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Investor-State Arbitration 2021

A practical cross-border insight into investor-state arbitration law

Third Edition

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The Impact of EU Law on ISDS

European Federation for Investment Law and Arbitration (EFILA)

Prof. Dr. Nikos Lavranos

The EU's Investment Law and Arbitration Policy Since the Lisbon Treaty

On 1 December 2009 when the Lisbon Treaty entered into force, the European Union (EU) obtained exclusive competence regarding foreign direct investment (FDI) (Art. 207 Treaty on the Functioning of the European Union (TFEU)). As a consequence thereof, the EU has become an active player in international investment law and arbitration by affecting the internal investment law policy of the Member States, as well as externally, by introducing modifications to substantive and procedural aspects of international investment law. The primary focus of the EU's effort has been to modify, or as it calls it, "reform" the existing investor-State dispute settlement (ISDS) system contained in practically all bilateral investment treaties (BITs) and free trade agreements (FTAs). In addition, the Court of Justice of the EU (CJEU) has issued several decisions, which increase the tension between EU law and international investment law.

In the following sections, the impact of EU law on ISDS will be reviewed by discussing the most important developments of the past year. The analysis starts with reviewing the situation post-*Achmea*, the ruling of the CJEU regarding intra-EU BITs, which culminated in the recently signed Termination Agreement that aims to terminate most, if not all, intra-EU BITs.

Subsequently, we will examine the recent developments regarding the Energy Charter Treaty (ECT), in particular the current negotiations for modernising the ECT.

Finally, we will focus on the external dimension of the EU's efforts to modernise the ISDS by introducing the concept of an Investment Court System (ICS) in its recently concluded FTAs and on a global level within the United Nations Commission on International Trade Law (UNCITRAL), by pushing for the creation of a so-called Multilateral Investment Court (MIC).

The Termination Agreement Regarding Intra-EU BITs

As is well known, in its *Achmea* judgment delivered in March 2018, the CJEU declared the arbitration provision contained in the Netherlands–Czechoslovakia BIT to be incompatible with EU law. The main reason for this was that arbitral tribunals operate "outside" the domestic legal system of the Member States and therefore cannot request preliminary rulings from the CJEU whenever EU law is at issue.

In other words, arbitral tribunals operate outside the control of the CJEU, which – according to the CJEU – might endanger the uniformity and consistency of EU law and undermine the final authority of the CJEU. It is worth noting that the CJEU in *Achmea* did not make any distinction between UNCITRAL and International Centre for Settlement of Investment Disputes (ICSID) arbitral awards. Neither did the CJEU distinguish between arbitral tribunals seated within the EU – as was the case in *Achmea* – and arbitral tribunals seated outside the EU. Arguably, these differences could lead to different conclusions.

In any event, in January 2019, the Member States adopted three political Declarations in which they explained the consequences that, in their view, follow from the *Achmea* judgment.

First, all Member States stated that as a consequence of *Achmea*, all arbitrations based on intra-EU BITs are incompatible with EU law and thus all pending and future disputes must be terminated or be considered impossible.

Second, the Member States expressed their intention to terminate all their *ca.* 190 existing intra-EU BITs by 6 December 2019.

Third, 22 Member States also extended these consequences to the intra-EU disputes based on the ECT. Interestingly, a handful of Member States refused to support this conclusion and instead considered it more appropriate to wait until the CJEU has explicitly decided this matter, in particular in view of the fact that domestic courts have requested preliminary rulings from the CJEU on exactly this question. Moreover, Hungary adopted a separate Declaration in which it declared that *Achmea* has no impact on the ECT whatsoever.

Fourth, the Member States stated in the Declaration that they would inform all courts – whether based within or outside of the EU – that all intra-EU BIT awards can no longer be recognised or enforced.

Finally, the Declaration also stated that Member States will direct any companies, which they control, to withdraw any ongoing disputes against other Member States.

In short, the Member States seized the *Achmea* judgment as an opportunity and justification to bring – once and for all – an end to all intra-EU BITs and any ongoing or future intra-EU BIT cases.

On 5 May 2020, the European Commission announced that 23 Member States had signed a Termination Agreement that would terminate all their intra-EU BITs. For obvious reasons, the UK did not sign up to this Termination Agreement, and neither did Finland, Sweden, Austria and Ireland.

The Termination Agreement essentially replicates the main intentions of the political Declaration referred to above. Thus, all intra-EU BITs and all disputes based on them are declared incompatible with EU law and thus are moot. New intra-EU BIT arbitrations are declared to be no longer possible.

In addition, all sunset clauses are also declared inapplicable, meaning that investors cannot rely on the sunset clauses of those intra-EU BITs for investments made prior to their termination. In other words, whereas sunset clauses kick in when BITs are terminated in order to protect the vested rights of investors for their investments that have been made prior to termination, the Termination Agreement retroactively takes that right away from investors.

The only major difference with the political Declaration is that the Termination Agreement explicitly does not apply to the ECT. The Member States and the EU state that they will deal with the ECT separately in due course.

The Modernisation of the ECT

As explained above, despite the fact that the *Achmea* judgment does not mention the ECT with a single word, several Member States are trying to use it as an argument to annul or set aside intra-EU awards rendered against them under the ECT. In particular, Spain (but also Italy, Romania, Germany, and the Czech and Slovak Republics), which is facing more than 40 intra-EU ECT claims, has been attempting to use the *Achmea* judgment to vacate awards that have been rendered against it. However, so far, all ECT arbitral tribunals have rejected the *Achmea* objection and concluded that the *Achmea* judgment has no bearing on their jurisdiction under the ECT.

As mentioned earlier, the question of the compatibility of the intra-EU ECT arbitration clause with EU law will sooner rather than later be answered by the CJEU. Depending on the CJEU's decision, the impact for European investors could be significant, especially if the CJEU were to conclude that intra-EU ECT arbitrations are incompatible with EU law. This would force European investors to rely on domestic courts in the Member States in order to seek protection against (in)direct expropriations and other unfair treatment, which would result in a lower level of investment protection because of the perceived lack of independence and impartiality of domestic courts and the backsliding of the Rule of Law level in many EU Member States. Alternatively, investors could restructure their investments via non-EU Member States, such as Switzerland or the post-Brexit UK.

In short, there is a clear conflict between, on the one side, the European Commission and the Member States, which no longer accept the jurisdiction of intra-EU ECT arbitral tribunals; and, on the other side, ECT arbitral tribunals, which see no problem with *Achmea* or EU law generally and thus continue to assert their jurisdiction.

It remains to be seen how this conflict will be resolved, but it seems likely that at the end of the day, the European Commission and the Member States will prevail, in particular if the CJEU were to conclude that intra-EU ECT arbitrations are incompatible with EU law. In any event, the majority of the Member States have clearly stated that they no longer accept intra-EU ECT disputes.

Meanwhile, the Council of the EU (i.e., the EU Member States) has given the European Commission a negotiating mandate to re-negotiate or "modernise" the ECT and align it with its new EU FTAs, such as the Comprehensive Economic and Trade Agreement (CETA). These negotiations are still ongoing, but the EU's proposal makes clear that the ECT should no longer be available for intra-EU ECT disputes. More fundamentally, the EU wants to replace the currently existing ISDS system with the ICS (see next section). However, there is some resistance against these proposals, in particular by Japan. Thus, it will be interesting to follow to what extent the EU will eventually succeed in implementing its reform agenda into the ECT.

The Investment Court System (ICS)

Forced by the mounting public backlash against ISDS, which started when the Transatlantic Trade and Investment Partnership (TTIP) negotiations were gaining traction around 2014, the European Commission decided to propose the ICS as a radical change to the existing ISDS system in the hope that this would appease the European Parliament, non-governmental organisations and the general public. Essentially, the ICS – largely inspired by the World Trade Organization (WTO) Dispute Settlement System – would create a semi-permanent, two-tier, court-like system, that significantly moves away from arbitration. The ICS would consist of a first instance tribunal with 15 members and an appellate tribunal of six members. The most important change is that the claimant would not have any say in the selection of the members of the tribunal. Instead, the Contracting Parties, including the Respondent in the respective dispute, would appoint all members by common agreement for several years. Consequently, the party autonomy, which is one of the hallmarks of arbitration, would be effectively eliminated. This obviously shifts the balance to the advantage of the States. In particular, it is not difficult to anticipate that States will appoint members whom they consider to be more pro-State biased rather than pro-investor biased. Indeed, the damaging effect of the politicisation of the appointment of members of international courts and tribunals is currently visible regarding the WTO Appellate Body, for which the US refuses to agree on the re-appointment of several WTO Appellate Body members; this has effectively paralysed the Appellate Body and prevents it from carrying out its functions. In fact, the EU – rather ironically – has proposed arbitration as a solution to overcome the current paralysis of the WTO Appellate Body.

The other important feature, which strongly deviates from arbitration, is the possibility of lodging an appeal on both points of law and fact. This obviously will increase the costs of the parties and extend the length of the proceedings further. It also gives both parties a second bite of the apple, which is exactly what arbitration intends to avoid by offering only a one-shot procedure with a final binding award.

Putting aside the question of whether the ICS is the best solution to address the (perceived) shortcomings of the current ISDS system, the EU has so far successfully been able to convince Canada, Vietnam, Singapore and Mexico to accept the ICS system in their new FTAs. At the same time, it ought to be noted that Japan did not accept the ICS in its FTA with the EU, while the European Commission has not even put the ICS on the table in the FTA negotiations with Australia and New Zealand; nor is the ICS part of the recently concluded FTA between the EU and Mercosur.

In the meantime, the CJEU rendered its Opinion 1/17, in which it gave its blessing to the ICS as contained in CETA by opining that the ICS system is compatible with EU law. However, the CJEU raised two important objections.

First, it concluded that additional measures are necessary in order to ensure that the ICS is actually accessible for small and medium-sized enterprises (SMEs), which is questionable considering the costs and length of the proceedings, that also potentially includes an appeal procedure. Unfortunately, the CJEU did not specify which additional measures must be added to the ICS as contained in CETA and the other new EU FTAs. So far, the CETA Contracting Parties have not adopted any specific measures to address the concerns of the access to the ICS for SMEs.

Secondly, the CJEU considered it incompatible with EU law that any joint binding interpretations, which the CETA Contracting Parties may adopt, would have retroactive effect and thereby interfere in ongoing disputes. This is an important correction of CETA, which was obviously incompatible with the Rule of Law. Nonetheless, by and large, the CJEU gave not only its blessing to the ICS but also referred several times to the MIC, which is currently being negotiated within UNCITRAL (see next section).

Towards a Multilateral Investment Court (MIC)

In 2017, the European Commission, together with Canada and Mauritius, convinced UNCITRAL to set up a Working Group with a broadly formulated mandate to identify and examine any of the perceived shortcomings of the current ISDS system and to propose possible solutions. The discussions began in late 2017 and have since then made significant progress. In these discussions, the European Commission, Canada, Mauritius and several South American States have repeatedly referred to the MIC as the panacea that would solve most, if not all, of the perceived shortcomings of the current ISDS system. The MIC would be based on the ICS as contained in CETA. However, many States are not convinced that creating a new international court would be the appropriate solution. In particular, Chile, Israel, Japan, Russia, the US and some Asian States are not yet convinced and instead consider reforming or modifying the existing rules and institutions, such as, for instance, the ICSID Convention or the Permanent Court of Arbitration (PCA), to be a more effective and realistic option. After all, in the past 50 years, more than 3,000 BITs and FTAs have been concluded and more than 1,000 ISDS disputes have been initiated, much to the general satisfaction of the users. Indeed, according to statistics provided by the United Nations Conference on Trade and Development (UNCTAD), States win more cases than claimants. Thus, States have little reason to complain about the current ISDS system, which is also confirmed by the fact that States continue to conclude BITs with ISDS provisions.

Meanwhile, the first results of the negotiations have been achieved.

First, as requested by UNCITRAL Working Group III, a draft Code of Conduct for Adjudicators has been jointly submitted by the Secretariats of ICSID and UNCITRAL and is currently under discussion.

Second, the Working Group agreed that third-party funding (TPF) should be regulated more tightly, in particular by requiring users of TPF to be more transparent about the identity and content of the TPF agreement.

Third, the Working Group agreed to establish a body that mirrors the Advisory Centre at the WTO, which provides legal assistance to developing countries involved in WTO disputes. However, the details regarding the Advisory Centre for Investment Disputes still need to be worked out.

While the discussions and negotiations have continued during the COVID-19 crisis, it is too early to say whether the MIC proposal will gain sufficient traction and support from all the major economies, investors and the arbitration community generally. Possibly, the parties might agree to adopt an incremental and flexible approach by taking several intermediate steps rather than going immediately for a full-blown, two-tier permanent court, which would require many more years of negotiations. Thus, the parties could agree to first establish only an Appellate Body for disputes brought under specified investment treaties, which could later be further developed into a proper Appeal Court with universal jurisdiction for all investment disputes.

Outlook

Over the past decade, the EU has become an active driver in shaping international investment law and arbitration. The impact of EU law on ISDS is particularly noticeable regarding the intra-EU BITs after the CJEU determined in *Achmea* that the relevant ISDS provision is incompatible with EU law. The recently signed Termination Agreement will largely eliminate intra-EU BIT disputes. Besides, the impact of EU law is becoming increasingly visible regarding the use of the ISDS provisions of the ECT in intra-EU disputes. The currently ongoing modernisation process of the ECT provides an opportunity for the EU and its Member States to implement its reform agenda.

At the international level, the European Commission's ICS proposal is one step closer to becoming reality now that it has received the blessing of the CJEU. At the same time, it must be noted that at the time of writing (September 2020), the CETA ICS investment chapter has only been ratified by about half of the 27 Member States, so it is far from certain that the ICS will actually become operational soon. However, if and when the ICS is put into operation, this could potentially have far-reaching consequences for investment treaty arbitration generally. This impact would be even more sweeping if the MIC proposal were to be embraced by a significant number of States around the world.

In any event, one thing is clear: EU law will continue to impact international investment law and arbitration over the coming years. Consequently, the arbitration community must engage more actively than in the past with the EU and its institutions and address more proactively any perceived shortcomings of the ISDS system; for example, by proposing improvements to the existing ISDS system that are credible, effective and workable.

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EFILA is unique in that it brings together arbitration practitioners, academics and policymakers who have extensive first-hand experience and a deep understanding of the relevant investment law and arbitration issues. EFILA provides a platform for a fact- and merit-based discussion on the pros and cons of the EU's investment law and arbitration policy.
In recognition of its important role, EFILA has been granted Observer Status at the UNCITRAL Working Group III, which is working on the reforms of the ISDS system.
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EFILA regularly submits its views to public consultations organised by the EU and ICSID, as well as to the UNCITRAL Working Group III. All its submissions are published on its website.
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