope of bail-ins, this – it might be argued – demonstrates an underlying discriminatory *animus*.

Requirements of non-arbitrariness and due process would require an examination of the formal aspects of the bail-in tools: are they formulated in sufficiently clear and predictable terms and not introduced and applied in a sudden or arbitrary manner? For example, in Cyprus, recapitalisation measures of BoC on 29 March used powers granted by a law that had been adopted only on 22 March (based on EU legislative proposals that themselves considered it too hasty to apply bail-ins before 2018). Have the necessary procedural guarantees (eg, appropriate information and consultation) been complied with?

An intermediate method of determining whether there had been indirect expropriation would draw together all the considerations identified and ask whether an ultimate relationship of proportionality has been maintained between the very severe

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The Cyprus case is also somewhat unusual in another respect. If a going concern, for instance, is expropriated, there is a significant difference in quantum between the compensation payable for a lawful taking and the damages (which can include lost future profits) payable if the taking was unlawful. Where the investment is a money claim, however, the difference may be hard to detect. Compensation will require the payment of the sum (or something close to it) plus interest; if the conduct is unlawful, repayment of the sum in question comprises the restitutionary element, whilst interest is the normal way of compensating for the loss of opportunity to utilise the money in question. Where the financial difference is marginal, respondent States may not be unduly troubled by the characterisation of their act, and so might not rely too heavily on necessity to demonstrate the lawfulness of their conduct. But a plea of necessity could make considerable sense in some serious crises, providing States with breathing space until the extraordinary circumstances are over, when the obligation will be reactivated. (Further questions could arise as to when that would be the case here: is it when Cyprus no longer requires emergency credit; when it has repaid the credit; or when it has recovered from the crisis?)

Finally, to return to issues of quantum, further delicate questions could arise. The quantum of compensation for a lawful taking is normally calculated on the basis of the value of the asset before the expropriation occurred or the intention to expropriate became known. One argument in the present case might be that deposits with an insolvent bank are worthless: it would be odd to require compensation for full value, if uninsured depositors would be unlikely to get anything at all in the event of insolvency, and the bail-in might both save the bank and give at least some possibility of a return for shareholders and bondholders. Another view might be that deposits are better analogised to contracts, where the benchmark for compensation would be the sum agreed as a matter of contractual obligation, rather than the fair market value of a contractual right at a particular point. Unlike shares, where the correlation between the market value and shares is an underlying

assumption, depositors do not expect the right to repayment of their deposit to be affected by such changes (at least to the extent that they are not included as part of the contract itself, eg, calculation of interest by reference to changes in the lending rates). Other issues about quantum could also be imagined.

### OTHER SUBSTANTIVE INVESTMENT RULES

Investors will naturally plead as many different breaches as they can. Often a finding of expropriation will yield a higher level of compensation or damages than a claim for breach of eg, the fair and equitable treatment standard, so there is an additional incentive to concentrate on expropriation. Still, in many cases investors will find it easier to prove that the State has acted in a discriminatory or unfair manner than that expropriation has occurred (eg, in the *Saluka* case cited above, although not in the *Deutsche Bank* case), and substantial

damages have also been awarded in disputes where no expropriation has been found.

Some of the considerations sketched in the previous sections dealing with expropriation will also be relevant for other substantive investment protection rules. For discrimination, the question is whether the State has treated investors in an unjustifiably less favourable manner: eg, have particular depositors or deposits been subject to bail-ins or provided less favourable associated guarantees? In the absence of *de jure* discrimination, has indirect discrimination taken place, affecting foreign investors in general or foreign investors from certain States in particular in a disproportionate manner? Fair and equitable treatment would focus on the formal and procedural characteristics of the measures: eg, whether the rules regarding bail-ins have been sufficiently transparent and predictable, their application in line with due process, and whether reasonable expectations have been complied with. The complexity and fluidity of the factual circumstances

surrounding the crisis in Cyprus makes it quite challenging to provide clear answers, with both the fine print and the broader themes – sudden and apparently unexpected introduction and application of the regime, severity of the crisis, and support by the IMF and the EU of the policies – pulling in different directions.

### CONCLUSION

Bail-ins may be a wonderfully neat way of recapitalising important financial institutions without spending a penny of taxpayers' money, but their lawfulness from the perspective of investment law is an entirely different question. This article has outlined some relevant considerations of a procedural and substantive character that a Tribunal might need to take into account in deciding a claim that a bail-in constitutes a breach of treaty. No clear answer has been provided here to all of the questions: there are legal issues on which reasonable people

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may disagree (eg, the definition of investments and of indirect expropriation); specific treaty provisions vary; factual circumstances are complex, may raise different issues in different situations, and in Cyprus the situation is still evolving; and finally, different forensic strategies might formulate the issue in different terms. Still, investment protection law certainly has to be accepted and accounted for as an important element in the complex web of legal rules and procedures framing the responses by States to crises (both the present one in Cyprus and those that will be covered by EU and US rules in the future), and will form an important part of the background to any resolution. ■

**1** Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms <[http://ec.europa.eu/internal\\_market/bank/docs/crisis-management/2012\\_eu\\_framework/COM\\_2012\\_280\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf)> at [4.4.10], recital [45], arts 37-51.