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List of used abbreviations

CCP – Common Commercial Policy

CJEU – Court of Justce of the European Union

Commission – European Commission

Draft regulation – Proposal for regulation establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is a party

EC – European Commission

EU – European Union

FDI – Foreign Direct Investment

TEU – Treaty of the European union

TFEU – Treaty on the Functioning of the European Union

IO – International Organization

Contents

Introduction

This contribution provides an insight into European Union's intended design of managing financial responsibility in investor-to-state arbitration arising from future international investment agreements concluded by the EU with non-member states.

European Union is fully engaged in negotiating Transatlantic Trade and Investment Partnership with the US (including chapter on foreign investment promotion and protection). Among others, EU negotiates with Canada (Comprehensive Economic and Trade Agreement) and started talks with China on bilateral investment treaty.[1]

As a newcomer to the investment treaty regime European Union has an ambition to substitute individual investment treaties between member states and third countries for investment treaties concluded at a Union level. Most importantly, this may have a substantial effect on the volume of financial compensation EU will have to pay as a respondent in investor-state disputes for ill-treatment. Therefore mechanism for allocating sum of monies from member states and the Union is needed. For this reason draft regulation for allocation of financial responsibility between EU and member states is to be passed in the following months.

The scope of this paper will concern referred draft regulation. It provides for concept of respondent status of EU and member states and introduces mechanism for allocation of costs arising from investment disputes.

For those reasons research question is stated:

What substantial inconsistencies may arise from current draft regulation

and if existent,

is there any alternative solution which might lessen costs of investment disputes or help to avoid practical obstructions in realizing European investment policy?

[1]Press release europa.eu. EU and China begin investment talks. Brussels, 20 January 2014 http://europa.eu/rapid/press-release_IP-14-33_en.htm (accessed 8 April 2014)

Paper proceeds as follows: Firstly we give an overview of investment law of arbitration. Then we proceed to the background of draft regulation on financial responsibility, stating reasons for its creation and potential results as compared to expectations of the EU. Subsequently, difference between international and internal responsibility of the EU is explained. Afterwards we focus on the text of draft regulation, specifically procedure for allocating reimbursement obligation between EU and the member states.

Arbitration in international investment regime

The system of investment law is based on international agreements which provide for certain level of treatment afforded to foreign national in the host state within its jurisdiction. Such an international agreement confers rights and privileges needed for foreign investor to base securely his investment in the host country. Most regularly may arise allegation of inadequate treatment of foreign investor by the host state. For such issues, investment treaty practice devised investor-state arbitration providing a resolution of alleged treatment and fiduciary compensation for an investor if a host state is in breach of its obligations. In the eyes of foreign investors, arbitration is seen as an attractive way of resolving investment disputes.[2] And that is the main reason why EU undertook steps in shaping Common investment policy as will be clarified in the following chapters.

The basic principles of investment arbitration:

Under the international investment treaty, the contracting parties confer to a foreign investor a right to initiate arbitration against contracting state which hosts the investor. It gives rise to jurisdiction of tribunal whose decision (arbitral award) is binding on the parties.

In other words, a foreign investor is elevated to the status of subject of international law with a specific capacity to challenge host state for the breach of international obligations arising from international investment treaty.

If the arbitration tribunal concludes that state's actions were in breach of treaty obligations then the duty to pay financial compensation is awarded by the tribunal. This results in constituting the secondary responsibility to compensate and, if feasible, the obligation to cease from the measures causing ill-treatment to the investor.

[2] Number of international investment disputes mushroomed in 2012, UNCTAD reports, PRESS RELEASE. UNCTAD/PRESS/PR/2013/007 (13th April 2013)
http://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=120

The background of EU investment policy

With the entry of Lisbon treaty into force in 2009[3], the EU acquired exclusive competence in foreign direct investment. This implies that issues of treatment of foreign investors which fell within regulatory space of member states are now in exclusive domain of the European Union. A year later, the European Commission introduced its Communication[4] outlining premises for the EU investment policy, moreover an intention to include investor-to-state arbitration in the future investment agreements. In December 2012 came into force EU regulation[5] on transitional arrangements for investment treaties of Member States and their termination in case the EU concludes investment treaty with the same non-member state. In the same year the European Commission introduced draft regulation to allocate financial responsibility of the EU and the member states in the event of investment dispute. First we take a look at the EU competence concerning foreign investment.

EU exclusive competence in FDI

If we want to comprehend how the EU is trying to achieve European investment policy we must look at the articles of TFEU concerning exclusive competence and common commercial policy. Article 2 and 3(1) of Treaty on Functioning of the EU provide:

Article 2 (1) TFEU

*„When the Treaties confer on the Union **exclusive competence** in a specific area, **only the Union may legislate and adopt legally binding acts**, the Member States being able to do so themselves only if so empowered by the Union or for the implementation of Union acts.“*

[3] European Union, Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, 13 December 2007, 2007/C 306/01

[4] European Commission, Towards a comprehensive European international investment policy . COM(2010) 343. COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIALCOMMITTEE AND THE COMMITTEE OF THE REGIONS. (7 July 2010)

[5] REGULATION (EU) No 1219/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries

Article 3 TFEU

*„1.The Union shall have **exclusive competence in the following areas**:*

...

*(e) **common commercial policy**."*

...

2. The Union shall also have exclusive competence for the conclusion of an international agreement when its conclusion is provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or in so far as its conclusion may affect common rules or alter their scope."

Article 207 (1)TFEU

***„The common commercial policy shall be based on uniform principles**, particularly **with regard to** changes in tariff rates, the conclusion of tariff and trade agreements relating to trade in goods and services, and the commercial aspects of intellectual property, **foreign direct investment**,.. ..**The common commercial policy shall be conducted in the context of the principles and objectives of the Union's external action**."*[6]

To sum up, by acquiring the exclusive competence in the sphere of FDI, only the EU can adopt legislative acts and conclude international agreements pertaining to foreign direct investment. The member states can act only to execute Union acts or if the Union gives full powers to the member state.[7] This means that every member state will have to coordinate its investors treatment according to the rules on foreign investment stated in EU law and international investment agreements concluded by the EU with third states.

However, the Lisbon Treaty only included "foreign direct investment" into CCP exclusive competence. There is no explicit reference to indirect or portfolio investment which is also a part of investment law regime. The European Commission circumvents this fact by pointing out to article 3 (2) TFEU that in case of portfolio investments the EU has implied powers since investment treaties may affect the scope of common rules on payments and capitals as afforded by TFEU.[8] What is most interesting, as highlighted by Kleinheisterkamp, is that in

[6] Art 207 (1) TFEU
[7] Article 2 (1), TFEU
[8] Communication, n 4.

leaked negotiation mandates for investment treaties given to the Commission by the Council of Ministers the competences for portfolio investments, are to be mixed.[9] The ultimate interpretation of this issue may be provided by the Court of Justice of the EU.[10]

The question concerning the scope of exclusive competence relating to foreign investment is crucial, since portfolio investment would be left out, unregulated, in the hands of member states. This would require more coordination and cooperation among the member states in concluding investment treaties. And on the other hand, secondary legislation concerning foreign investment would only apply to FDI. It may thwart the effort of the EU to act as an unified international actor in relation to third states.

As it can be seen in next chapter, this may even affect draft regulation rules on allocation of financial responsibility between the member states and the EU.

Communication *Towards a comprehensive European international investment policy*[11]

In 2010 the Commission introduced Communication *Towards a comprehensive European international investment policy* stating premises for future extra-EU investment regime. The EC presses importance of FDI and links it with the need for legal regulation to pursue aims of the Treaties relating to external action and CCP concerning abolition of restrictions on foreign direct investment.[12]

After that, the EC suggests that regulating investment policy on the EU level should provide better results in comparison with individual investment policies by the member states.

The better results should be accomplished by creation of detailed legal rules on the EU level, thus creating legal certainty for subsequent conclusion of investment treaties. The referred treaties should include provisions on investor-state arbitration and consequently allow the responsibility of the European Union and the member states.

[9] Kleinheisterkamp, J., Financial Responsibility in the European International Investment Policy. LSE Law, Society and Economy Working Papers 15/2013. London School of Economics and political Science Law Department. p. 5
[10] Art 263 TFEU
[11] Ibidem n 4
[12] Art. 206 TFEU

In this document Commission gives an argument why indirect (portfolio) investment is also included in the scope of EU's exclusive in FDI.[13] The member states have an opposite opinion (as it was mentioned before).

It should be repeated that there is a certain discrepancy between the EU and the European Commission regarding exclusive competence in foreign investment matters. This diverging view may also externalize in the case of draft regulation on financial responsibility as it will be provided in next chapters.

[13] Wording of TFEU explicitly provides for exclusive competence of EU in „foreign direct investment", contrary to the alternative wording such as „indirect investment", „porftolio investment" or simply „foreign investment" (see articles 206, 207 TFEU). For those reasons European Commission derives competence in portfolio investments from TFEU provisions on common rules conerning capitals and payments.
European Commission: COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THEEUROPEAN PARLIAMENT, THE EUROPEAN ECONOMIC AND SOCIALCOMMITTEE AND THE COMMITTEE OF THE REGIONS Towards a comprehensive European international investment policy COM(2010)343. 7.7.2010 p. 8

Draft regulation on financial responsibility

The proposal for regulation was introduced by the EC in June 2012. Draft regulation (if passed) is meant to complement broader EU internal rules on common investment policy and shall set forth régime applicable for financial reimbursement of future investment disputes.

The previous proposal of the European Commission for regulation was in some instances[14] amended by the European Parliament in March 2013. In the current stage, the EU Council and the European Parliament agreed the proposal to be passed in the first reading before the EP elections at the end of May 2014.[15] Indeed, it is right on time with negotiations on TTIP.

Turning now to the text of draft regulation, the EU had in mind that in order to properly manage duality of the EU and the member states in future investment regime following basic principles of investor-to-state arbitration should be taken into account:

The main features potential respondent (providing treatment) should have to attract foreign investors are:

- Legal capacity to conclude investment treaties (conferred by the Lisbon Treaty)
- Representation in dispute proceedings (draft regulation solution)
- Mechanism for ensuring payment of remedies or financial settlement to the investor wronged (draft regulation solution)

The first requirement is solved by broadening the scope of EU's Common Commercial Policy to the matters related to FDI. However it is interesting to point the status of the EU regarding its responsibility as an international organization in the light of Draft articles on responsibility of international organization. This will be provided in next subsection.

The second and third requirement are included in draft regulation. Draft regulation alone comprises of 3 main parts. The first one deals with procedural rules on responsibility to respond in an investment dispute. The second part deals with attribution of financial responsibility to compensate and the third part regulates payment of remedies to foreign investor.

[14] European Parliament, Amendments adopted by the European Parliament on 23 May on the proposal for a regulation of the European Parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party (COM(2012)0335 – 2012/0163(COD)) (23th May 2013)

[15] Council of the EU, Investor-state dispute settlement: Council Confirms deal with EP. Presse 210 (4th April 2014) (Last access 8 April 2014)

Despite the fact, that draft regulation provides for remarkably systematic rules it still leave some unresolved questions which might strike as a negative path dependency.[16]

Searching for the EU's cues for proposed financial responsibility regime, we take a look at *Les Chapeaux* of aforementioned draft regulation and amendments by the EP.

The EP in amending draft regulation held that determining liability should not significantly exceed the EU law limits of liability or the general principles as offered in majority member states intra-EU bilateral investment treaties.

Who is to be respondent in arbitral proceedings (EU/MS)?

If EU will become a party to investment treaty then same obligations from investment agreements will apply including responsibility as a respondent. Draft regulation indicates that state investor will not have a right to choose respondent when initiating arbitration. Due to experience of the EU in other international forums[17], Union determined that this decision should be in its own competence. This was due to broader discretion on the part of the claimant, which could choose respondent acting before international judicial or quasi-judicial organ. That is to say, if regime allows for selection of respondent to a dispute and investor can take advantage of it, inclination towards forum-shopping will be present. Equally important is that in some cases judicial or quasi-judicial organs did not accept requested respondent status based on their legal reasoning.[18]

For this reason, draft regulation introduces internal rules on determining respondent status between EU or the member states.

[16] Solum, L. Path dependancy. 2006 Legal theory blog (last accessed 5 April 2014)
[17] See Hoffmeister, F., Litigating against the European Union and Its Member States – Who Responds under the ILC's Draft Articles on International Responsibility of International Organizations? EJIL. Vol. 21, No. 3 (2010) p. 731-733
[18] Article 4, Draft Regulation

Draft regulation concept for deciding respondent status of the EU and MS in future investment disputes:

- *Status of responding party is linked to eventual obligation to compensate for ill-treatment.*
- *EU shall act as a respondent to the dispute when treatment was afforded by institutions, bodies or agencies of the Union*[19]*;*
- *EU shall be represented by EC*

In additional cases concerning at least partial treatment by state

- *Disputes concerning treatment that was afforded by state fully, or partially special set of rules will apply*[20]*where EC decides if state should have respondent status or the EU*

Conditions when EC may withhold respondent status from state are in the case when multiple disputes may arise, if treatment was provided partly by EU bodies, or if unsettle issue of law pertains in other investment agreements and may trigger more disputes.[21]

Interesting are draft regulation provisions obliging EC and member states to act in cooperation, from initiating proceedings against EU and mutual assistance to limit delays in proceedings or to prepare common defense. In the case respondent is member state draft regulation requires that information, documents be set forward to Commission or if EC may require MS to lodge an appeal, review, or annulment of the arbitral award.[22]

On the other hand, if Commission acts as a respondent in the proceedings, it shall also inform or provide concerned member state with documents from arbitration proceedings.[23]

Reason for procedural duality is effectiveness. Since in case of treatment which was provided by member states and which was required by EU law, then common defense would be most optimal solution to simplify proceedings on the part of respondent.

[19] Article 4, proposal for a regulation of the European Parliament and of the Council establishing a framework for managing financial responsibility linked to investor-state dispute settlement tribunals established by international agreements to which the European Union is party COM (2012) 0335
[20] Ibid. Article 5.
[21] Ibid. Article 8 (2) a., b., c., d.
[22] Ibid. Article 9
[23] Ibid. Article 10

Attribution of financial responsibility

In language of draft regulation, *financial responsibility* is obligation to pay sum of monies for breach of international obligation as set in international investment treaty. This sum of monies consists of financial compensation to foreign investor, expenses from arbitral proceedings and costs of legal defense on site of EU.

Draft regulation provides for division of financial responsibility pertaining to arbitration:

- International responsibility (EU as a party to investment treaty)

  International financial responsibility is obligation of EU to pay financial compensation and costs as provided in arbitral award or as was negotiated in settlement.

- Internal responsibility (intra EU and member status)

  On the other hand, internal responsibility is obligation between EU and MS to mutually reimburse financial compensation already paid to foreign investor and proceedings expenses. This is regulated wholly under the draft regulation

International financial responsibility

It is basically paid by the EU since it has legal capacity to conclude extra-Union investment treaties. Specifically it will be Commission arrange payment based on request of investor demonstrating final and binding arbitral award or settlement.

Exception to this rule is, if member state had accepted financial responsibility at any stage of dispute or if MS is acting as a procedural respondent then he shall bear the financial responsibility for the outcome of the dispute.[24] Even, if the member state refused to pay basic rule would apply that Commission will pay the financial compensation. In that case Commission on behalf of EU will reimburse paid compensation from specific member state.

[24] Ibid. Article 3 (3)

Internal rules for financial responsibility

Draft regulation sets out rules for internal allocation of responsibility to pay. These rules provide that: "*..financial responsibility should fall internally on the entity responsible for defining the content of the treatment afforded to the foreign investor.*"[25]

To illustrate, Article 3 (1) of draft regulation provides for 3 rules to determine who shall bear the financial responsibility to reimburse financial cost of paying remedy and paying arbitration costs:

1. EU is responsible if treatment was provided by institutions, bodies or agencies of EU
2. MS is responsible if treatment was provided by member state not required by EU law (conduct and legal acts of member states or its agents)
3. EU should be responsible if treatment was provided by a member state required by EU law (e.g. transposing directive, executing regulation and so on)

Where provided by draft regulation, EC shall adopt decision determining financial responsibility of member state based on aforementioned rules.

In first and second case, attribution is easily determined.

More concerning may be third case in which means that member state is acting as an agent of EU in implementing law of EU.

As Hoffmeister puts it: *It is nowadays accepted that EU can affect an investor not only directly (through regulation or decision addressed to the investor), but also indirectly "through directive or decision addressed to the Member State which then acted accordingly""*[26]

Complicating situation may arise when with implementation of EU law member state, e.g. transposes directive, and however provides for "surplus" or so-called *gold-plating.* At first glance it may not be entirely clear as to who attribute the ill-treatment regarding that directive. In case if Commission decides that member state shall bear financial responsibility for such ill-treatment, state may be reluctant to comply.

[25] Ibidem. Kleinheisterkamp, J., n.9, p.9

[26] Ibidem. Hoffmeister, F. n. 23, p. 736
(and second part of the citation)
Happ, R., The Legal status of the Investor vis-a-vis the European Communities: Some Salient Thoughts. Vol 74 International Arbitration Law Review. p 77

Another situation can be when EU directive is transposed incorrectly. Additionally if MS improperly implements regulation figuring out financial responsibility may be a problem. Situation when MS disagrees with its financial responsibility even potential responsibility is described in following paragraph.

Draft regulation predicts disagreement to financial responsibility. If EU acts as a respondent and EC considers that MS should pay the award or settlement then they start consultations. If no agreement is reached, EC shall adopt decision requiring MS to pay no more than 3 months before request of payment on the basis of settlement or arbitral award. If MS fails to object EC decision it "shall" compensate EU budget. If MS objects and EC will not agree, second decision will be adopted requiring MS for reimbursement of financial compensation including interest. In such case EU will compensate foreign investor from EU budget and shall request reimbursement of financial compensation from state. Whereas Court of Justice of EU will provide for adjudication based on article 263 TFEU.

Mechanisms for payment of awards and settlements[27]

EC bearing in mind promptness in compensating foreign investor included provisions on payments. A foreign investor is to request the EC for a financial compensation under a final and binding arbitral award or under the terms of a settlement negotiated with the EU. After that EC will arrange payment for the investor wronged. Exception from this rule is situation when respondent member state. As was mentioned earlier, in some cases respondent status is linked to responsibility to compensate. Therefore, respondent state in the proceedings should be request by foreign investor. Another situation that may arise is in the case when MS has a financial responsibility to compensate however refuses to pay. In this case EU will compensate the investor from EU budget and request reimbursement from member state.

Equally, it is important to consider a situation when EU as a respondent in arbitration proceedings would refuse to pay financial compensation to foreign investor, e.g. on grounds of gross misconduct on the part of the tribunal. The explanatory memorandum to the draft regulation provides an answer. Hypothetically, in a case where EU is reluctant to pay, foreign investor may have the arbitral award recognized and enforced before the Court of Justice of the EU based on Protocol on the privileges and immunities of the European Union which states in article 1: *The property and assets of the Union shall not be the subject of any*

[27]Chapter V of the Draft regulation

administrative or legal measure of constraint without the authorization of the Court of Justice.[28]

Summing up draft regulation

The draft regulation provides internal rules for determining respondent in arbitration proceedings. Interests of member states are preserved unless the investment dispute or its unresolved legal question might trigger chain-effect of future investment disputes.

Other rather advantageous elements of draft regulation are internal rules of financial responsibility. It is because it leaves the allocation of responsibility based on 3 rules in article 3 and if contested Court of Justice of the EU may provide for binding decision. This circumvents discretion of arbitral tribunal in interpreting EU law and also circumvents potential forum-shopping.

Rather for EU's momentarily disadvantage is that even if MS acts in accordance with EU law and arbitral tribunal will find EU law in breach of its international obligations, EU will still bear financial responsibility in this matter. This will narrow legislative powers of EU.[29]

Other paradoxical situation may arise when state in order to avoid international responsibility of EU would want to act *contra legem* EU. This situation can be even more interesting if substantial economic risk was present if EU breached its investment obligations. Respecting hierarchy of EU law, amendment could be only enacted by the EU. However it would be intriguing to EU or the Court of Justice of the EU to invent circumstances precluding wrongfulness actions of EU bodies or member states or provide for other solution.

Another and significant question is: how would arbitral tribunal react to set of procedural rules included in draft regulation if they are part of legal order of the defendant? In this case as Kleinheisterkamp reasonably points out, to increase legal certainty, EC as EU subject negotiating future investment treaties should insist on including obligation for tribunal to accept provisions of draft regulation.[30]

[28] Art. 1, Protocol (No.7) on the privileges and immunities of the european union annexed to the Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union2012/C 326/01
[29] Ibidem n. p.14
[30] Ibid. p. 16

Conclusion

The draft regulation on financial responsibility provides for logical and innovative rules for managing allocation of costs of ill-treatment to a investor. Remarkable is to withhold from foreign investor the right to choose the respondent (MS or EU) and thereby avoiding forum-shopping. This also solves problem with the allocation of responsibility to pay compensation, since draft regulation and Court of Justice of the EU will create rules of attribution, either to member state or the EU.

Conversely rules of attribution may be problematic. Attribution will depend on the question if contested treatment or act was prescribed by EU law or was in the domain of member states. If treatment was provided by EU bodies attribution is can easily determined. However, troubling may be if a member state is obliged to carry out EU law, for example in the case of transposing EU directives. To some extent this may increase reluctance of member states to reimburse financial compensation previously paid by EU to the foreign investor.

Accordingly, member state's reluctance to pay should not affect international responsibility of EU to compensate, since EU pays financial costs of the dispute and eventually member state has to reimburse the sum paid by the EU to the investor wronged. This may burden EU budget if proper guarantee of monies is not provided by the member states beforehand or on a regular basis.

Another aspect is conflicting view of European Commission and member states about EU's exclusive competence. Does it regulate only foreign direct investment? Or does it also contain a competence in a portfolio investment? This point is significant since it determines whether the draft regulation on financial responsibility can be applied to matters of portfolio investment or if it should be left to defense of member states. Until left unresolved, EU plans for unification of external investment policy may remain doubtful. In any case, final say will have the Court of Justice of the EU.

Rather unanswered procedural question is that of mass claims as in case *Abaclat and others v. Argentina.* Risk of multi-party arbitration is possible if taking into account broad EU competence in common policies. This may require additional rules on dispute settlement in the future, weighing the overall costs for the EU and the member states. EU is trying to minimalize residual effects of investor-to-state arbitration by introducing requirement for

broader transparency[31], more consistency in deciding investment disputes and increasing regulatory space that should be provided for in investment agreements.

Summing up, EU efforts to centralize the external action in common investment policy can be seen as withdrawing competences from arbitral tribunals to adjudicate or decide on matters related to internal structure of EU as amended by Lisbon Treaty. Additionally, they introduce internal authority of allocating financial responsibility to some extent similar to federal states mechanism.

What is more, EU this regulation can be seen as an example of „narrowing the playfield" of member states. Since they are bound by decisions produced by European Commission this may limit the states in their legal certainty, since only ultimate decision on this matter can be given by Court of Justice of the EU.

[31]European Commission: European Commission to fund new international transparency database for Investor-to-state disputes (ISDS) Brussels, 1 April 2014
http://trade.ec.europa.eu/doclib/press/index.cfm?id=1054 (last access 8 April 2014)