

June 2017

Brexit — The Divorce Bill



BREXIT

“... Please believe me, it’s not because of money but because of rules ...”

*(Donald Tusk, President of the European Council,
when asked about a Brexit financial settlement)*

Introduction

It has recently been announced that Brexit negotiations are scheduled to begin on 19 June – 11 days after the forthcoming UK election, and almost a year after the Brexit referendum.

Even before the first formal meetings, the omens are not good. As has been well-publicised, the EU is seeking substantial agreement on the UK’s “divorce bill” before discussing the details of a future trade relationship. Initial estimates of this figure were in the region of €50 billion. However, the figure suddenly increased to €100 billion following Mr Juncker’s taste of English cuisine at 10 Downing Street on 26 April. To add insult to that particular injury, details of the discussions were leaked to the German press, and Mrs May was accused of living in another galaxy. However, that may be, it is hard to see how the UK Government could agree to write such a large cheque before proper trade negotiations have even begun – that cheque is perhaps the UK’s main bargaining chip. As the Brexit Secretary has said, the EU’s refusal to run parallel discussions on divorce and trade is therefore likely to be “... *the row of the summer...*”.

Now, the EU is a treaty-based structure and must be operated in accordance with the rules laid down in the treaties. The EU cannot escape this basic principle, even if its interpretation of the rules at times appears to be both imaginative and fluid. Whilst acknowledging that political realities are very likely to dominate and recourse to the courts must be a remote prospect, it is still relevant to consider the legal framework within which these negotiations will progress. This is even more the case when one considers Mr Tusk’s assurance – however unconvincing – that the negotiations are all about following the rules, rather than extracting money. So what are the relevant rules, and how do they operate in the context of Brexit?

Article 50

As is well known, Article 50 of the Treaty on European Union provides the framework for the UK's departure from the EU. Following the Supreme Court's decision in the *Miller* case and the passage of the European Union (Notification of Withdrawal) Act 2017, the UK Government served its notice of withdrawal on 29 March 2017.

The effect of Article 50(3) is that the UK will cease to be a member of the EU on the earlier of (i) midnight on 29 March 2019 (or such later date as may be mutually agreed to complete withdrawal negotiations) and (ii) the date on which the withdrawal agreement comes into effect. So there is a set timetable for UK withdrawal, even if there is some built-in flexibility. But what are the respective parties required to do between now and then?

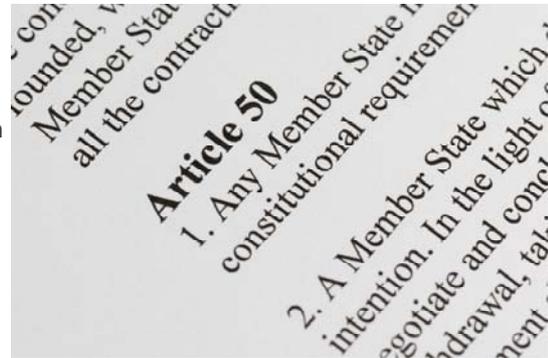
Article 50(2) contemplates the following process:

- the European Council is to provide guidelines for the negotiations;
- based on those guidelines, the EU is to negotiate a withdrawal agreement with the United Kingdom. In accordance with Article 218(3) of the Treaty on the Functioning of the European Union, the EU will act through the Commission for that purpose and Michel Barnier has been appointed as their lead negotiator;
- both the EU and the UK must seek to "... *negotiate and conclude an agreement ... setting out the arrangements for [the United Kingdom's] withdrawal, taking account of the framework for its future relationship with the Union...*";
- the withdrawal agreement must be approved by the Council (acting by a qualified majority) with the consent of the European Parliament; and
- in line with Article 4(3) of the Treaty on European Union and general principles of international law, all parties must cooperate sincerely and in good faith with a view to achieving a settlement.

The Council published its Article 50(2) guidelines for the Brexit negotiations on 29 April. These were followed by more detailed directives for the initial phase on 22 May. Both documents emphasise that the withdrawal agreement must be negotiated in the first instance. The guidelines state that "... *an agreement on a future relationship between the Union and the United Kingdom can only be finalised and concluded once the United Kingdom has become a third country. Article 50 TEU requires to take account of that framework for its future relationship with the Union in the arrangements for withdrawal ...*". In that respect, the EU states that it will engage in "... *preliminary and preparatory discussions...*" on the future trade relationship "... *as soon as the Council decides that sufficient progress has been made on the first phase towards reaching a satisfactory agreement on the arrangements for an orderly withdrawal.*"

The directives issued to flesh out the guidelines contemplate that they may be amended and supplemented as the negotiations proceed. The first stage priorities are stated to include the following:

- safeguarding the residence, social security and other rights of EU citizens in the UK, and of UK citizens in the EU;
- an orderly financial settlement in accordance with the principles discussed below;
- transitional arrangements with respect to movement of goods;
- matters relating to Ireland, including the avoidance of a "hard" border between Northern Ireland and the Republic;
- issues relating to the UK's bases in Cyprus;



- the protection of the EU's interests in the United Kingdom;
- the need for administrative, enforcement and dispute settlement procedures. This segment envisages a role for the European Court of Justice and may therefore be inflammatory from the perspective of the UK government. It also contemplates a separate institutional structure to deal with withdrawal issues; and
- resolution of issues relating to third country partners and international organisations.

There is much in the negotiating guidelines that will be contentious from the viewpoint of the UK Government. But the absence of certain material from those guidelines will also contribute to the argument. For example, there is nothing about the provision of cross-border services, an issue of particular importance to the City and its financial industry. Indeed, very little at all is said about a post-Brexit trading relationship because, as already noted, the guidelines consign those matters to stage 2 of the negotiations.

Financial settlement

Given the possible range of settlement figures already noted, the Brexit financial arrangements are likely to command detailed attention from press and public alike.

The guidelines contemplate a single financial settlement comprising all matters arising with respect to the EU's multiannual financial framework, the European Investment Bank, the European Development Fund and the European Central Bank. The principle requires "...both the Union and the United Kingdom to respect the obligations resulting from the whole period of the United Kingdom membership in the Union ...".

In this context, the EU has also published a working paper titled "Essential Principles on Financial Settlement", which sets out the position that the EU will present to the United Kingdom. The working paper states that the settlement "... must be based on the principle that the United Kingdom must honour its share of the financing of all the obligations undertaken while it was a member of the Union. The United Kingdom obligations should be fixed as a percentage of the EU obligations calculated at the date of withdrawal in accordance with a methodology to be agreed in the first phase of the negotiations ...". Other problems apart, the working paper imposes significant currency risks on the United Kingdom because it requires that all payments must be made in Euro. Whilst this is understandable and reflects current practices, a decline in the comparative value of Sterling could significantly increase a Brexit bill which will probably be very large in any event.

The working paper sets out a series of liabilities to be taken into account, including the multiannual financial framework up to 2020 and other liabilities (such as pension obligations), as shown in the EU accounts. The UK is expected to pick up its pro-rata share of these and other amounts. It is also to terminate its membership of the European Investment Bank but to maintain part of its funding obligations for that institution and various other funds. Again, this will be contentious from a UK perspective because the Government had expressed an intention to deduct the value of these assets from the ultimate Brexit bill.

So, is the EU entitled to require that the divorce bill – or at least its methodology – is settled before trade negotiations can commence? Does Article 50 contain any justification for the two-stage approach? The answer to this would appear to be in the negative. Article 50(2) contemplates a *single* agreement which must set out the arrangements for



withdrawal but which must also “... take account of the framework for [the United Kingdom’s] future relationship with the Union...”. It seems that this language should be interpreted in its broadest sense and there is no apparent implication that the agreement should be restricted to the *financial* consequences of the departure and future relationships. And in any event, how can a withdrawal agreement “...take account of the framework for... the future relationship...” when that issue has not even been discussed?

Obligations of the United Kingdom

It will be apparent from the above discussion that the UK and the EU are not even agreed on the format of the negotiations. Whilst it may be a priority for the UK government to obtain a workable trade deal in return for its exit cheque, the remaining EU 27 have different priorities. Whatever the merits of the respective positions, it must be said that the prospect of a “hard” Brexit (i.e. without a withdrawal/trade agreement) does seem to have increased given the sharply contrasting views on the structure of the talks.

If no withdrawal agreement is concluded, then it becomes highly relevant to ask to what extent the UK has an obligation to contribute to the EU budget as part of the Brexit process. Article 50 itself does not directly seek to address this issue and, if no withdrawal agreement is negotiated, there will be no settled formula. It therefore becomes necessary to fall back on other sections of the treaties.

The enthusiastic reader of the Treaty on the Functioning of the European Union must get as far as Articles 310-324 in order to find the core financial provisions relating to the EU. These rules require the Council and the European Parliament to establish an annual, balanced budget. Article 311 requires the budget to be financed from the Union’s own resources, which comprise customs tariffs, a share of VAT and other items. The budget must operate within the scope of a “multiannual financial framework” (or MFF). The current MFF covers a seven year period from 2014 until 2020.

The MFF is not itself a budget. Rather, it sets out the maximum that the EU can spend in various areas (e.g., economic growth, security etc) over the seven year period. The MFF thus allocates funds to political priorities over an extended period, hopefully providing both a framework and a time period within which the EU’s policies can take root and have a real impact. The current MFF Regulation was adopted pre-Brexit, and it is noteworthy that the MFF is capable of adjustment “... in the event of unforeseen circumstances ...”.

The MFF must be approved by individual Member States. Beyond that, however, it should be emphasised that, whilst many of these amounts will be *collected* by individual Member States, the funds are treated as the *property* of the EU (hence “own resources”). As a matter of EU law, therefore, these funds do not strictly represent Member State *contributions*, since they are EU funds in the first place. This position is recited in the Council’s Own Resources Decision dated 26 May 2014, but also reflects earlier practice. It also appears to be confirmed by several decisions of the European Court of Justice (e.g., Case 93/85, *Commission v United Kingdom*; *Commission v French Republic*, case C-30/89; Case 284/05, *Commission v Republic of Finland and others*; Case C-60/12, *Commission v United Kingdom*). The inevitable result appears to be that:

- a) relevant duties and other amounts collected by the UK up to the final withdrawal date will be EU property, to the extent that they fall within the definition of “own resources”;
- b) since the EU’s entitlement to such amounts ultimately derives from the Treaties, it will cease to be entitled to any such amounts that are collected by the UK with reference to the post-withdrawal period; and



- c) by the same token, the UK will cease to be entitled to any rights or benefits under the Treaties with effect from the final withdrawal date.

This may appear to be somewhat artificial, but any fictitious element of this analysis derives from the EU's desire for its own resources and the legal structure that has been put in place to achieve that end. It may be added that these conclusions appear to be consistent with Article 70 of the Vienna Convention on the Law of Treaties, which provide that a State must meet its obligations up to the date of treaty termination but is absolved from them thereafter.

It must follow that the EU has no financial/own resources claims against the UK following its final departure from the EU. It may be added that, in its March publication titled *Brexit and the EU Budget*, the House of Lords Select Committee on the European Union adopted a broadly similar approach to the likely legal outcomes in the event that no deal can be struck.

Depending on one's viewpoint, these conclusions are either appealingly straightforward or excessively simplistic. But the following points would appear to support the conclusions that we have outlined:

- first of all, Article 50 provides for a two year negotiation period. This affords time for the EU to reorganise its own finances to meet the changed circumstances;
- secondly, it is true that the MFF is currently planned over a seven year period. However, this factor was known when Article 50 and the two year withdrawal period were inserted into the Treaty on European Union. Furthermore, the view that a Member State must fulfil all commitments in relation to the current MFF would work to the obvious disadvantage of a Member State that gave notice early in an MFF cycle. As a result, it is difficult to defend the argument that a withdrawing Member State must fund its membership for the remainder of the current MFF; and
- thirdly, in any event, and as noted above, the MFF Regulation specifically contemplates a revision that is made necessary due to unforeseen circumstances. Given that the current MFF Regulation was approved in December 2013, it is plain that Brexit ranks as an "unforeseen circumstance" and that the EU should now be revising its plans and policies to adapt to changed circumstances, rather than seeking UK contributions for an extended period post-withdrawal.

Disputes

Whilst most will hope that a "hard" Brexit can be avoided, the current situation is not encouraging. If the UK departs the EU without a withdrawal agreement, then the prospect of legal disputes over financial obligations will loom large. But, in the absence of a settlement, who can adjudicate on such disputes?

The EU might claim that the Court of Justice has the necessary jurisdiction. It may well retain power to adjudicate on disputes affecting the UK up to the date of withdrawal. But the UK is not disputing that it has to meet its financial obligations up to that date. For reasons given earlier, the MFF Regulation will cease to apply to the UK post-withdrawal, so it is very doubtful that the Court would have jurisdiction to deal with such matters.



Some have suggested that the International Court of Justice might be the ultimate resort, but this is highly doubtful because:

- i) the Court only has jurisdiction in disputes between *States*;
- ii) any payment obligations owed by the UK would be payable to the European Union; and
- iii) the European Union is a self-standing legal entity but is not a *State*.

Conclusions

In summary, therefore, the legal consequences of a “hard” Brexit with no withdrawal agreement would appear to include the following:

- a) the UK would be obliged to make any payments due to the EU up to the date of final withdrawal, but not thereafter; and
- b) even if that conclusion is disputed by the EU, there will no court or tribunal that has the power to adjudicate on the issue or to make any necessary orders.

We must, of course, await developments as the negotiations progress. But if no settlement is reached, then it is suggested that the above principles would have to be invoked to fill the resultant legal void.

This briefing has been prepared by Charles Proctor, a member of our banking and finance team. It does not necessarily reflect the views of the firm as a whole.

Further information?



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