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Case summary

ADC Affiliate Limited and ADC & ADMC Management Limited
v
The Republic of Hungary

Year of the award: 2006
Forum: ICSID
Applicable investment treaty: Cyprus-Hungary BIT (1989)

Arbitrators	**Timeline of the dispute**
Neil Kaplan CBE QC, President The Hon. Charles Brower Professor Albert Jan van den Berg	7 May 2003 – request for arbitration 8 March 2004 – arbitral tribunal constituted 15 February 2005 – decision on jurisdiction 2 October 2006 – arbitral award

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I. Executive Summary

In 1995, the Claimants, ADC Affiliate and ADC & ADMC Management, both Cypriot companies ultimately owned by Canadian investors, entered into a contract with a Hungarian state agency, ATAA, whereby they had to renovate, construct and operate two terminals of Budapest-Ferihegy International Airport in Hungary. In late 1998 the Claimants successfully finished construction and renovation of the terminals and operated them until the end of 2001. However, in December 2001 a Decree issued by the Minister of Transport of Hungary resulted in the take over of all the activities related to the operation of the Airport from the Claimants.

In 2003, ADC Affiliate and ADC & ADMC Management initiated arbitration proceedings against Hungary under the Cyprus-Hungary BIT (1989) claiming that their investments had been expropriated and requesting an award of damages in the amount ranging from US$ 68 million to US$ 99.7 million.

The Tribunal found that an unlawful expropriation had indeed occurred. In its evaluation of damages, the Tribunal declined to apply the BIT standard of "just compensation" equal to "market value of the expropriated investments at the moment of the expropriation", as in the Tribunal's view, that BIT standard applied in cases of *lawful* expropriation. Instead, the Tribunal applied relevant rules of customary international law as elucidated in the PCIJ *Chorzów Factory* case ("payment of a sum corresponding to the value which a restitution in kind would bear"). As a relevant date for the assessment of damages, the Tribunal chose the date of the Award because the value of the investments increased considerably since the date of expropriation.

To estimate the market value of the investments, the Tribunal applied the DCF analysis, although without a detailed explanation. The Tribunal awarded approximately US$ 76.2 million to the Claimants, plus post-Award interest at 6% p.a. compounded monthly until payment.

II. Factual Background and Claims of the Investor

In 1994, ADC, a Canadian company, won the tender in relation to the Airport of Budapest-Ferihegy International Airport (the "Airport"). The work to be performed consisted of renovating Terminal 2/A, constructing Terminal 2/B and participating in the operation of these two Terminals.

In 1995, ADC concluded with the Air Traffic and Airport Administration (ATAA), a Hungarian State agency, a "Master Agreement", which laid down the terms and conditions of the transaction. Under the Master Agreement, ADC formed a Hungarian wholly-owned subsidiary, the "Project Company". To benefit from an advantageous tax regime, ADC made its capital contribution to the Project Company through its affiliate – a Cypriot company "ADC Affiliate". ADC also incorporated in Cyprus "ADC & ADMC Management", in order to provide management services to the Project Company.

In late 1998, the Project Company successfully finished construction and renovation of the Terminals and operated them until the end of 2001. The Master Agreement had an initial term of twelve years from the operations commencement date subject to a possible extension for another six years.

On 20 December 2001, the Hungarian Minister of Transport issued Decree No. 45/2001 ("Decree") which provided for the transformation of the ATAA. The statutory successor of ATAA, Joint Stock Co. Budapest Ferihegy International Airport Management Ltd., sent a letter to the Project Company notifying it of the Decree and stating that it will take over all operations and related activities of the Airport from 1 January 2002. A similar letter was also sent to ADC & ADMC Management.

In 2003, ADC Affiliate and ADC & ADMC Management initiated arbitration proceedings against Hungary under the Cyprus-Hungary BIT (1989) claiming that their investments in Hungary had been expropriated as a result of the Decree. They argued that they had been put in a situation where they were unable to pursue their sole aim, i.e. the operation of the Terminals. The Claimants argued that the expropriation had been unlawful because (a) the taking was not in the public interest; (b) it did not comply with due process, as allegedly the Claimants had been denied "fair and equitable treatment" required by Article 3(1) of the BIT and Hungary failed to provide "full security and protection" to the Claimants' investment under Article 3(2) of the BIT; (c) the taking was discriminatory, and (d) not accompanied by the payment of just compensation.

The Claimants contended that as a result of the measure at issue, ADC Affiliate had been deprived of the stream of dividends from the Project Company and that ADC & ADMC Management had been deprived of the management fees payable to it by the Project Company. The Claimants also argued that in the long run, the Project Company would have had the opportunity to participate in the financing, building and operation of the proposed new Terminal 2/C or in the renovation and reopening of Terminal 1.

To compensate for the damage incurred, the Claimants requested to award them the market value of expropriated investment, either at the moment of expropriation or at the date of the Award (the amount requested varied from approx. US$ 68 million to US$ 76.2 million). As a third alternative claim, the Claimants requested US$ 99.7 million under the unjust enrichment approach.[1]

III. Findings on Merits[2]

A. Applicable law

[1] The unjust enrichment was rejected by the Tribunal without a substantive discussion, as not "substantiated by the Claimants with either sufficient facts or law". (para.500) It will not be discussed further.

[2] Before proceeding to the merits of the case, the Tribunal considered objections to jurisdiction and found that that it had full jurisdiction to hear the claims. (paras. 294-364)

In accordance with Article 42(1) of the ICSID Convention, the Tribunal had to apply the rules chosen by the parties. For the Tribunal, the rules of law chosen by the parties were those contained in the Cyprus-Hungary BIT, as the BIT was the legal basis for the arbitration. The Tribunal also considered that this consent comprised a choice for general international law, which included customary international law. (paras. 288-293)

B. Expropriation

The Tribunal agreed with the Respondent that a sovereign State possesses an inherent right to regulate its domestic affairs, but stated that this right had boundaries laid down in the BIT, meaning that the State should not resort to an unlawful expropriation. The Tribunal also rejected the Respondent's contention that the Claimants' losses were part of the business risk borne by foreign investors. The Tribunal determined that the Decree led to the expropriation of the investment. (paras. 423-425)

In order to determine whether the expropriation was lawful or unlawful, the Tribunal proceeded to analyze each of the four requirements set out in Article 4 of the BIT (public interest, the respect of due process of law, non-discrimination and just compensation). First, the Tribunal found that Hungary failed to establish that the Decree served public interest. Secondly, the Tribunal found that the taking did not meet the due process of law requirements such as a reasonable advance notice, a fair hearing and an unbiased and impartial adjudicator to assess the claims. Thirdly, the Tribunal held that the actions were discriminatory. And finally, the Tribunal stated that it was obvious that just compensation was not provided by Hungary to the Claimants. (paras. 426- 444)

Additionally, the Tribunal concluded that Hungary breached the protection standards found in Article 3 of the BIT, i.e. "fair and equitable treatment", "unreasonable or discriminatory measures" and "full security and protection". (para. 445) However, for the purposes of the arbitration, those treaty violations did not have a separate significance, because under the Cyprus-Hungary BIT investors could use the investor-State dispute settlement only for *expropriation* claims. Therefore, the Tribunal viewed violations of the named standards as a manifestation of the breach of the "due process" requirement in the expropriation provision. (para.476(d))

IV. Findings on Damages

A. Law Applicable to the Determination of Damages

As mentioned above, the Tribunal applied both the BIT and general international law. The choice between the two was a contentious issue in relation to the award of damages. Although the Tribunal accepted that in general, relevant BIT is a *lex*

specialis whose rules will prevail over rules of customary international law,[3] in this case the Tribunal applied the latter (for details, see the following sections "Standard of Compensation" and "Date Relevant for the Assessment of Damages").

B. Standard of Compensation

The Tribunal first addressed the issue of whether the BIT standard or the standard of customary international law was to be applied to the assessment of damages. Article 4 of the BIT prohibited expropriation without the payment of "just compensation" and provided additionally:

> 2. The amount of compensation must correspond to the market value of the expropriated investments at the moment of the expropriation.
> 3. The amount of this compensation may be estimated according to the laws and regulations of the country where the expropriation is made.

Article 4.3 of the BIT thus referred to Hungarian law in the present case.

As mentioned above, although generally a BIT was *lex specialis* prevailing over rules of customary international law, the Tribunal determined, however, that Article 4 of the BIT stipulated only the standard of compensation payable in case of a *lawful* expropriation and that the BIT was silent about rules on damages payable in case of an *unlawful* expropriation. The Tribunal decided that the application of the BIT standard to a case of unlawful expropriation would be inappropriate as this would "conflate compensation for a lawful expropriation with damages for an unlawful expropriation." (paras.480-482)

Therefore, in order to compensate for an unlawful expropriation found in this case, the Tribunal decided to apply "default standard contained in customary international law" for the assessment of damages resulting from an illegal act. In Tribunal's view, this standard was set out in the decision of the PCIJ in the *Chorzów Factory* case:[4]

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[3] In support, the Tribunal referred to: *Phillips Petroleum Co. Iran v. Iran*, 21 Iran-U.S. Cl. Trib. Rep. at 121.

[4] In support of its application of the *Chorzów Factory* case as setting out the standard of customary international law, the Tribunal referred to a large number of legal authorities (paras.486-494). First, the Tribunal referred to a number of investor-State disputes: *Metalclad Corporation v. Mexico,* ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000, at para. 122; *S.D. Myers, Inc. v. Canada,* UNCITRAL (NAFTA) Award (Merits), 13 November 2000, at para. 311; *CMS Gas Transportation Company v. The Argentine Republic,* ICSID Award, Case No. ARB/01/8, 12 May 2005, at para. 400; *Petrobart Limited v. The Kyrgyz Republic,* Arbitration No. 126/2003, Arbitration Institute of the Stockholm Chamber of Commerce (Energy Charter Treaty), 29 March 2005, p 77-78, *Amoco International Finance Corporation v. Iran,* 15 IRAN-U.S. C.T.R. paras. 191-194; *MTD Equity Sdn Bhd and MTD Chile SA v. Chile,* ICSID Case No. ARB/01/7, 25 May 2004, para.238.

Secondly, the Tribunal referred to the statement in *Oppenheim's International Law* (9th ed., 1996), pp.528-529.

Thirdly, the Tribunal enumerated relevant judgments of the International Court of Justice: *Gabcikovo-Nagymaros Project (Hung. v. Slovakia),* 1997 ICJ 7 (Sept 25); *LaGrand* Case *(Ger. v. U.S.),* 2001 ICJ 466 (June 27); *Arrest warrant of 11 April 2000 (Democratic Rep. of Congo v. Belgium)* 2002 ICJ 3 (February 14); *Case Concerning Avena and other Mexican Nationals* (Mexico v. U.S.), 2004 I.C.J. 12 (March 31); *Advisory Opinion on the Legal Consequences of the Construction of a Wall in the Occupied Palestinian Territory* , 2004 ICJ 136 (July 9).

> "*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.*" (p.47)

In Tribunal's view, the *Chorzów Factory* case also established principles to determine the amount of compensation for an act contrary to international law:

> "*Restitution in kind, or, if it is not possible, payment of a sum corresponding to the value which a restitution 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.*" (p.47)

The Tribunal decided that actual restitution could not take place in this case and therefore, proceeded to determine a "*sum corresponding to the value which restitution in kind would bear*" in accordance with the *Chorzów Factory* judgment.

C. Date Relevant for the Assessment of Damages

The Tribunal had to decide whether it should assess the expropriated property as at the date of expropriation (1 January 2002) or at the date of the Award. The Tribunal noted that this case was "unique" since the value of the investment after the date of expropriation increased very considerably, while usually the value of the investment declined after the interference of the State. (para.496)

The Tribunal reasoned that "to put the Claimants in the same position as if the expropriation had not been committed" (as required by the *Chorzów Factory* standard), in the present, *sui generis*, type of case the date of valuation should be the date of the Award and not the date of expropriation. In support of this approach, the Tribunal referred to the statement of the PCIJ in the *Chorzów Factory* case, according to which damages are "*not necessarily limited to the value of the undertaking at the moment of dispossession*".[5] (para.497)

Therefore, the Tribunal decided that the market value of the expropriated investments was to be assessed at the date of the Award taken as 30 September 2006.

D. Method of Assessment

In order to arrive at the fair market value of the investments at the time of the Award, the Tribunal applied the Discounted Cash Flow (DCF) method, proposed by the

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Finally, the Tribunal said that the ILC's Draft Articles on State Responsibility (in particular Article 31(1)) "expressly rely and closely follow C*horzów Factory*".

[5] The Tribunal also referred to an ECHR case, where the Court awarded to the expropriated party the higher value the property enjoyed at the moment of the Court's judgment rather than the considerably lesser value it had had at the earlier date of dispossession, as well as to the findings of the Sole Arbitrator Dupuy in *Texaco Overseas Petroleum Company v. Government of the Libyan Arab Republic* (53 ILR p.389) who cited the view of former ICJ President Jiménez de Aréchaga confirming this approach. (paras. 497-498)

Claimants. The Tribunal rejected the Balancing Payment method,[6] proposed by the Respondent, because in the Tribunal's view, that method did not take into account, at least not sufficiently, the remaining term of the investments. (paras.502-503)

The Claimants supported their calculation of damages with the reports of their experts, LECG LLC. These latter relied on the 2002 Business Plan of the Project Company as a basis for the DCF calculations. The Tribunal agreed with the use of the 2002 Business Plan, since prior to the Decree, the ATAA had itself approved it. The Tribunal thus decided that the 2002 Business Plan constituted "the best evidence before the Tribunal of the expectations of the parties at the time of expropriation for the expected stream of cash flows." (paras.506-507)

The Tribunal generally endorsed the LECG calculations as "reasonable and reliable". Moreover, the Tribunal emphasized that LECG reports were "an example as to how damages calculations should be presented in international arbitration; they reflect a high degree of professionalism, clarity, integrity and independence by financial expert witnesses." (paras.514, 516)

As to the claim for lost future development opportunities (the parking garage facility and the additional terminal capacity), the Tribunal rejected that claim because the Claimants had had "no firm contractual rights to those possible projects." The Tribunal also noted that the Claimants had been "unable to quantify, with any fair degree of precision, the damages that would have resulted from the loss of those alleged opportunities." (para.515)

E. Calculation

The Tribunal did not set out the exact methodology, relevant assumptions and projected figures. Importantly, the Tribunal did not indicate how far into the future the cash flows were projected and what was the discount rate applied. Certain aspects of relevant calculations, discussed by the Tribunal in the Award, are very difficult to follow without an inside knowledge of the circumstances of the case. (e.g., paras.508-513)

The Tribunal stated that the claim for damages under the restitution approach fell into two parts: (a) the estimated value of the Claimants' stake in the Project Company as of the award date; and (b) all unpaid dividends and management fees from the date of expropriation until the date of the award. (para.518) However, the Tribunal did not show how it had allocated the awarded amounts between these parts.

[6] It is not totally clear from the Award what is meant by the Balancing Payment method. The Respondent defined this method as the "sum required to provide the Claimants with an [internal rate of return ("IRR")] of 17.5% at the date of termination, after accounting for the payments already made." And the IRR was defined as "discount rate that equates the discounted value of a stream of cash flows to the costs of the investment that produced the cash flows, calculated over the entire life of the investment." It appears that the Balancing Payment method is not an investment valuation method of general application but rather a method that could potentially be applied on the facts of this particular case (perhaps, because the possibility of such "balancing payment" had been envisaged by the relevant contract).

The Tribunal emphasized its discretion and the need for approximation when awarding damages:

> "[T]he assessment of damages is not a science. True it is that the experts use a variety of methodologies and tools in order to attempt to arrive at the correct figure. But at the end of the day, the Tribunal can stand back and look at the work product and arrive at a figure with which it is comfortable in all the circumstances of the case. (para.521)

Taking 30 September 2006 as the probable date of the Award, the Tribunal awarded ADC Affiliate US$ 55,426,973 and ADC & ADMC Management US$ 20,773,027.

F. Interest

The Tribunal stated that since the calculation of compensation was based on the value of the expropriated investments as of the *date of the Award*, no pre-Award interest was due. The Tribunal awarded post-Award interest at 6% per annum until payment, compounded monthly. On the issue of simple v. compound interest, the Tribunal stated that the current trend in investor-State arbitration was to award compound interest. (paras.520-522)

V. Implications / Initial Analysis

- Generally, BIT is *lex specialis* prevailing over rules of customary international law.
- According to the Tribunal, **different standards of compensation** apply in cases of lawful and unlawful expropriation. BITs usually provide for a standard of compensation for lawful takings but not for unlawful takings. In those cases, customary international law applies.
- The *Chorzów Factory* case and the Draft Articles on State Responsibility are recognized as establishing the **customary international law** standard of compensation.
- Due to the increase in the value of the expropriated property after the expropriation, the Tribunal used the market value at the **date of the Award**, not at the date of expropriation. This became possible by virtue of the application of the *Chorzów* standard, which required reestablishment of the situation which *would have existed*.
- **DCF method** was applied but the details of its application are quite obscure (in particular, the time period for the future projection and the applicable discount rate).
- In case the compensation is estimated as at the date of the Award, no pre-Award **interest** is due.

- Tribunal stated that the current trend in investor-State arbitration was to award **compound**, not simple, interest. Post-Award interest was compounded on a **monthly** basis.