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The Downfall of Investment Treaty Arbitration and Possible Future Developments

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Introduction

The framework of investment protection treaties provides foreign investors with substantive and procedural protection against interference in their businesses by host states. One of the prominent features of investment protection treaties is the mechanism of investor-state dispute settlement (ISDS), enabling investors to directly initiate arbitral proceedings against the host state.

The compatibility of investment protection treaties and, in particular, the investor-state dispute settlement mechanism with the legal framework of the European Union is subject to major controversy. While the decision of the Court of Justice of the EU (CJEU) in *Achmea (formerly Eureko) v Slovakia* ('CJEU's Decision') clarified that the ISDS mechanism contained in investment protection treaties concluded between Member States of the EU (intra-EU bilateral investment treaties ('intra-EU BITs')) is incompatible with the provisions of the Treaty on the Functioning of the EU (TFEU), it did not address a number of matters relevant to the protection of investors in the EU.

A political declaration issued by the representatives of the governments of the EU Member States on 15 January 2019 (the 'Declaration') clarifies the consequences of the CJEU's Decision and specifies a number of actions that the signatory states committed to undertake in light of the CJEU's Decision.

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Recent developments raise several concerns with respect to the future of intra-EU investment protection treaties. This article discusses the potential implications of these developments to investors engaging in the European market and the system of foreign direct investment (FDI) protection in the EU.

The approach of the CJEU: preliminary ruling in *Achmea (formerly Eureko) v Slovakia*

In the decision in *Achmea (formerly Eureko) v Slovakia* issued on 6 March 2018 (the 'Achmea Decision'), the CJEU stated that disputes before arbitral tribunals based on intra-EU BITs may relate to matters of interpretation and application of EU law. While a preliminary ruling procedure under Article 267 of the TFEU enables courts and tribunals of Member States to file a request pertaining to the interpretation and application of EU law, arbitral tribunals do not represent a court or tribunal within the meaning of the provision and, therefore, cannot rely on the procedure. Moreover, decisions of arbitral tribunals, in principle, cannot be appealed against before the national courts, which may create a threat to the proper interpretation and application of EU law and, consequently, has an adverse impact on the autonomy of EU law.[1]

The CJEU concluded that the ISDS mechanism in the intra-EU BIT concluded between Slovakia and the Netherlands prevents investment treaty disputes from being decided within the judicial system of the EU and, thereby, is incompatible with EU law.[2]

Reaction of arbitral tribunals

On 31 August 2018, the arbitral tribunal *in Vattenfall AB and others v Federal Republic of Germany* issued a decision on the jurisdictional objection made by the Federal Republic of Germany, in which it confirmed its jurisdiction, despite the argument of the Federal Republic of Germany based on the Achmea Decision.

As the proceedings were initiated pursuant to the Energy Charter Treaty (ECT) and International Centre for Settlement of Investment Disputes (ICSID) Convention, the Federal Republic of Germany essentially claimed that Article 26 of the ECT, providing for the ISDS mechanism, must be interpreted restrictively in such a manner that ISDS is not applicable in

1 Case C 284/16 *Slovak Republic v Achmea BV* (2018) paras 55–59.

2 Case C 284/16 *Slowakische Republik (Slovak Republic) v Achmea BV* (2018) paras 59–60.

intra-EU investor-state disputes.[3] It further noted that the reasoning of the CJEU in the *Slovak Republic v Achmea* Decision extends to intra-EU investor-state disputes initiated under multilateral treaties, such as the ECT, as the risk to the consistent interpretation and application of EU law exists irrespective of the bilateral, or multilateral, character of a treaty.[4]

The ICSID tribunal rejected the respondent's argument by concluding that the CJEU in *Achmea (formerly Eureko) v Slovakia* limited its considerations to the ISDS clauses in the intra-EU investment protection treaties of bilateral character. The CJEU did not extend its reasoning to multilateral treaties concluded between EU Member States and third states.[5] The ICSID tribunal therefore noted that the ECT, as a multilateral treaty, does not constitute a treaty concluded between EU Member States within the meaning of the preliminary ruling in *Achmea (formerly Eureko) v Slovakia,* but a mixed treaty concluded between EU Member States, third states and the EU itself.[6]

The ICSID tribunal further pointed out that, in line with the view expressed in *Masdar Solar & Wind Cooperatief UA v Kingdom of Spain,* the CJEU in its decision did not examine the argument in the Opinion of the Advocate General (AG) Wathelet, which distinguished between ISDS clauses in BITs and the ECT, which further supports the position of the ICSID Tribunal.[7]

Finally, having carried out an interpretation of Article 26 of the ECT in accordance with Article 31 of the Vienna Convention on the Law of Treaties (VCLT), the ICSID Tribunal reached the conclusion that the ECT creates obligations between EU Member States and the EU and does not exclude intra-EU ECT arbitration.[8] On the contrary, one can argue that the EU, as a party to the ECT, is bound by its provisions, including the ISDS mechanism contained there.

Post-Achmea declaration of EU Member States

By the Declaration issued on 15 January 2019, Member States inform investment arbitration tribunals about the legal implications of the CJEU's Decision in *Achmea (formerly Eureko) v Slovakia* and commit to undertake appropriate actions.

3 *Vattenfall AB and others v Federal Republic of Germany*, ICSID Case No ARB/12/12, Decision on the Achmea issue (31 August 2018) para 50.

4 *Ibid* paras 51–52.

5 *Ibid* para 213.

6 *Ibid* para 162.

7 *Ibid* paras 163–164; Case C 284/16 *Slowakische Republik (Slovak Republic) v Achmea BV* (2018), Opinion of AG Wathelet (2017) para 43; see *Masdar Solar & Wind Cooperatief UA v Kingdom of Spain*, ICSID Case No ARB/14/1, Award (16 May 2018).

8 See n 5 above paras 201–207.

The Declaration stipulates that EU law takes precedence over Intra-EU BITs and, thereby, the ISDS mechanism contained in such treaties is incompatible with EU law. Arbitral tribunals established on the basis of intra-EU BITs lack jurisdiction to adjudicate the dispute due to the lack of a valid offer to arbitrate.[9] Accordingly, arbitral tribunals should not assert jurisdiction in intra-EU investment treaty arbitrations. Analogically, national courts, whether of a Member State or any third state, should set aside, or not enforce awards rendered in intra-EU arbitrations.

The Declaration further clarifies that ISDS clauses in intra-EU BITs do not produce effects in respect to the sunset clauses that provide extended protection of investments existing prior to the termination of a treaty.

Contrary to the reasoning of tribunals in *Vattenfall AB and others* and *Masdar Solar & Wind Cooperatief UA,* signatories to the Declaration consider that the approach of the CJEU extends to multilateral treaties concluded by EU Member States that provide for the ISDS mechanism due to the fact that such agreements form an integral part of the EU legal order and, thereby, must be compatible with EU law.[10]

The Declaration asserts that EU investors act within the scope of application of EU law and by reason of that benefit from the rights conferred by EU primary and secondary legislation, as well as the Charter of Fundamental Rights of the EU and general principles of EU law, which guarantee adequate protection to such investors. Accordingly, Member States are to ensure that the national judicial system meets the requirements of effective judicial protection.[11]

Finally, signatories commit to terminate all intra-EU BITs through mutual consent by means of a multilateral treaty, or bilaterally.[12]

Implications

The Achmea Decision and the Declaration have important implications for investors operating, or wishing to operate in the European market. It is now clear that ISDS clauses in intra-EU BITs are incompatible with EU law and, by reason of that, settlement of disputes between investors and EU Member States through investment treaty arbitration may no longer be possible.

Depriving investors of the benefit of the ISDS mechanism is likely to influence their decision to invest in the European market and limit the

9 Declaration of the Member States of 15 January 2019 on the legal consequences of the Achmea judgment and on investment protection in the European Union (15 January 2019) 1.

10 *Ibid* 2.

11 *Ibid.*

12 *Ibid* 4.

inflow of foreign investment capital, which may be disadvantageous for the European economy. While the signatories of the Declaration endorse the view that the legal system of the EU sufficiently protects investors engaging in the European market, it is doubtful that EU law and the national law of Member States will be always perceived to guarantee effective procedural and substantive protection to foreign investors. In particular, the reasoning of the CJEU and the position adopted in the Declaration indicate that the domestic judicial system of Member States is the only appropriate forum for the settlement of investor-state disputes, which raises several concerns associated with the potential bias of national judges, political pressure exerted by governments, corruption and malfunctioning of the domestic judiciary in general. In addition, recourse to a domestic judicial system may be problematic as Member States will often act in the exercise of their sovereign powers, which indicates that the settlement of investment disputes with host states before domestic courts may fail due to state immunity.[13]

The commitment of signatories to the Declaration to terminate intra-EU BITs through a multilateral treaty or bilaterally confirms that intra-EU BITs will be terminated by mutual consent of the involved parties, which would, in principle, lead to the immediate cessation of any effects of these treaties. Due to the lack of a valid offer to arbitrate, the ISDS clauses in intra-EU BITs may not be covered by so-called sunset clauses providing for continued protection of investments existing prior to the termination of the relevant BIT. Nonetheless, the application of sunset clauses to substantive treaty standards of protection will, in principle, remain unaffected, which may therefore enable investors to enjoy substantive protection for a specified period of time under a terminated intra-EU BIT.

However, it seems possible to terminate intra-EU BITs together with sunset clauses, or to modify the agreements with the aim of removing the clauses and, subsequently, terminating the treaty. While the effectiveness of such a termination or modification of a treaty may be debatable, parties' consent may prevail over the safeguards contained in sunset clauses.[14]

Contrary to the conclusion reached by the Tribunal in *Vattenfall AB and others* and *Masdar Solar & Wind*, the reasoning presented in *Achmea*, by virtue of the Declaration, extends to the Energy Charter Treaty. This raises a concern as to the effectiveness of the guarantees contained in the ECT. However, as the issue of non-compliance with EU law relates merely to ISDS

13 Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (OUP 2012) 235–236.

14 See, eg, Tania Voon, Andrew Mitchell and James Munro, 'Parting Ways: The Impact of Mutual Termination of Investment Treaties on Investor Rights' (2014) 29(2) ICSID Review 461–463 and 465–467.

clauses, one may consider that substantive standards of protection under, inter alia, the ECT ought to remain unaffected, which opens the door for EU investors to enforce substantive guarantees under the ECT through the domestic judiciary.

As a result of the discussed developments, investors may decide to engage in so-called treaty shopping practice through, for example, corporate restructuring with the aim of changing corporate nationality in order to benefit, in the procedural and substantive scope, from BITs concluded between EU and third states. While investment protection treaties often provide for safeguards against treaty shopping through a denial of benefits clause or determination of corporate nationality on the basis of the nationality of the entity exercising direct or indirect control, treaty shopping is, in principle, permissible for legitimate reasons.[15]

Additionally, it is apparent that while the CJEU focused on the incompatibility of ISDS clauses contained in intra-EU BITs, the reasoning of the CJEU may be adopted in relation to BITs concluded between EU states and non-EU states. Disputes covered by such BITs and settled through investor-state arbitration may relate to matters concerning the treatment of foreign investors engaging in the European market and, therefore, the interpretation and application of EU law. While it is rather doubtful that tribunals constituted on the basis of such BITs will reject a jurisdiction over a dispute, there is a threat to effective recognition and enforcement of arbitral awards in the EU.

The national court faced with a request for recognition or enforcement of such an arbitral award, or the CJEU faced with a request for a preliminary ruling, may declare that the arbitration between a foreign investor and EU Member State adversely affects the autonomy of EU law and, therefore, recognition and enforcement of such awards should be refused.

This would have a devastating impact on the effectiveness of guarantees contained in such BITs. In addition, this approach, if adopted, would severely impact the recognition and enforcement mechanism contained in the ICSID Convention, namely Article 54 of the ICSID Convention which provides that each contracting state shall recognise an award rendered by an ICSID Tribunal as binding and enforce the pecuniary obligations imposed by that award as if it were a final judgment of a court where recognition is sought. As the mechanism does not leave room for any ground on which the recognition could be refused, potential refusal of a national court to

15 See, eg, *Pac Rim Cayman v The Republic of El Salvador*, ICSID Case No ARB/09/12 (2012) Decision on the Respondent's Jurisdictional Objections paras 2.96–2.100; *Philip Morris Asia Limited v The Commonwealth of Australia*, PCA Case No 2012-12 (2015) Award on Jurisdiction and Admissibility paras 566, 570, 584 and 585–588.

recognise an award issued in arbitrations under ICSID rules would adversely affect the effectiveness of the ICSID Convention and possibly pose a threat to its existence.

Equally, any non-EU host state could conclude that recognition and enforcement of any award obtained by an investor from the EU against such state shall be refused based on lack of reciprocity.

The Declaration is not a piece of legislation or international convention and, formally, is not binding the courts in Member States. Should such courts choose to adopt the reasoning of the Declaration, they would be able to base their judgment merely on the interpretation of the TFEU and on the position taken by the CJEU and not directly on the Declaration itself.

Opportunities for the future: modernisation of the ISDS mechanism

The imminent downfall of investment treaty arbitration in the EU highlights the necessity for the modernisation of the framework of investment protection treaties and, most importantly, the system for the settlement of investment disputes.

Recent developments in regional treaties indicate the direction in which the issue is developing. The Investment Court System (ICS), initially proposed in the context of the negotiations on the Transatlantic Trade and Investment Partnership (TTIP), adopted in the Comprehensive Economic and Trade Agreement (CETA), may provide a foundation for the creation of a standing European or multilateral investment court. Considering recently issued Opinion of the AG Yves Bot, in which the AG declared the ICS contained in CETA as compatible with EU law, modernisation of the traditional ISDS mechanism is already underway.[16]

The very structure and design of the ICS in CETA, which is a transparent two-tier body with quasi-permanent adjudicators chosen by a joint committee consisting of representatives of contracting states, may operate as a model for the establishment of European investment court, which could offer an effective and desirable alternative to the existing ISDS mechanism.

Conclusion

The CJEU's Decision in the *Achmea* case, as well as the commitment of signatories of the Declaration, give rise to important repercussions on the investment protection system in the EU and functioning of the ISDS mechanism. ISDS clauses in intra-EU BITs are now considered incompatible with EU law, which necessitates that Member States take appropriate actions

16 Opinion of AG Yves Bot 1/17 (29 January 2019).

with the aim of ensuring compatibility. It is anticipated that Member States will terminate their intra-EU BITs through mutual consent, by means of either a bilateral or multilateral treaty.

Recent developments can be perceived reducing the level of investor protection in intra-EU relations, which in turn could weaken the investor's perception of legal certainty and the rule of law in the EU, and adversely affect FDI capital inflows.

Due to the lack of a valid offer to arbitrate, ISDS clauses may not produce effects as regards sunset clauses. This, however, may not deprive investors of the benefit of extended substantive protection of their investments made prior to termination. Enforcement of substantive protections could be possible through domestic judicial system.

Some investors may decide to engage in the treaty shopping practice and seek protection under existing BITs other than intra-EU ones. However, one may consider that the reasoning demonstrated in the Achmea Decision and Declaration may extend to investment treaty arbitrations initiated on a basis of BITs concluded between an EU Member State and a non-EU state.

Finally, regional treaties may provide a tool for the reform of the traditional ISDS mechanism. The ICS contained in CETA, in light of the Opinion of the AG Bot affirming the compatibility thereof with EU law, signals that the development may provide a model for the establishment of a European or multilateral investment court that could operate as an effective alternative to the domestic judicial system and ISDS mechanism currently in place.

Consequences to non-BIT arbitration ('commercial arbitration') between investors and respective organisational units of the Member States are not the subject matter of this article. However, it can be noted that arguments built with respect to ISDS mechanisms contained in BITs could affect commercial arbitration, as well.