Swiss Supreme Court refuses to vacate Energy Charter Treaty award in Czech photovoltaic case

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In *Decision 4A_80/2018*, the Swiss Supreme Court declined to set aside an Energy Charter Treaty award on jurisdiction and liability.

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Speedread

In a recently published French-language decision, the Swiss Supreme Court refused to set aside an investor-state arbitral award rendered in a dispute related to tariff and taxation measures introduced by the Czech Republic following the so-called "solar boom" investment rise in its renewable energy sector and concerning a dispute between *Natland et al v Czech Republic*

The dispute between the Czech Republic and four investors concerned investments in photovoltaic production in the Czech Republic. Leveraging on certain benefits introduced by the Czech government to incentivise renewable energy production, the claimants made investments in 2009 by acquiring shares in a local holding company, as well as providing financing to this company. After the Czech government eliminated these incentives, the investors commenced investment arbitration proceedings against the Czech Republic. They argued that modifications to the benefits introduced by the Czech Republic and the

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introduction of a solar levy affected their investments, violating the standards of protection guaranteed to them by four investment treaties, namely the Energy Charter Treaty (ECT) and the relevant Czech Bilateral Investment Treaties (BITs).

Following a partial award on jurisdiction and liability on 20 December 2017 in favour of the investors by an ad hoc arbitral tribunal seated in Geneva, the Czech Republic sought to vacate the award, invoking Article 190(2)(b) of the Swiss Private International Law Act (PILA) and submitting that the arbitral tribunal erred when it assumed jurisdiction and recognised the state as liable for violation of the fair and equitable treatment (FET) standard.

In its decision, the Swiss Supreme Court dismissed the Czech Republic's application in its entirety, concluding that the solar levy had been adopted by the government as a reaction to the costs induced by the solar boom that became untenable for end consumers. Further, the investments were foreign and the Czech Republic had not discharged its burden of proof, in that it had failed to demonstrate any evidence of any abuse of rights associated with the investors' alleged treaty shopping that would justify piercing the corporate veil of the claimants' duly structured investments. (*Decision 4A_80/2018 (7 February 2020).)*

Background

Private International Law Act (PILA)

Article 190(2) of PILA provides an exhaustive list of grounds for challenging an arbitral award. In general, recourses under Article 190(2) of PILA are of a purely "cassatory" effect, save for one exception in Article 190(2)(b) of PILA, which provides that "the award may only be challenged ... if the arbitral tribunal wrongly accepted or declined jurisdiction."

Therefore, the Swiss Supreme Court cannot decide on the merits of the case underlying a challenged award, as it can only set an award aside for one of the Article 190(2) grounds. However, if Article 190(2)(b) of PILA is invoked, the Swiss Supreme Court reviews *de novo* (with full cognition) the arbitral tribunal's legal analysis in order to find whether the arbitral tribunal wrongly ruled on its own jurisdiction. Nevertheless, the Swiss Supreme Court bases its decision on the facts established in the arbitral award under appeal.

Achmea

On 6 March 2018, in *Slowakische Republik v Achmea BV (C-284/16)*, the Court of Justice of the European Union (ECJ) held that Articles 267 and 344 of the Treaty on the Functioning of the European Union (TFEU) must be interpreted as precluding investor-state dispute settlement (ISDS) provisions in intra-EU BITs, such as the one contained in Article 8 of the Dutch-Slovak BIT (see *Legal update, ECJ: Arbitration clause in intra-EU BIT incompatible with EU law*). The ECJ ruling went against Advocate General Wathelet's opinion issued on the matter in September 2017 (see *Legal update, Advocate General opinion on compatibility of intra-EU BIT arbitration clause with EU law*).

EU member states' declarations

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On 15 and 16 January 2019, EU member states issued declarations recognising the consequences of *Achmea* (see *Legal update, EU member states issue declaration recognising consequences of Achmea*).

Twenty-two member states consider that the consequences of *Achmea* are that all ISDS provisions in intra-EU BITs are incompatible with EU law and all member states undertook to terminate all intra-EU BITs by 6 December 2019, a move welcomed by the European Commission (EC). On 6 May 2020, 23 EU member states signed an agreement to terminate all existing intra-EU BITs (see *Legal update, Agreement to terminate intra-EU BITs signed by 23 EU member states)*.

To follow developments related to intra-EU BITs, see *Intra-EU bilateral investment treaties: tracker*.

Fair and equitable treatment

Investment treaties frequently impose an obligation on host states to accord foreign investments fair and equitable treatment (FET). FET is one of the most widely invoked standards of investment protection. There is no single definition of the FET standard and its precise meaning will in part depend on the facts of a particular case (*Mondev International Ltd v USA (ICSID Case No ARB(AF)/99/2), Award, 11 October 2002, at paragraph 118*). FET is considered to be a general standard that also encompasses other standards of treatment, such as prohibition of arbitrary or discriminatory treatment or the obligation to provide full protection and security.

For further details, see *Practice note, Fair and equitable treatment in international investment law*.

Energy Charter Treaty (ECT)

Article 21 of the ECT provides a carve out for taxation measures and defines the term as:

"(i) any provision relating to taxes of the domestic law of the Contracting Party ... ; and (ii) any provision relating to taxes of any convention for the avoidance of double taxation or of any other international agreement or arrangement by which the Contracting Party is bound."

For further details on the ECT, see *Practice note, Investment arbitration under the Energy Charter Treaty*.

Facts

Czech Republic's measures relating to renewable energy

As of 2005, with the adaptation of the 2005 Act on Promotion of Electricity Production from Renewable Energy Resources (Renewable Electricity Act), the Czech Republic introduced a so-called "Support Scheme": a legal framework to incentivise investment in renewable energy production. The Support Scheme guaranteed the investors certain Feed In tariffs (FIT) to be calculated on the basis of investment and operational costs of renewable energy facilities and set by a central governmental authority, the Energy Regulatory Office (ERO). Any investor was also exempt from income tax for a period of five years after the commencement of power generation, that is, was entitled to benefit from an income tax holiday.

The idea of the Support Scheme was to ensure that investors would return their investments in the field of solar energy within a period of 15 years (then increased to 20 years), which corresponds to the estimated lifespan of a photovoltaic installation. Initially, these legislative measures did not generate significant investments. However, between 2009 and 2010, the price for solar panels significantly decreased, so that the FIT level, based on higher investment prices suddenly became much more advantageous for the investors, leading to unpredictably high

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investments in the photovoltaic sector. Although the Support Scheme provided for a 5% brake rule, that is the ERO was barred from modifying the FIT levels by more than 5% from one year to another, the rapid drop in the cost of solar panels was far greater than the maximum allowed 5% drop in FIT. The solar boom combined with the political turbulence in the Czech Republic and the global economic crisis of 2008 led to an extremely serious situation.

Just like Spain and Italy, the Czech Republic was eventually forced to amend the Support Scheme to overcome financial unsustainability for the end-customers as the FIT was passed on in form of a surcharge on their electricity bills. Following massive investments, in 2010, the Czech Republic's government adopted a series of measures significantly reforming the Support Scheme and capped the amounts paid by the end-customers to finance the FITs and simultaneously, with immediate effect, abolished the 5% brake rule. These measures were formulated in the amendments of 17 March 2010 to the Renewable Electricity Act, and targeted all installations to be connected to the network after 1 January 2011. On 28 December 2010, the Czech Republic introduced further amendments to the Renewable Electricity Act when instituted a so-called "solar tax" or "solar levy" (to be paid by the solar energy power plants commissioned between 1 January 2009 and 31 December 2010 that benefitted from the FIT. Finally, on 1 January 2011, the income tax holiday was also rescinded.

Ad hoc arbitration proceedings

On 8 May 2013, four investors, one from the Netherlands, two from Cyprus, and one from Luxembourg initiated ad hoc arbitration proceedings under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL Rules) against the Czech Republic. The proceedings were consolidated in August 2013 and the arbitral tribunal was constituted in early 2014. The claimant investors argued that they made investments in the Czech Republic's photovoltaic power generation stretching from 2008 to 2011 by funding a company based in the Czech Republic. The company, Energy 21, was a holding company for eleven special purpose vehicle companies (SPVs) operating the claimants' solar parks. The claimants claimed that the amended Support Scheme, abolition of the income tax holiday, and the newly introduced solar levy violated the claimants' rights under the ECT, the Agreement on reciprocal promotion and protection of investments between the Belgium-Luxembourg Economic Union (BLEU) and the Czech and Slovak Socialist Republic of 24 April 1989 (BLEU-Czech Republic BIT), the Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic of 29 April 1991 (Netherlands-Czech Republic BIT), and the Agreement on encouragement and reciprocal protection of investments between the Republic of Cyprus and the Czech Republic of 15 July 2001 (Cyprus-Czech Republic BIT). All four treaties grant the covered investments certain standards of treatment, including FET, full protection and security (FPS), as well as non-discriminatory treatment that should not hinder their management, maintenance, use, enjoyment and disposition.

As in the Spanish and Italian photovoltaic cases, the EC contested the validity of the intra-EU BITs under EU law. However, the Czech government did not put forward any jurisdictional objections concerning the intra-EU BIT validity and did not plead that the BITs invoked by the claimants were incompatible with EU law. Additionally, the Czech Republic did not rely on the *Achmea* case that was pending before the ECJ and was brought to the arbitral tribunal's attention by the EC. Instead, the Czech Republic raised seven other preliminary objections relating to the jurisdiction of the arbitral tribunal.

The claimants conceded that some of the Czech government's measures (for example, the repeal of an income tax exemption) were indeed taxation measures. However, the parties disputed whether the solar levy that was initially collected out of the FITs payments to the investors qualified as a taxation measure for the purposes of the ECT.

The arbitral tribunal issued its partial award on 20 December 2017, declining jurisdiction over the claims in connection with revocation of the income tax holiday and modifications of the tax depreciation regime, as well those based on the Czech BITs with Cyprus and BLEU (only in relation to the two out of the four claimants, one

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from Luxembourg and one from Cyprus). With regard to the two other claimants, the investors incorporated in the Netherlands and Cyprus, the arbitral tribunal found itself competent to rule on the violations of the subsequent protections granted to the covered investments. It held that the Czech Republic was in breach of the FET contained in Article 10 of the ECT, and Articles 2 and 3 of the Czech BITs with Cyprus and the Netherlands respectively by enacting a solar tax that reduced the FIT minimum level. With regard to the claims that the tax exemption and the solar levy contravened their legitimate expectations of a fixed FIT for the duration of their investment, the arbitral tribunal did not deem the claimants' claim reasonable given that the guarantee of a 15-year return period had not been abolished. Likewise, the tribunal was not convinced that the claimants could have had any legitimate expectation that the income tax exemption would not be amended or abolished by the Czech Republic given that there were no stabilisation clauses for a preferential tax regime.

Tax measures

In terms of the taxation measures, the arbitral tribunal reviewed several domestic decisions addressing the said measure and analysed whether the measure was formally a tax under Czech tax law. The arbitral tribunal found that the Supreme Administrative Court (SAC) decision of 10 July 2014 was the most convincing element as to the nature of the solar levy according to the laws of the Czech Republic. The arbitral tribunal agreed with the SAC that the solar levy was not a "tax" for the purpose of the prohibition against double taxation. The SAC described the solar levy as a governmental subsidy (the FIT payable by the state) that was decreased, and not a tax. The arbitral tribunal then referred to the other jurisprudence, confirming that the solar levy led specifically to reduction of expenditures as opposed to the taxation purpose of bringing revenue to the state's budget.

The arbitral tribunal also held that the rationale of the solar levy was to reduce revenue outflow as opposed to raising revenue for the state. Therefore, as long as the solar levy was not covered by the ECT's tax carve-out, the arbitral tribunal had competence to deal with this issue. However, the arbitral tribunal noted that the Czech Republic did not act in bad faith when introducing the solar levy, as the measure undertaken was merely designed to reduce the governmental support payable to producers of solar energy. Besides, the state was searching for ways to reduce the level of subsidy in a manner that it hoped would be consistent with its investment protection obligations.

Treaty shopping

In relation to the allegation of treaty shopping, the Czech Republic contended that the arbitral tribunal had erroneously upheld jurisdiction over the Cypriot and Dutch investors. Those claimants had based their claims on three treaties: the Cyprus-Czech Republic BIT, the Netherlands-Czech Republic BIT and the ECT.

It was the Czech Republic's view that the investments of these two claimants were purely domestic in the understanding of the BITs and the ECT since those companies were mere "facades" de facto controlled by three Czech individuals. The Czech Republic also claimed that their incorporation in 2009, at a point when the Czech government already threatened to remove the 5% FIT price limitation making the dispute foreseeable, was an attempt of treaty shopping, that is, the strategic adoption of a certain nationality to benefit from the investment treaty protection. Specifically, the three Czech nationals allegedly committed "round-tripping" to internationalise their domestic investments when they orchestrated a purchase of shares in Energy 21 by a Dutch entity on 18 December 2009, only ten days following its incorporation (8 December 2009). In turn, the Dutch entity was owned by a newly founded Cypriot company, incorporated on 29 October 2009. Both investors were part of a broader investment group, beneficially owned by these Czech individuals.

However, the arbitral tribunal, found no support for the effective control requirement in the BITs' language as well as believing that the "solar boom" was unpredictable before mid-2010 and, therefore, declined this jurisdictional objection.

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Given that the arbitral tribunal confirmed the breach of the FET standard only, the tribunal decided to deal with the quantification of the claimants' losses connected with the introduction of the solar tax separately.

In the meantime, on 1 February 2018, the Czech Republic seized the Swiss Supreme Court alleging breach of Article 190(2)(b) of the PILA and requested that the court vacate the partial award on two grounds:

- The measures challenged by the claimants fell within the ECT's carve-out for taxation measures.
- Two of the claimants (the Cypriot and Dutch investors) had engaged in treaty shopping.

Decision

The Swiss Supreme Court refused to set aside the partial award

The Court examined two alleged defects of the award. With regard to the first complaint, it held that the arbitral tribunal correctly accepted its jurisdiction when it found that the solar levy was not covered by the ECT's tax carve-out. Secondly, the Swiss Supreme Court also denied the allegations that two of the four claimants, companies incorporated in the Netherlands and Cyprus, pursued treaty shopping to obtain investment protection. Other interesting issues were discussed.

No precedent in Investment State Dispute Settlement

In the setting aside proceedings before the Swiss Supreme Court, the Czech Republic invoked the *Achmea* decision of the ECJ. However, the Swiss Supreme Court held that the Czech Republic itself, during the arbitration proceedings, recognised that it could not raise the intra-EU jurisdictional objection for the first time during the annulment proceedings. Hence, the Swiss Supreme Court did not further delve into the *Achmea* decision.

The Czech Republic also relied on an award rendered on 2 May 2018 by another UNCITRAL arbitral tribunal within the same factual matrix and against the same respondent state, that is *Antaris Solar GmbH and Dr. Michael Göde v Czech Republic (PCA Case No 2014-01)*. The Court found the *Antaris* award inadmissible, given that it post-dated the challenged award and any additional jurisprudence or doctrine cited therein should have been submitted by the Czech Republic during the arbitral proceedings in question. In conformity with its previous jurisprudence, the Swiss Supreme Court again held that case law decisions are not legally binding on arbitral tribunals in subsequent investment arbitrations and do not qualify strictly speaking as a source of arbitration law. Therefore, the Swiss Supreme Court could freely examine questions of law to determine the arbitral tribunal's jurisdiction set forth in the challenged award.

Solar levy not a taxation measure for the purposes of carve-out in Article 21 ECT

The Czech Republic also challenged the arbitral tribunal's jurisdiction and contended that the measures challenged by the claimants fell within the ECT's carve-out for taxation measures.

The Czech Republic claimed that the arbitral tribunal's conclusion that the solar levy was not a "taxation measure" for the purposes of the carve-out provision in Article 21 ECT was erroneous. The Czech Republic challenged the authority of the SAC decision and contended that the arbitral tribunal's reasoning was based on "an isolated, undebated,

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superfluous and groundless holding from an unpublished, uncited [decision], devoid of all authority". The state also pleaded that other domestic authorities had treated the solar levy substantially as a tax.

The Swiss Supreme Court disagreed. It emphasised that the SAC specifically evaluated the material nature of the solar levy in the context of deciding the double taxation complaint bought by a producer of photovoltaic electricity benefiting from the FIT purchase price. All other sources quoted by the Czech Republic only called the solar levy a tax, yet, without any deeper analysis. The Swiss Supreme Court also stated that, when addressing the applicable law, the arbitral tribunal's approach was to rely on the opinion of the highest judicial body of the foreign state concerning the relevant case, and nothing in the application of the Czech Republic suggested that the SAC decision of 10 July 2014 did not express such a position. Agreeing with the arbitral tribunal, the Swiss Supreme Court, therefore, held that the SAC decision should be given considerable weight.

Finally, the Swiss Supreme Court found that the arbitral tribunal's analysis, which had gone beyond the formal name of the measure (which the Czech government called a "levy") and reviewed its context and operation, was sound and justified and the solar tax targeted FIT paid to solar producers and was partially subsidized by the Czech government. Therefore, there was no violation of Article 21 of the ECT and the principles governing the interpretation of the treaties, and accordingly the Supreme Court rejected the first ground for the set aside application.

The Cypriot and Dutch investors did not undertake treaty shopping

As to its second ground for annulment of the arbitral award, the Swiss Supreme Court noted that treaty shopping involves drawing a line between legitimate planning and the abusive process. A request to pierce the corporate veil, often made before the arbitral tribunals, would rarely be successful unless justified by proven abuse of rights circumstances. Therefore, the Swiss Supreme Court had to examine whether the Cypriot and Dutch companies were investors protected by the three treaties on which they relied and whether claiming such protection would be an abuse of rights.

The Czech Republic argued that the ECT and the BITs require "a trans-territorial flow of assets from one contracting party to another contracting party controlled in the country of origin of the flow." The Swiss Supreme Court reviewed the definitions of the terms "investment" and "investor" separately in the ECT and the BITs and held that the treaties' definitions require investors to be foreign in relation to the host state and to hold an asset constituting an investment either directly or indirectly, exercising de facto control over such asset. The Swiss Supreme Court suggested that in the case of corporations, these only needed to be incorporated in the foreign state to meet the formalistic definition of foreignness. The Swiss Supreme Court concluded that the foreign companies that acquired shares of Energy 21 in 2009 were qualifying foreign investors that effectively own their investments, and that the factual situation presented before the Swiss Supreme Court did not allow them to infer that these investments were instead de facto controlled by the three Czech individuals or were under their substantial influence. Therefore, the Czech Republic did not meet its burden of proof to convince the Swiss Supreme Court that the three Czech nationals de facto controlled the investments instead of the Dutch and Cypriot investors, or that the two investor companies were empty shells.

On abuse of rights, the Swiss Supreme Court joined the arbitral tribunal's analysis that although the Czech Republic had proclaimed certain amendments to the Support Scheme in 2009, there was no warning that these amendments would apply to existing investments such as the claimants. There was also no indication that the Czech Republic would eventually (almost one year later) enact a solar levy affecting all renewable energy producers.

The Swiss Supreme Court further stated that it is an investor's legitimate choice to structure its investment in a way to benefit from a treaty protection. In the case at hand, this did not amount to an abuse of rights, particularly because the initial investment was made through a Dutch entity in 2007 when Energy 21 was incorporated in the Czech Republic, meaning that the element of foreignness was pre-existent long before any amendments to the

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renewables regime in the Czech Republic could have become foreseeable. At this point in time it was unclear whether the claimants would need any protection, if at all, and if additional protection could have been obtained under the Cyprus-Czech Republic BIT by bringing in an additional corporate layer. Ultimately, the Swiss Supreme Court held that the factual situation here did not have characteristic features that would allow recourse to such an exceptional remedy as an abuse of rights.

Comment

This case adds to the recent and growing body of the Swiss Supreme Court's jurisprudence in investment arbitration. However, in substance, the decision breaks little new ground: regarding the qualification of the solar levy, the arbitral tribunal's reliance on one of the highest judicial authorities in the Czech Republic provided a fairly non-controversial basis on which the Swiss Supreme Court could rely. On the reliance on the ECT, and Dutch and Cyprus investment treaties with the Czech Republic by companies whose ultimate beneficial owners were Czech nationals, the Court adhered to the formal criterion of incorporation and did not view the claimants, in the circumstances of this case, as "mailbox" or shell entities deliberately inserted into the corporate group to create a foreign "façade" for Czech nationals' domestic investments. The Swiss Supreme Court noted that generally strategic corporate planning to gain investment protection is legitimate. This, however, is limited, among other things, by the prohibition against an abuse of rights, which the facts here did not establish.

The Swiss Supreme Court also adhered to the narrow interpretation of the issue of control of investment, concluding that the ultimate de facto control of the claimants allegedly exercised by the Czech nationals was not properly established by the facts of this case. The Czech Republic was not able to show evidence confirming that the Czech individuals took an active part in the investment operations. Absent the latter, the Court saw no grounds to disregard separate corporate personality of the Dutch and the Cypriot investors.

Unusually, the Swiss Supreme Court took almost two years to decide on the setting aside application.

Case

Decision 4A_80/2018 (7 February 2020) (Swiss Supreme Court).

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