

Article 346 and the qualified application of EU law to defence

by Vincenzo Randazzo

For decades, the defence sector has been considered as being outside the scope of application of EU law. But excluding defence from the internal market has contributed to market fragmentation, a lack of competition and a strong national preference in procurement – all of which have encouraged, in turn, inefficient spending, the unnecessary duplication of capabilities, and sub-optimal levels of competitiveness for Europe's industry. From a legal standpoint, this is mainly due to the fact that Article 346(1)(b) of the Treaty on the Functioning of the European Union (TFEU) was read as excluding the *whole* defence sector from the remit of EU law. On the basis of established case law of the Court of Justice, however, it is now clear that this is – instead – a case-by-case derogation that is to be applied strictly in exceptional situations.

While past discussions on Article 346 (previously Art. 296 of the European Community Treaty) have often been focused on what kind of military products are covered, more recent case law seems to show that the key conditions for the application of this Treaty provision are *necessity* and *proportionality*. It is for member states to prove that the measures they take are necessary in order to protect their essential security interests, and that such an objective cannot be achieved through

less restrictive means. This now appears to be the most important challenge for member states seeking to rely on Article 346 – and is likely to be at the centre of future case law, as well as discussions among academics and stakeholders.

From automatic exemption to case-by-case derogation

Member states have long avoided applying EU law to defence by extensively relying – implicitly or explicitly – on Article 346. The underlying assumption was that, on the basis of this provision, activities related to the production of (and trade in) arms and war material were automatically excluded from EU law. In other words, this was considered a provision delimiting the competences of the EU – and setting out the boundaries between the EU's and its member states' domains.

Following significant developments which have occurred over the last 10-15 years, however, the legal situation has changed profoundly. In four cases relating to equal treatment for men and women, one of which dates back to 1986, the Court of Justice simply referred to the now Article 346 when listing all the Treaty derogations related to public security. Since member states had

not specifically invoked this provision, the Court did not analyse it in detail. Since 1999, however, Article 346 – alone or together with other provisions – has been specifically invoked before the Court of Justice in twelve cases (including seven almost identical *Community Customs Code* cases) – and always unsuccessfully.

Article 346 of the Treaty on the Functioning of the European Union

1. The provisions of the Treaties shall not preclude the application of the following rules:

(a) no member state shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

(b) any member state may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes.

2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.

In the light of such well-established case law of the Court of Justice, it is now crystal clear that Article 346 is neither an automatic exclusion of defence from EU law, nor a provision limiting EU competence. As the Court of Justice ruled in the *Spanish Weapons* case (concerning the VAT exemption of imports and acquisitions of armaments) and confirmed in several subsequent rulings, Article 346 is just one of the Treaty-based derogations which deal with exceptional and clearly defined cases, and one which must be interpreted strictly. This means that this provision can be used – on a case-by-case basis – only where the specific conditions for its application are fulfilled. Furthermore, it demonstrates that the burden of proof lies with the claimant member state.

What conditions for application?

In order to apply Article 346, in essence, two sets of conditions must be met. The first concerns the material scope, i.e. what type of product is

covered. The second is about the *necessity* and *proportionality* of the member state's specific measure for the protection of its essential security interests.

As for the first set of conditions, the scope of Article 346 is limited to measures relating to the products included in the list adopted by the Council on 15 April 1958. The General Court in *Fiocchi munizioni* and, more recently, the Court of Justice in the *Finnish turntable* case both confirmed such a reading, which is also consistent with the need to interpret this derogation in a restrictive manner.

Furthermore, this provision can only apply to measures relating to products intended for specifically military purposes. To this end, it is not sufficient that a member state intends (subjectively) to make use militarily of a given product. Nor is it sufficient, as the Court held in the *Agusta helicopters* case, that such a product is merely suited to military use and, thus, will probably be used for such purposes. As the Court stated in the *Finnish turntable* case, it must have been specifically designed and developed – also after substantial modifications – for exclusively military purposes.

The fact that a measure relates to products included in the 1958 list and is intended for specifically military purposes does not mean, however, that use of Article 346 is justified. It only means that the first set of conditions is fulfilled.

With regard to the second set of conditions, Article 346(1)(b) allows 'any member state to take such measures as it considers necessary for the protection of the essential interests of its security.' Although member states have long supposed that they enjoyed great discretion owing to this part of the provision and that there was effectively no limit to the possibility of its use, it has, however, proven to be a crucial condition.

In the 2009 *Community Customs Code* cases, Sweden argued that the purpose of Article 346 is to ensure that member states have freedom of action in areas affecting national defence and security. Germany, Greece, Finland and Denmark also contended that the very wording of that provision – in that it refers to 'measures as it considers necessary' – shows that the Treaty intended to confer on member states significant discretion. These arguments, however, failed to convince the Court of Justice. It responded that, despite that reference, Article 346 cannot be read in such a way as to allow member states to depart from EU

law based on no more than a desire to protect – what they deem to be – essential security interests. The Court added that it is for the member state seeking to rely on Article 346 to prove how this is indeed the case.

In doing so, member states have first to identify the ‘essential security interests’ they intend to protect. And here they do, in fact, enjoy a margin of discretion: neither the Commission, nor the Court of Justice, nor national courts would second-guess the member states’ choices in identifying their security interests or in qualifying them as essential. And any review would probably be limited to a plausibility test. Hence, member states must make a credible case that the interest at stake is a security (not an economic) one, and that it can be defined as essential.

Member states have then to prove that the specific measure that they intend to justify on the basis of Article 346 is necessary in order to protect such vital security interests (*necessity*). Furthermore, and perhaps more importantly, any member state seeking to rely on Article 346 has then to demonstrate that the objective of protecting its essential security interests cannot be achieved through less restrictive means (*proportionality*). The Court has consistently applied this condition in cases concerning the application of the ‘traditional’ Treaty-based derogations to the fundamental freedoms of the internal market. With regard to Article 346, the Court referred to this condition in an unequivocal manner for the first time in the *Finnish turntable* case, which concerned the non-application of the ‘classical’ Public Procurement Directive.

Public procurement and state aid control

In the early 2000s, the case law of the Court of Justice – and in particular the indication that Article 346 does not provide the automatic exclusion of defence from EU law – set in motion a process that eventually led the European Parliament and the Council, in 2009, to pass the Defence Procurement Directive.

It was thought that member states routinely invoked Article 346 because the ordinary EU public procurement rules were not suited for the specificities of the defence market. Hence, the Defence

Procurement Directive lays down rules aimed at ensuring competition, transparency and non-discrimination while meeting the specific needs and requirements of defence procurement. The legislator’s rationale was that, with such defence-specific rules in place, member states would no longer need to make extensive recourse to Article 346.

The Directive provides member states with more flexible rules and special safeguards – but with a flipside: its existence can make it harder, in practice, to resort to Article 346. In order to rely on this derogation to purchase military equipment without following the rules of the Directive, a member state will have to demonstrate, as required by the case law mentioned above, that the non-application of the Directive is necessary

and proportionate for the protection of its essential security interests. The existence of defence-specific, tailor-made rules is likely to make it more challenging for member states to prove that they cannot protect these interests within the competitive

tendering procedures of the Directive.

State aid control is another area where developments in the case law on Article 346 have had significant implications. In the past, it seems that the Commission’s primary concern when assessing state aid measures in favour of defence companies was to avoid spill-over effects that could impact on the non-military sector. More recently, however, the Commission highlighted in a Communication from July 2013 that member states seeking to rely on Article 346 in the context of state aid must be able to demonstrate that the measures that they take (e.g. the concrete state aid scheme) fulfil the same necessity and proportionality conditions set out in the case law. This makes it clear that the limiting of state aid measures to the purely military sector in order to ensure that they do not affect the civil market is no longer sufficient when attempting to justify them using Article 346.

Looking ahead: some emerging issues

Undoubtedly, there will still be cases in which member states endeavour to rely on Article 346 in order to *not* apply the Directive. Member states could argue that a given procurement contract



entails such extremely demanding security of supply requirements and/or is so confidential that even the specific provisions of the Directive are insufficient to protect their essential security interests.

In most of these cases, the use of Article 346 and the non-application of the Directive will translate into the awarding of the procurement contract to a national supplier. At the end of the day, only on the basis of a comprehensive case-by-case assessment would it be possible to find out whether member states' arguments are well-founded or, in fact, simply concealing economic protectionism. It will be for national courts or the Court of Justice to rule on concrete cases, following market operators' challenges against national procurement decisions or infringement procedures launched by the Commission.

Finally, besides the non-application of the Directive, Article 346 is also likely to be used to try and justify offset requirements. Offsets are compensations required by national authorities when purchasing defence equipment from non-national suppliers. They can take different forms, such as investments from the non-national supplier in the domestic industry of the purchasing authority, or the integration of national companies in the main contractor's supply chain. Regardless of how they are officially labelled (as offsets, countertrade, industrial cooperation or participation) these are, as stated by the Commission departments in their 2010 guidance note, discriminatory and market-distortive measures that go against the fundamental principles of the EU Treaties – and can, therefore, be justified only on the basis of Treaty-based derogations such as Article 346.

Similar to the conditions mentioned previously, member states would need to prove that the specific offsets requirement imposed on the non-national supplier is a *necessary* and *proportionate* step in order to protect its essential security interests. Bearing in mind that economic motivations are not acceptable, passing this test in concrete cases seems to be particularly difficult (if not impossible) where offset requirements are aimed to foster defence-industrial capabilities and are not directly connected to any specific military purchase.

Furthermore, the question of Article 346 may be raised in the context of efforts to strengthen defence cooperation between member states and to consolidate demand via pooling and sharing. It initially appears to be worth considering, for example, whether this provision could be applied for the protection of 'transnational' or 'European' security interests. But although this may seem, at

first glance, an attractive approach, on closer inspection it proves rather misleading.

As mentioned above, member states enjoy a wide margin of appreciation in identifying the essential security interests to be protected. Several member states involved in defence-related cooperation or in pooling and sharing could similarly identify among themselves the pursuit of those activities as essential security interests to be protected. The key challenge is – and will remain – to prove the necessity and proportionality of the specific measure derogating from EU law (e.g. non-application of the Directive, offsets requirements) in order to protect such interests. Pondering on rather elusive issues – such as defining in abstract terms the notion of 'essential security interests' or harmonising this notion at European level – does not seem useful for the purpose of correctly applying this Treaty provision.

Since defence procurement has been at the forefront in implementing the Court of Justice's interpretation of Article 346, it should not come as a surprise that all these emerging issues relate to this area. This does mean, however, that Article 346 may become, in the future, ever more relevant in areas such as transport, energy, or international trade. The case law of the Court of Justice – although not yet abundant – arguably provides sufficient guidance to interpret the fundamental conditions of application of Article 346 across all areas of EU law and policy.

Further clarifications on the concrete situations in which these conditions are fulfilled (or not) will only come – on the basis of in-depth, case-by-case assessments – with future practice. Significant clarifications may well stem from legal challenges before national courts and will not necessarily follow infringement procedures initiated by the Commission.

In the meantime, member states should perhaps use a sort of precautionary principle to limit risks linked to litigation: accordingly, Article 346 should only be used in those truly exceptional cases where national authorities are entirely confident that they can prove that all the required conditions are fulfilled. If in doubt, EU law should be applied.

Vincenzo Randazzo is a Legal Officer at the European Commission. He writes here in a personal capacity and his views do not represent the official position of the European Commission.

