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"COUNTERCLAIMS IN INTERNATIONAL INVESTMENT ARBITRATION: A STEP TOWARDS BALANCE OF INTERESTS"

Prepared by a second-year postgraduate student

Specialty 081 Law

Nelli Kichigina 

Supervisor: Nataliia Berlach, Dr. Hab in Law, Associate Professor

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ДЕКЛАРАЦІЯ АКАДЕМІЧНОЇ ДОБРОЧЕСНОСТІ СТУДЕНТКИ НАУКМА

Я, Кічігіна Неллі Михайлівна, студентка 2 року навчання магістерської програми за спеціальністю "Право" факультету правничих наук НаУКМА, адреса електронної пошти – nelli.kichihina@ukma.edu.ua.

- Підтверджую, що написана мною магістерська робота на тему: "*Інститут зустрічного позову у міжнародному інвестиційному арбітражі як шлях до балансу інтересів*", відповідає вимогам академічної доброчесності здобувачів НАУКМА від 07.03.2018 року, зі змістом якого ознайомлена.

- Підтверджую, що надана мною електронна версія роботи є остаточною та готовою до перевірки;

- Згодна на перевірку моєї роботи на відповідність критеріям академічної доброчесності, у будь-який спосіб, у тому числі порівняння змісту роботи та формування звіту подібності за допомогою електронної системи Unicheck;

- Даю згоду на архівування моєї роботи в репозитаріях та базах даних університету для порівняння цієї та майбутніх робіт.

17 червня 2022 року  Кічігіна Неллі Михайлівна

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LIST OF ABBREVIATIONS

ABBREVIATION	MEANING
ASEAN	Association of Southeast Asian Nations
BIT	Bilateral Investment Treaty
COMESA	Common Market for Eastern and Southern Africa
DR-CAFTA	Dominican Republic-Central America Free Trade Agreement
ECT	Energy Charter Treaty
FET	Fair and equitable treatment
FPS	Full protection and security
ICSID	International Centre for Settlement of Investment Disputes
ICSID Convention	Convention on the Settlement of Investment Disputes between States and Nationals of Other States, adopted on 18 March 1965
MFN	Most-favoured-nation treatment
MIT	Multilateral Investment Treaty
PCA	Permanent Court of Arbitration
NAFTA	North American Free Trade Agreement
SADC	South African Development Community
SCC	Stockholm Chamber of Commerce
UNCTC	United Nations Centre for Transnational Corporations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
USMCA	United States-Mexico-Canada Agreement

INTRODUCTION

The relevance of the thesis. The evolution of international investment law has become an area of increased political, economic, and legal scrutiny.[1] For the last 15 years, investor-state dispute settlement has been suffering from the so-called legitimacy crisis, with critics arguing that investment arbitration is pro-investor and compromises states' regulatory powers.[2] This backlash phenomenon has led some states to terminate their investment treaties and voices the call for reforms. One of such reforms is the development of the mechanism of counterclaims.

In my thesis, I will be addressing the main argument, that lies at the core of the states' disenchantment with investment arbitration – namely, its asymmetrical nature. The foundation of the existing pro-investor bias in investment arbitration lies in its historical evolution, which deserves particular attention. Initially, the instruments of investment protection were perceived as a win-win deal, with developing states receiving financing and improving infrastructure and investors expanding their presence in the new markets, until the first claims challenging the host state's regulatory powers came into play.

The purpose of the thesis is to analyse the root causes of the asymmetric nature of investor-state arbitration and how it is reflected in the international law instruments of investment protection, as well as the prospects of imposing obligations on investors, especially in the human rights and environment sectors. The ultimate goal is to present a mechanism of counterclaims as a way to improve the imbalances of the investor-state arbitration, as well as to avoid the regulatory chill effect on the host states.

To achieve this purpose, the author of the thesis set the following tasks:

1) To describe the emergence of investment arbitration in its historical context.

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[1] Susan D. Franck, *Arbitration Costs: Myths and Realities in Investment Treaty Arbitration,* Oxford University Press (2019) ("**Franck**"), p. 1.

[2] Malcolm Langford and Daniel Behn, "*Managing Backlash: The Evolving Investment Treaty Arbitrator?"* 29(2) *European Journal of International Law* (2018), 551–580.

2) To elaborate on the development of the investment treaty protection framework and the main characteristics of different investment protection instruments.
3) To give an overview of the substantive standards of investment protection and how they reflect the asymmetric nature of investment arbitration.
4) To describe the effects of investment arbitration on the state's right to regulate in the public interest.
5) To analyse the causes and manifestations of the states' backlash against investment arbitration, as well as to propose potential solutions.
6) To assess the scope of obligations imposed on investors and describe the recent developments in investors' accountability for human rights and environmental violations.
7) To analyse the legal foundations of counterclaims and case law interpreting their main jurisdictional prerequisites and the potential to cure the asymmetry.

The object of the research is the conflict of interests between private investors and the host states and the mechanism of counterclaims as a tool to balance those interests. *The subject matter of this thesis* is the legal framework of counterclaims in investment arbitration, with a particular focus on the asymmetric design of investment treaties and their interpretation in the case law of arbitral tribunals.

The author had used the following scientific methods to accomplish the purposes of this thesis:

1) **Descriptive method** – to provide an overview of the legal framework of investment arbitration and examples of its asymmetric design.
2) **Comparative method** – to compare different instruments of investment protection and determine the scope of the substantive protections and the scope of the arbitration clauses permitting counterclaims.
3) **Method of analysis and synthesis** – to analyse the existing practice of arbitral tribunals regarding the substantive standards of investment protection and their effects on the state's regulatory powers.
4) **Hermeneutical method** – to interpret the meaning of legal terms and scope of substantive provisions in bilateral and multilateral investment treaties.

5) **Dialectical method** – to determine the approach of different tribunals and scholars to the scope of obligations imposed on investors and jurisdictional prerequisites of counterclaims.

The theoretical basis of the thesis. This thesis is based on the theoretical works of scholars and practitioners in the field of international investment arbitration, such as Mr Schreuer, Ms Miles, Ms Bjorklund, Mr Born, Mr Redfern, Mr Hunter, Mr Waibel, Ms Franck, Mr Vandevelde, Mr Behn, Ms Zarra, Ms Atanasova and others.

The practical importance of the study. The analysis made in this thesis may be used by scholars studying counterclaims, arbitral tribunals deciding on the permissibility of counterclaims, states and other stakeholders engaged in the drafting process of new investment treaties and educational institutions for the purpose of research.

Structure of the thesis. The work consists of the following elements: a list of abbreviations, an introduction, three chapters, conclusions, and a list of references. The total scope of work is 80 pages.

SECTION 1
LEGAL FRAMEWORK OF INVESTOR-STATE DISPUTE SETTLEMENT

1.1. Historical foundation of investor-state dispute settlement

Investment treaty arbitration is arbitration between a foreign investor against a state that has failed to protect the investment. One should distinguish investment treaty arbitration from international commercial arbitration, as both forms of arbitration are sometimes referred to as "international arbitration." The former, unlike its commercial counterpart, is quintessentially a field of public international law.[3]

As commercial activity usually involves the risk of the host state harming the investment, there is always a chance that such conflict will escalate into an investment dispute. Traditionally, if an investor experienced some violations towards its investment in a foreign state, it would normally have to seek protection by approaching its home state, which would then engage in diplomatic negotiations with the host state. Such protection might have resulted in an agreement of the host state to submit the dispute to arbitration by a claims commission, but the prior intervention of the home state was always required.[4]

Other historical options for addressing investment conflicts included obtaining political risk insurance, soliciting the home state to engage in a "gunboat diplomacy", or making formal declarations of war to protect the underlying economic interests.[5] During the nineteenth century, influential individuals could convince their government to send a small contingent of warships to stay at the coast of the offending state until

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[3] Ilias Bantekas, *An Introduction to International Arbitration*, Cambridge University Press (2015) ("**Bantekas**"), p. 274.

[4] Campbell McLachlan, Laurence Shore, and Matthew Weiniger, *International Investment Arbitration: Substantive Principles* (Second Edition), Oxford University Press (2017) ("**McLachlan**"), page 4.

[5] *Franck*, p. 10.

the latter grants reparation.[6] For example, in 1902, Great Britain, Germany and Italy sent warships to the Venezuelan coast to demand reparation for the losses suffered by their nationals when the sovereign debt of Venezuela suffered default.[7]

This practice ended with the codification of the Calvo doctrine in the 1907 Hague Convention respecting the Limitation of the Employment of Force for the Recovery of Contract Debts, which outlawed the use of force to collect private debts.[8] The Calvo doctrine played a substantial role in the promotion of principles of non-intervention and equality of foreign and local investors, seeking to protect the right of newly independent states to be free of such intervention by major powers.

Over time, formal adjudicative options developed, including, for instance, espousal of investors' claims by its home state in the International Court of Justice.[9] However, as can be seen from practice, the states are usually unwilling to take an investment dispute to the inter-state level due to various political considerations, in particular for the avoidance of tension in international relations.

Therefore, the stability of investments depended entirely upon investors' ability to negotiate with the host state directly or the willingness of their home state to use diplomacy to seek redress for investors. However, the home state might not wish to espouse an investor's claim against the other state or simply refuse to pass on any compensation received to the investor in case of a successful outcome. In the absence of an independent, reliable, and predictable adjudicative forum, such non-adjudicative options contributed to commercial risk and uncertainty.[10]

At a certain point, it became evident that it is necessary to create the possibility for investors to sue the host states directly for any harm done to their investments. Thus, investment treaties emerged, providing investors with the right to sue another

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6 Nigel Blackaby, Constantine Partasides, *et al.*, *Redfern and Hunter on International Arbitration* (Sixth Edition), Oxford University Press (2015) ("**Redfern and Hunter**"), p. 441.

7 *Redfern and Hunter,* p. 441.

8 *Bantekas*, p. 276.

9 *Franck*, p. 12.

10 *Franck*, p. 11.

state directly in a neutral forum. I will address the issue of how the investment treaty protection framework developed in the next sub-section.

1.2. The emerging framework of investment treaty protection

Modern investment treaties have a long history, tracing their roots back to the 18th century. The whole treaties devoted to the protection of investment evolved from the less elaborated provisions in their forerunners – commercial treaties, which States have been concluding between themselves for centuries, including certain guarantees of foreign investment treatment to them.[11]

Substantive protections of investment first began to appear in treaties of Friendship, Commerce and Navigation, although those provisions largely remained ineffective due to the absence of an adequate forum that could provide a remedy to a foreign investor.[12] One such attempt was made back in 1796, during the negotiation of the first United States' Treaty on Friendship, Commerce and Navigation with France, where the second president of the United States John Adams stated:

"There is no principle of the law of nations more firmly established than that which entitles the property of strangers within the jurisdiction of another country in friendship with their own to the protection of its sovereign by all efforts in his power."[13]

After the Second World War, the growing number of newly independent developing states, on the one hand, and capital-exporting states, on the other, had major confrontations about the status of customary law governing foreign investment.[14] A compromise between developing and developed countries was finally reached in 1962, with an adoption of the UN General Assembly Resolution 1803, which required states

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11 *McLachlan*, p. 4.

12 *Franck*, p. 12.

13 Cited in John Bassett Moore, A Digest of International Law, The American Journal of International Law (vol. 4) Cambridge University Press (1906).

14 Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (Second Edition) Oxford University Press (2012) ("**Dolzer and Schreuer**"), p. 4

to pay the *"appropriate compensation"* to the owner of investment in case of expropriation.[15]

Later, there were some unsuccessful attempts of developing states to place the protection of foreign investment under the purview of the domestic jurisdiction of states. However, as noted by the distinguished scholar Christoph Schreuer, around 1990 *"it became clear that, together with the end of the Soviet Union, the Socialist view of the property had collapsed and that the call for economic independence had brought a major financial crisis, rather than more welfare upon the people of Latin America."*[16]

Against this backdrop, states and investors started to conclude investment treaties, permitting foreign investors to invoke the arbitration claims against the host state directly. This considerably new form of dispute settlement required neither the intervention of the home state of the investor nor the existence of any prior contractual relationship between the host state and investor.[17]

Previously, the investment contract with an arbitration agreement was a necessary requirement for arbitration between the state and foreign investors. Nowadays, by concluding the investment treaty, the state is considered to give its standing consent to any of the host state nationals, allowing them to initiate arbitration.[18] Accordingly, it follows that only the investor can be the claimant in investment arbitration, while the state will always be the respondent.

1.3. International Law instruments of investment protection

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15 General Assembly resolution 1803 (XVII) on *"Permanent Sovereignty over Natural Resources"* (14 December 1962), para 4.

16 *Dolzer and Schreuer*, p. 5.

17 *McLachlan*, p. 4.

18 *McLachlan*, p. 5.

To start an arbitration, the investor should first obtain necessary guarantees of protection from the host state. There are three main instruments of investment protection, namely: bilateral investment treaties and multilateral investment treaties, as well as investment agreements with the host state, which are described in subsections 1.3.1-1.3.3 below.

1.3.1. Bilateral investment treaties

As described in the previous section, the rules providing for minimum guarantees of the foreign investment treatment have existed for more than two centuries. However, bilateral investment treaties ("**BITs**") are the first international instruments, which are specifically devoted to the treatment of foreign investment.[19]

In essence, BITs are treaties negotiated between the two contracting states to protect and promote investments by nationals of one party in the territory of the other party. The era of modern investment treaties began in 1959 when Germany became the first country to enter into BIT with Pakistan.[20] Other European countries quickly followed Germany's example: Switzerland concluded its first BIT in 1961, France in 1972.[21] Remarkably, all three pioneer countries remain at the leading positions in the BITs "fan list", having signed 155 treaties (Germany), 127 treaties (Switzerland) and 115 treaties (France) accordingly.[22]

In general, the number of BITs entered worldwide increased dramatically in the middle of the 1990s.[23] According to UNCTAD Investment Policy Hub Database, there

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19 Katia Yannaca-Small, *Arbitration Under International Investment Agreements A Guide to the Key Issues,* (Second Edition), Oxford University Press (2018) ("**Yannaca-Small**"), p. 3.

20 *Dolzer and Schreuer*, p. 6.

21 *Dolzer and Schreuer*, p. 6.

22 UNCTAD, Investment Policy Hub, International Investment Agreements Navigator ("**UNCTAD Database**"), URL: https://investmentpolicy.unctad.org.

23 *Yannaca-Small*, p. 3.

are currently 2794 BITs concluded worldwide.[24] This dramatic increase can be explained by the globalization of the economy and a common understanding of the role that foreign investment play in the national economic growth, especially in the case of former colonies which became newly independent states.

International instruments of investment protection were viewed as aiding the international flow of goods and services, thereby fostering the economic development of the states. According to scholarly opinion, the exponential growth of the number of BITs concluded in the 1990s was caused by (1) an increasing global commitment to economic liberalism and (2) the lack of real alternatives to Foreign Direct Investment (FDI) for developing states.[25] The expanding network of BITs has strengthened the protection of foreign investment and allowed investors to demand compensation directly from host states.

The dispute settlement provisions in BITs have not been invoked until the late 1980s, with the first reported investment arbitration award being rendered in 1987 in *Asian Agricultural Products Ltd v. Sri Lanka (AALP)* under the Sri Lanka-UK BIT.[26] However, the number of investments claims against states truly skyrocketed during the last two decades, amounting to as much as 1104 cases as of 1 January 2021.[27]

The key feature of BITs is that they provide investors with the right to sue another state directly in a neutral forum, giving investors the choice to decide whether to pursue the claim, taking into account the time and costs of potential arbitration.[28] It is important to note that certain prerequisites (such as a cooling-off period and efforts

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24 UNCTAD Database.

25 Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standards of Treatment*, Kluwer Law International (2009) ("**Newcombe and Paradell**"), p. 48; *Asian Agricultural Products Ltd v Sri Lanka* (Award) ICSID Case No ARB/87/3, 4 ICSID Rep 245, IIC 18 (1990).

26 *Ibid*, p. 58

27 UNCTAD, *World Investment Report 2021*, UNCTAD/WIR/2021 (2021), p. 129.

28 *Franck*, p. 14.

to settle the dispute amicably) must be complied with before investors may bring a dispute against a state to the arbitral tribunal.[29]

As a general rule, BITs are designed to provide guarantees for investors of contracting states by putting corresponding obligations of protection on states where the respective investments are made. By contrast, BITs do not normally cover the obligations of investors, although most treaties provide that investment must be made in accordance with the law of the host state in order to be protected.[30] Therefore, BITs only protect investment which are admitted in the host country under requirements set out in their national legislation (the so-called 'admission clause').[31] This apparent pro-investor bias of investment arbitration has gained a fair amount of criticism and will be subject to detailed analysis in the chapters below.

Most BITs contain similar provisions on the scope of application, definitions of investment and investor, substantive investment protections and procedural provisions. In particular, almost all BITs include the following core elements: a broad definition of investments, an admission clause, a guarantee of fair and equitable treatment, a guarantee of full protection and security, as well as national treatment, and most-favoured-nation clauses.[32]

Apart from substantive provisions, BITs normally provide for dispute settlement mechanisms, both between contracting states and between a contracting host state and a foreign investor.[33] Although dispute settlement provisions in BITs may vary, investors can usually choose to commence arbitration either before the United Nations Commission on International Trade Law ("**UNCITRAL**") *ad hoc* tribunal, or before

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29 *Franck*, p. 15.

30 *Inceysa Vallisoletana S.L. v. Republic of El Salvador*, ICSID Case No. ARB/03/26, Award, 2 August 2006, para. 186.

31 *Yannaca-Small*, p. 6.

32 Christoph Schreuer, *International Protection of Investments*, Max Planck Encyclopedias of International Law [MPIL] (2013) ("**Schreuer MPIL**"), para. 8.

33 *Yannaca-Small*, p. 6.

the International Centre for Settlement of Investment Dispute ("**ICSID**"), the Stockholm Chamber of Commerce ("**SCC**") or any other arbitral institution.[34]

Although many BITs' provisions have similarities, they are by no means identical and have significant variations in certain important aspects.[35] Moreover, according to the report of the Study Group of the International Law Commission, BITs are not self-contained regimes.[36] As a result, the meaning of their terms must be interpreted in accordance with the *"relevant rules of international law applicable in the relations between the parties"* as required by the Vienna Convention on the Law of Treaties.[37] At the same time, the BITs protections apply regardless of whether there is an investment contract between an investor and the host state, which is described in detail in sub-section 2.3. below.

Therefore, put simply, each contracting state under BIT promises foreign investors certain basic protections, including freedom from unlawful expropriation without proper compensation, freedom from discrimination, guarantees of fair and equitable treatment *etc*.[38] Consequently, if the host state's conduct undermines those guarantees, causing harm to an investment, the investor may initiate arbitration under the respective BIT.

1.3.2. Multilateral investment treaties

Multilateral investment treaties ("**MITs**") are international investment agreements concluded between several countries with an aim to protect investments

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34 *Franck*, p. 16.

35 *Schreuer MPIL*, para. 9.

36 Martti Koskenniemi, "Fragmentation of International Law: Difficulties arising from the Diversification and Expansion of International Law," Report of the Study Group of the International Law Commission, UN Doc A/CN4/L682, 4 April 2006.

37 Vienna Convention on the Law of Treaties (1969) 1155 UNTS 331, Art 31(3)(c).

38 *Franck*, p. 15.

made by individuals and companies in each other's territories.[39] MITs contain similar provisions to BITs in the "investment chapters" of multilateral economic co-operation treaties and free trade agreements.[40] The most notable difference between MITs and BITs is that the former usually protect the investments associated with the particular sector of the economy. By contrast, BITs do not contain industry or subject matter limitations on what investment claims are permissible.

The first multilateral treaty containing substantive rules on foreign investments' protection is the 1994 Energy Charter Treaty ("**ECT**").[41] Essentially, the ECT covers various substantive issues, including trade, energy and transit, as well as a procedural chapter on dispute settlement and therefore is not limited to investments.[42] According to the information provided on ECT's official website, 52 states and the European Union have so far ratified this treaty.[43]

The second most prominent multilateral instrument in the field of investment protection is the 1992 North American Free Trade Agreement ("**NAFTA**"),[44] which was recently replaced by the 2020 United States-Mexico-Canada Agreement ("**USMCA**"). While the scope of USMCA is restricted to three contracting States (namely, Canada, Mexico, and the United States), currently the arbitration is available only between foreign investors and the United States and Mexico as host states.[45]

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39 Glossary, UK Practical Law, URL: https://uk.practicallaw.thomsonreuters.com/4-502-5545.

40 Investment treaty arbitration: overview, UK Practical Law, URL: https://uk.practicallaw.thomsonreuters.com/3-205-5046.

41 Energy Charter Treaty (1994) 2080 UNTS 100.

42 *Dolzer and Schreuer*, p. 15.

43 ECT's official website, URL: https://www.energycharter.org/process/energy-charter-treaty-1994/energy-charter-treaty/.

44 North American Free Trade Agreement (1992) 107 Stat 2057, CTS 1994 No 2.

45 US-Mexico-Canada Agreement enters into force, Practical Law UK Legal Update, URL: https://uk.practicallaw.thomsonreuters.com/w-026-2911.

McLachlan concludes that *"both treaties represent significant state practice in the investment field, and both have given rise to a number of significant arbitration awards."*[46]

There have also been important multilateral developments in the investment field in the Asia-Pacific region.[47] The Association of Southeast Asian Nations ("**ASEAN**") member States concluded a new Comprehensive Investment Agreement in 2009.[48] An ASEAN-Australia-New Zealand Free Trade Agreement followed in 2010.[49] A potentially even more significant multilateral agreement, given the range of States parties and the scope of its coverage, is the Trans-Pacific Partnership Agreement (TPPA).[50]

1.3.3. Investment contracts between the host state and investor

Investment contracts are agreements negotiated between a particular foreign investor and a state (or a state-owned entity) that regulate an investment placed in the territory of that state.[51] Foreign investment contracts include concession agreements, mining development agreements, production-sharing contracts.

Generally, a violation of an investment contract by the state, being a separate contractual obligation, would not automatically give rise to a claim under the respective

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46 *McLachlan*, p. 16.

47 *McLachlan*, p. 16.

48 ASEAN Comprehensive Investment Agreement (2009), URL: http://investasean.asean.org/index.php/page/view/asean-free-trade-area-agreements/view/757/newsid/871/asean-comprehensive-investment-agreement.html.

49 *McLachlan*, p. 16; ASEAN–Australia–New Zealand Free Trade Agreement, [2010] NZTS 1, URL: https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-in-force/asean-australia-new-zealand-free-trade-agreement-aanzfta/aanzfta-text/.

50 Trans-Pacific Partnership Agreement (2016) (TPPA), URL: www.tpp.mfat.govt.nz/text.

51 Jan Ole Voss, *The Impact of Investment Treaties on Contracts between Host States and Foreign Investors,* Brill (2010), p. 25.

BIT. Therefore, as noted by Reisman and Crawford, foreign investors can rely upon both contractual and treaty-based dispute resolution mechanisms for investment protection.[52] Such treaty-based tribunals can exercise jurisdiction over claims concerning the breach of an investment contract by using the so-called "umbrella clause."[53]

As a rule, the investment contract will be governed by the municipal law of the host State unless the parties agree otherwise, subjecting investment to political and other risks.[54] However, based on the principle of party autonomy, parties to an investment contract remain free to agree to the application of international law and have done so on numerous occasions.[55] For example, in *TOPCO v Libya*, the choice of law clause provision of respective concession contract stated that:

"Concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals."[56]

Moreover, in order to protect investor from unilateral modifications of the law governing the contract by the host State, the so-called 'stabilisation clause' is often included in a contract.[57] Such stabilization clause basically "freezes" the law of the

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52 Michael Reisman, James Richard Crawford, *et al*. (eds), *Foreign Investment Disputes: Cases, Materials and Commentary* (Second Edition), Kluwer Law International (2014) ("**Reisman and Crawford**"), p. 179.

53 *Reisman and Crawford, p*. 189.

54 *Reisman and Crawford*, p. 181.

55 Hege Elizabeth Kjos, *Applicable Law in Investor State Arbitration: The Interplay between National and International Law*, Oxford University Press (2013), p. 70.

56 *Texaco Overseas Petroleum Co v The Government of the Libyan Arab Republic*, Award on the Merits, January 19, 1977 (1978) 17 International Legal Materials 1, para. 32.

57 *Reisman and Crawford*, p. 183.

state as it stands at the moment when the investment contract is concluded, and subsequent changes in legislation by the host state simply do not apply to the investor.

As was concluded by UNCTAD, *"foreign investors are increasingly resorting to (...) arbitration"* under investment treaties.[58] Therefore, investment contracts may be perceived as an additional measure of investment protection, which is also intended to promote the investment flows.

1.4. Substantive standards of protection

1.4.1. Protection against unlawful expropriation

At the outset, it is important to clarify that international investment agreements, in general, do allow states to expropriate foreign investments.[59] The most highly qualified authors of public international law, such as Grotius, already in the 17th century considered the expropriation of foreigners to be, in principle, lawful.[60] Arbitral tribunals also accept that the expropriation is a sovereign right of states that may be exercised within the limits of international law. For instance, in *Achmea v. Slovak Republic* case, the tribunal stated that:

"It is true that the exact scope of the requirements which make an expropriation lawful have been hotly debated in the past decades, but the core principle under international customary law has remained untouched, i.e., that a State may expropriate foreign-held assets."[61]

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58 UNCTAD, *Recent Developments in Investor-State Dispute Settlement (ISDS),* IIA Issues Note No.1 (2013), URL: http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d3_en.pdf.

59 *Dolzer and Schreuer*, p. 98.

60 Hugo Grotius, *The Rights of War and Peace,* Book I, Chapter I, Section 6-10 (1625).

61 *Achmea B.V. v. Slovak Republic [II]*, Award on Jurisdiction and Admissibility, PCA Case No. 2013-12, 20 May 2014, para. 245.

Therefore, one of the basic protections offered by BITs and MITs is that the host state shall not take any measures depriving, directly or indirectly, investors of their investments unless certain conditions are complied. Consequently, the expropriation is allowed if the following conditions are compiled with: (1) the measures are taken in the public interest and under due process of law, (2) the measures are not discriminatory, and (3) the measures are accompanied by provision for the payment of prompt, adequate and effective compensation.[62]

Importantly, such compensation shall represent the real (or market) value of the investments affected.[63] In practice, the calculation of the real value of expropriated investments is based on the evaluation of experts appointed by the parties in investment arbitration.[64] As to the promptness requirement, in *Siag v. Egypt,* a tribunal held that:

"Even the most charitable of impartial observers would not, in the Tribunal's view, contend that a 12-year delay was 'prompt.' The Tribunal finds on all the evidence that Egypt has not paid 'adequate and fair' compensation to the Claimants." [65]

Although the most common type of expropriation is one in which a state unilaterally transfers the property without compensating the previous owners, it can also do so through discriminatory taxation or regulation.[66] For instance, such 'indirect expropriation' may take the form of imposition of a higher tax rate on a company's benefits or limitation the prices at which a company may sell its products.

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62 August Reinisch and Christoph Schreuer, *International Protection of Investments: The Substantive Standards*, Cambridge University Press (2020) ("**Reinisch and Schreuer"**), p. 1; *Spyridon Roussalis v. Romania*, ICSID Case No. ARB/06/1, Award, 7 December 2011 ("**Roussalis v. Romania**"), para. 114.

63 ECT, Article 13(1).

64 Irmgard Marboe, "*Compensation and Damages in International Law: The Limits of Fair Market Value"*, 7 Journal of World Investment & Trade (2006), pp. 723-759.

65 *Waguih Elie George Siag and Clorinda Vecchi v. Arab Republic of Egypt*, ICSID Case No. ARB/05/15, Award, 1 June 2009, p. 435.

66 Juan Carlos Hatchondo and Leonardo Martinez, *"Legal Protection to Foreign Investors"*, Economic Quarterly-Volume 97, No. 2 (2011), pp. 175–187, p. 175.

Therefore, the state should carefully weight all consequences before implementing the measure that could amount to unlawful expropriation, taking into account the practice of arbitral tribunals which have interpreted its elements.

1.4.2. Fair and equitable treatment

Most BITs and other investment agreements provide for fair and equitable treatment ("**FET**") of foreign investments.[67] In practice, the FET has proved to be the most frequently invoked standard in investment disputes[68] and the majority of successful international arbitration claims are based on a violation of this standard.[69] The FET clause was interpreted so broadly that investors tried to apply it in response to any adverse effect on an investment.[70] This standard has also provoked the most public controversy, since it lies at the core of the conflict between the right of investors for adequate protection and the sovereign right of states to pursue their public policy interests.[71]

According to *Sempra v Argentina* case, the purpose of the FET is *"to fill the gaps which may be left by the more specific standards, in order to obtain the level of investor protection intended by the treaties*."[72] In particular, this standard is aimed to guarantee procedural fairness, due process, stability and protection of investor's legitimate expectations, as well as compliance with contractual obligations and

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67 *Dolzer and Schreuer*, p. 130.

68 *McLachlan,* p. 12.

69 *Dolzer and Schreuer*, p. 130.

70 *Yannaca-Small*, p. 13.

71 *McLachlan*, p. 12.

72 *Sempra Energy International v. The Argentine Republic*, Award, ICSID Case No. ARB/02/16, 28 September 2007, para 297, referring to Rudolf Dolzer, *"Fair and Equitable Treatment: a Key Standard in Investment Treaties",* The International Lawyer (2005) Vol. 39, No. 1, 87-106, p. 90.

freedom from coercion and harassment.[73] Those guarantees are especially important in light of UNCTAD's observation that one of the main reasons for the 18% *"sharp decline"* in cross-border investment is due to the *"policy uncertainty in a number of major economies"* which *"gave rise to caution among investors"*.[74]

A classic example of the FET violation is the denial of justice to an investor, for instance by host state creating the procedural delays. In *Pey Casado v Chile*, the tribunal concluded that Chile had denied justice and thereby breached the fair and equitable treatment provision by the absence of any decision by the Chilean authorities during a period of more than seven years, followed by the lack of response to the claimant's inquiries by the President.[75]

However, in the context of the FET standard evolution, the international investment law has shifted from protecting investors against denial of justice to the broader range of governmental measures that can be contested by the investor. As was noted by the tribunal in *Saluka v Czech Republic*, BITs *"[a]re designed to promote foreign direct investment as between the Contracting Parties; in this context, investors' protection by the "fair and equitable treatment" standard is meant to be a guarantee providing a positive incentive for foreign investors. Consequently, in order to violate the standard, it may be sufficient that States' conduct displays a relatively lower degree of inappropriateness*."[76]

Despite being included in the majority of BITs and MITs, the FET standard lacks a clearly shaped definition.[77] Accordingly, the content of this standard is subject to

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73 *Schreuer MPIL,* para 51.

74 UNCTAD, World Investment Report 2013, New York: UNCTAD (2013), p.XII, URL: https://unctad.org/webflyer/world-investment-report-2013.

75 *Víctor Pey Casado and President Allende Foundation v. Republic of Chile*, ICSID Case No. ARB/98/2, Award, 8 May 2008, paras. 650-674.

76 *Saluka Investments BV v. The Czech Republic*, PCA Case No. 2001-04, Partial Award, 17 March 2006, para. 293.

77 Alexandra Diehl, The Core Standard of International Investment Protection, International Arbitration Law Library, Volume 26, Kluwer Law International (2012) ("**Diehl**"), p. 528.

arbitral tribunal's interpretation. As the ICSID tribunal pointed out in *Mondev v United States* case, *"a judgment of what is fair and equitable cannot be reached in the abstract; it must depend on the facts of the particular case."*[78] The circumstances in which the FET standard may be breached include a denial of justice by the judicial organs of the host state or application of administrative actions that run contrary to the investor's legitimate expectations.[79]

1.4.3. Full protection and security

Full protection and security ("**FPS**") place the host state under an obligation to take active measures to protect the investment from adverse effects, which includes not only harming investments directly, but also the protection against actions of private parties.[80] For instance, the state might violate FPS standard by changing the legal framework in such a way that it renders the investor vulnerable to adverse action by private persons.[81]

Traditionally, the main purpose of this standard was to protect the investor against physical violence.[82] Over time, some international tribunals developed the position that the FPS principle extends beyond safeguards from physical violence and also cover legal protection for the investor. At a minimum, FPS standard guarantees

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78 *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award, 11 October 2002, para 118.

79 *McLachlan*, p. 13; *Diehl*, p. 503

80 *Schreuer MPIL,* para 52.

81 *Schreuer MPIL,* para 54, referring to *CME Czech Republic B.V. v Czech Republic,* UNCITRAL, Partial Award, 13 September 2001, para 613.

82 *Schreuer MPIL,* para 53.

investors access to the judicial system of the host state.[83] Moreover, some investment treaties specifically refer to the legal security of an investor in the context of FPS.[84]

At the same time, according to the authoritative opinion of Dolzer and Schreuer, there is "*a broad consensus that the standard does not provide absolute protection against physical or legal infringement."*[85] Accordingly, FPS standard does not impose a strict liability on the host state to prevent any violations in relation to investment. Therefore, it will be sufficient for the host state to exercise 'due diligence' and take such measures to protect the foreign investment as are reasonable under the circumstances.[86]

1.4.4. Most-favoured-nation treatment

Most-favoured-nation treatment ("**MFN**") standard provides that investors should be accorded treatment no less favourable than that accorded to third parties by the host state.[87] The purpose of this standard is to avoid discrimination between foreign investors. Accordingly, MFN is a relative standard that depends upon the level of treatment given by the state to the third states and their nationals.[88]

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83 *Schreuer MPIL,* para 54, referring to *Ronald S. Lauder v. The Czech Republic*, UNCITRAL, Award, 3 September 2001, para 314.

84 Treaty between the Federal Republic of Germany and the Argentine Republic on the Promotion and Reciprocal Protection of Investment, 171 UNTS 1910, BGB II 1993, 1245, Art. 4(1).

85 *Dolzer and Schreuer*, p. 161.

86 *Elettronica Sicula SpA (ELSI) (US v Italy),* ICJ Reports (1989) 15, para 108; *Noble Ventures Inc v Romania*, ICSID Case No. ARB/01/11, Award, 12 October 2005, para 164.

87 OECD, "*Most-Favoured-Nation Treatment in International Investment Law*", OECD Working Papers on International Investment, 2004/02, OECD Publishing (2004), p. 2.

88 *Reinisch and Schreuer*, p. 686.

While MFN clauses are included in virtually every BIT, their wording in different BITs varies.[89] For example, 1996 Austria-Ukraine BIT provides that:

"Each Contracting Party shall accord to investors of the other Contracting Party and their investments treatment no less favourable than that which it accords to its own investors and their investments or to investors in third States and their investments."[90]

Under the so-called *Maffezini* approach taken by the ICSID tribunal in 2000, an investor is entitled to rely on an MFN clause in order to 'import' more favourable dispute settlement clause available under BIT of the host state with the third country.[91] Another position was taken by ICSID tribunal in 2011 *Hochtief v Argentina case*, where the tribunal stated that the MFN clause is not intended to *"create wholly new rights where none otherwise existed"* in the BIT.[92] However, the prevailing scholarly opinion is that it is too early to conclude in which direction the practice may evolve in question of the invocation of MFN clause of another treaty.[93]

1.4.5. National treatment

Another standard usually contained in investment agreements is the national treatment standard, which provides a guarantee to foreign investors that they will be treated no less favourably than the nationals of the host state. Similarly, to the MFN

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89 *Schreuer MPIL,* para 71; *Reinisch and Schreuer*, p. 686.

90 Agreement Between the Republic of Austria and Ukraine for the Promotion and Reciprocal Protection of Investments (1996), Article 3(1).

91 *Bantekas*, p. 313; *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction, 25 January 2000, paras 43-50.

92 *Hochtief Aktiengesellschaft v. Argentine Republic*, ICSID Case No. ARB/07/31, Decision on Jurisdiction, 24 October 2011, para 81.

93 *Dolzer and Schreuer*, p. 211.

principle, the national treatment standard is clearly relative, meaning that it can only be assessed by reference to the treatment offered to the host state's nationals.[94]

National treatment has two necessary elements: (1) the requirement that the foreign investor is being placed 'in like circumstances' with local investors and that (2) the host state must treat the foreign investor 'less favourably' than the local investor.[95]

1.5. Conclusions to Section 1

Investment arbitration has evolved from "gunboat diplomacy" to the peaceful settlement of investment disputes. Historically, if an investor experienced some violations towards its investment in a foreign state, the only resort it had was the protection of its own state, that were often unwilling to take the dispute to the inter-state level.

Over time, different instruments of investment protection, namely bilateral and multilateral investment treaties emerged, giving investors the right to sue another state directly in a neutral forum. By concluding investment treaties, states express their general consent to submit disputes with foreign investors to arbitration.[96] This offer is accepted by an investor when the latter challenges the actions of the host state under the dispute resolution mechanism contained in the respective treaty.

As a general rule, BITs are designed to provide guarantees for investors of contracting states by putting corresponding obligations of protection on states where the respective investments are made. Most BITs contain similar provisions on the scope of application, definitions of investment and investor, substantive investment protections and procedural provisions. Apart from substantive provisions, BITs normally provide for dispute settlement mechanisms.

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94 *Bantekas*, p. 311.

95 *McLachlan*, p. 13.

96 *Reisman and Crawford*, p. 186.

In general, BITs and MITs protect investors by granting them the two main types of treatment. Among them, the standards of FET and FPS are considered 'non-contingent', in the sense that the protections that they extend are absolute.[97] In other words, they do not depend on the scope of protection afforded to other investors, whether foreign or local. By contrast, the MFN and national treatment provisions are contingent standards, meaning that the extent of the protection they afford is dependent upon the treatment that the host state provides to others.

The standards of protection provided by investment treaties, as well as the ability to enforce them through investor-state arbitration, have significantly enhanced investors' legal position.[98] At the same time, it is critical to safeguard the interests of the host country as well. To use the words of Mr Schreuer, "*the task of international investment law is to find an appropriate balance between these conflicting interests*."[99] Therefore, the next sections of my thesis are devoted to the description of this conflict, or asymmetry, its causes, and counterclaims as a tool to balance the interest of investors and host states.

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97 Eric De Brabandere, "*Fair and Equitable Treatment and (Full) Protection and Security in African Investment Treaties Between Generality and Contextual Specificity"*, The Journal of World Investment & Trade 18, 3 (2017), pp. 530-556.

98 *Schreuer MPIL,* para 113.

99 *Schreuer MPIL*, para 2.

SECTION 2
THE BACKLASH AGAINST INVESTMENT ARBITRATION: CAUSES, MANIFESTATIONS, AND POSSIBLE SOLUTIONS

In this section, I will first describe the main causes of the backlash against investment arbitration – namely, its asymmetric nature (2.1.1) and the related chilling effect of investment arbitration on the host states' right to regulate (2.1.2). As a second step, I will provide an overview of the manifestations that this backlash takes (2.1.3).

I will then propose measures which governments can employ in order to limit the effect of the so-called regulatory chill (2.2). Finally, I will explain the necessity of imposing obligations on investors to balance the investor-state dispute settlement by strengthening investors' accountability (2.3).

2.1. Causes of backlash against investment arbitration

2.1.1. Asymmetric nature of investment arbitration

As a starting point, the legitimacy of any institution has normative ("the right to rule") and sociological ("it is widely believed to have the right to rule") standpoints.[100] For almost two decades, the investor-state dispute settlement system has been undergoing a legitimacy crisis, with States experiencing the pro-investor bias and unfairness of the system.[101] As Daniel Behn contends, there is no wonder that virtually every aspect of this decentralised system has been challenged and criticised, since the task of balancing the private interests of investors (mainly from developed countries)

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[100] Maria Laura Marceddu and Pietro Ortolani, "*What Is Wrong with Investment Arbitration? Evidence from a Set of Behavioural Experiments*," European Journal of International Law, Volume 31, Issue 2 (2020), 405–428, p. 411, referring to Allen Buchanan and Robert Keohane, "*The Legitimacy of Global Governance Institutions*," 20 Ethics and International Affairs (2006) 405.

[101] Michael Waibel *et al.*, *The Backlash against Investment Arbitration: Perception and Reality*, Kluwer Law International (2010) ("**Waibel**"), p. 408.

and the public interests of developing states is definitely not an easy one.[102] Therefore, the analysis will be based on a sociological component of the legitimacy crisis, bearing in mind the normative causes of the backlash. However, the authority of arbitral tribunals to adjudicate the acts of the sovereign states as such is not the subject of this thesis.

The lack of balance between investment protection and the interests of host states has provoked fierce criticism of the investor-state dispute settlement system as a whole. In a view of the absence of a global legal framework for the investment regime, the relationship between host states and investors has been developing mostly at a bilateral and regional level.[103] There is no doubt that capital-exporting and capital-importing states have different approaches in relation to trade and investment policy since they follow different goals.

Kate Miles takes the view that the construction of international investment law was initially driven by European colonialism, the use of force, and the exploitation of legal doctrines for financial benefits.[104] The rules governing investment have therefore evolved "*so as to advance the interests of capital-exporting states in engaging with the non-European world and, as such, protected only the investor*."[105] She concludes that the host states are still unable to rely upon the rules of international investment law to address any damage caused by investor activity.[106]

Under virtually any BIT, the host state has no right to initiate arbitration to demand damages from an investor that fails to perform its obligations, if any such

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102 Daniel Behn *et al*, *The Legitimacy of Investment Arbitration: Empirical Perspectives*, Cambridge University Press (2022) ("**Behn"**), p. 4.

103 *Yannaca-Small*, p. 3.

104 Kate Miles, *The Origins of International Investment Law: Empire, Environment and the Safeguarding of Capital*, Cambridge University Press (2013) ("**Miles**"), p. 32.

105 *Ibid*, p. 32.

106 *Ibid,* p. 126.

obligations are provided at all.[107] It is for this shortcoming the prominent arbitration practitioner Gary Born has called the investor-state arbitration a "one-way" street.[108] The state's ability to submit a counterclaim against investor violating the domestic law of the host state or its international obligations under BIT will be analysed in Section 3 below.

Since BITs were primarily designed to attract investment by safeguarding them from arbitrary measures imposed by host states, they do not normally impose any corresponding obligations on foreign investors regulating the way they operate. Historically, foreign corporations were perceived as a more vulnerable party (as opposed to the powerful states) and required special protections to operate in countries with a weak rule of law.[109] However, the revenues of transnational corporations eventually exceeded the GDP of most developing states.[110]

Despite the expansion of investors' activities to what was traditionally reserved by sovereign states, most BITs are primarily structured to protect foreign investment and lack necessary regulatory provisions, such as prohibiting corrupt payments by investors.[111] BITs prescribe plenty of rights to investors and zero obligations owed to the host state. Despite claiming to be impartial, international investment law is essentially aimed at the protection of investors and facilitation of trade and investment.

Therefore, the main deficiency which led to the backlash against investment arbitration steams from the asymmetric nature of the instruments of investment

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107 Michael Waibel, Asha Kaushal *et al*. (eds), *The Backlash against Investment Arbitration*, Kluwer Law International (2010) ("**Waibel**"), p. 345.

108 Gary Born, *International Arbitration: Law and Practice* (Third Edition). Kluwer Law International (2021), p. 499.

109 Yarik Kryvoi, "*Three Dimensions of Inequality in International Investment Law*," The British Institute of International and Comparative Law (2020) ("**Three Dimensions of Inequality***"*), p. 7.

110 *Ibid*, p. 8

111 Kenneth Vandevelde, *Bilateral investment treaties: History, policy, and interpretation*. Oxford University Press (2010) ("**Vandevelde**"), p. 5.

protection, which proved to be designed to grant extensive protection to foreign investors "*at the expense of the host State's regulatory space*."[112] This effect has received substantial scholarly attention and is referred to as regulatory chill, as will be described in the next subsection.

2.1.2. Regulatory chill effect

Regulatory chill stands for a hypothesis that the investor-state dispute settlement system "*directly or indirectly prevents states from implementing measures in the public interest.*"[113] In a definition proposed by scholars, regulatory chill refers to a situation when there is a high threat of investment arbitration (at least a perceived one), to which the state might respond by not enacting or enforcing bona fide regulatory measures.[114] Canada, for example, put off its plans to introduce public automobile insurance after private insurance industry players threatened to file an arbitration claim under Chapter 11 of NAFTA.[115]

Moreover, states often struggle due to the shortage of expertise to deal with investment claims.[116] This is especially the case with developing countries, which are not always able to afford hiring an international counsel to properly defend such states in investment arbitration, which requires sufficient expertise and huge costs.[117] As a result, developing countries resort to representation by in-house government lawyers,

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112 Javier García Olmedo, "Recalibrating the International Investment Regime through Narrowed Jurisdiction" 69 International and Comparative Law Quarterly 301, Cambridge University Press (2020) ("**Olmedo**"), p. 2.

113 *Behn*, p. 68.

114 Chester Brown and Kate Miles, *Evolution in Investment Treaty Law and Arbitration*, Cambridge University Press (2011) ("**Brown and Miles**"), p. 610.

115 Steven Shrybman, "*Public auto insurance and trade treaties,*" Briefing Paper: Trade and Investment Series, Canadian Centre for Policy Alternatives, Volume 5 (2004), pp. 3-5.

116 *Three Dimensions of Inequality*, p. 7.

117 *Brown and Miles*, p. 612.

usually those employed in the justice departments and often lacking necessary experience and access to resources.[118]

As Eric Gottwald concluded, "*this can lead to shocking disparities in the quality of legal representation between investor claimants and developing nation defendants*," adding yet another gap between developed and developing countries in terms of their access to investor-state arbitration.[119] This factor also vests foreign investors with a greater bargaining power, allowing them to continue operating the investment on their own terms after threatening to submit the next multi-million-dollar arbitration claim. Moreover, even if the state wins an arbitration, the mere existence of arbitration claims against it reduces that state's chances to attract foreign direct investment because of its reputational damage after being accused of breaching investor's rights.[120]

As rightly pointed out by Professor Sattorova, another ongoing concern lies in "*the magnitude of financial consequences of investment arbitration for respondent states*," which face enormous damages awards and high costs of arbitration.[121] It was concluded by UNCTAD that developing states suffer detrimental effects on their budgets, having to take funds reserved for crucial sectors of public health, education, and infrastructure to expedite payment of the awards.[122]

As the number of cases exploded at the beginning of the 21st century, the state's authority to regulate such vital sectors of its economy as the protection of public health, safety, and the environment had been put on trial. It has been concluded by scholars in the field that investor-state dispute settlement fails to balance the rights of foreign

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118 *Brown and Miles*, p. 612.

119 Eric Gottwald, "*Leveling the Playing Field: Is it Time for a Legal Assistance Center for Developing Nations in Investment Treaty Arbitration?*" American University International Law Review 22, no. 2 (2007): 237-275, p. 254.

120 *Brown and Miles*, p. 613.

121 Mavluda Sattorova, *The Impact of Investment Treaty Law on Host States: Enabling Good Governance?* Oxford: Hart Publishing (2018) ("**Sattorova**"), p. 5.

122 *Ibid*, p. 5; UNCTAD, *Best Practices in Investment for Development*, Investment Advisory Series, Series B, number 10 (2011), p. 7.

investors with the host state's need to protect human rights and environment.[123] The reason for that is that investors often invoke BIT violations in a way that constrains the sovereign right to regulate in the public interest, especially in these crucial spheres.

Looking into the practice of investment tribunals, the challenges of host state's environmental regulations deserve particular attention. According to the empirical analysis performed by Daniel Behn and other scholars, there is a tremendous 70% success rate for investors challenging the host states environmental policies if they overcome initial jurisdictional stage.[124] For this reason, critics argue that arbitral tribunals "*favor the property rights of foreign investors over the need of host states to environmentally regulate and legislate in the public interest*."[125]

One of the first claims that raised significant concern regarding the state's ability to adopt environmental regulations was *Methanex* arbitration.[126] In this case, the tribunal held that measures prohibiting a carcinogenic substance, although amounting to expropriation without compensation, did not breach the provisions of NAFTA because they were legitimate regulations adopted with a view to protect public health.[127] However, the mere risk of similar regulations being challenged by investors led the government to adopt the new 2004 Model BIT, adding provision to the effect that indirect regulatory takings are not generally compensable unless exceptional circumstances are present.[128]

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123 *Behn*, p. 68.

124 Daniel Behn and Malcolm Langford, "*Trumping the Environment? An Empirical Perspective on the Legitimacy of Investment Treaty Arbitration*" (2017) 18(1) JWIT 14 ("***Trumping the Environment***"), p. 27.

125 *Ibid*, p. 1.

126 *Methanex v. USA*, UNCITRAL (NAFTA), Ad Hoc Arbitration, Final Award, 3 August 2005.

127 Muthucumaraswamy Sornarajah, *Resistance and Change in the International Law on Foreign Investment*, Cambridge University Press (2015) ("**Sornarajah**"), p. 399.

128 *Ibid*.

Moreover, the studies show the correlation between foreign investment and environmental degradation, especially in developing countries.[129] One of the reasons for this is the high competition among developing countries to attract foreign investment, which motivates them to loosen environmental standards, thereby encouraging investors from states with more stringent requirements to move their pollution-intensive production to developing countries.[130]

Further, the extent to which a sovereign state has a right to adopt necessary measures (inevitably affecting the investment) in times of crisis was questioned. The first decade of this century brough a lot of critique of investment arbitration after the destabilised Latin American economies faced the highest number of claims challenging measures adopted to address the crisis.[131]

The most prominent example is the adoption of the set of so-called Corralito measures by Argentina when faced with a severe economic collapse in 2001-2002 with almost half of the population living below poverty and businesses shutting down.[132] These measures included a significant devaluation of the national currency (peso), the pesification of all financial obligations and freezing all bank accounts, which inevitably affected foreign investors.[133] This resulted in more than 50 claims being brought

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129 Binyam Afewerk Demena and Sylvanus Kwaku Afesorgbor, "*The effect of FDI on environmental emissions: Evidence from a meta-analysis*," Energy Policy, Volume 138 (2020), URL: https://www.sciencedirect.com/science/article/pii/S0301421519307773.

130 *Ibid*.

131 Jonathan Hamilton and Michael Roche, "*Developments in Latin American Arbitration Law, Transnational Dispute Management*," Vol. 6, Issue 4 (2009), p. 12.

132 *LG&E Energy Corp. et al v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006 ("***LG&E v Argentina***"), paras 231-234.

133 *Waibel*, p. 410.

against Argentina by foreign investors claiming that those measures violated their rights under BITs, taking it to the top of the list of the most frequently sued states.[134]

During those arbitrations, the government asserted two main legal arguments concerning the ability of states to respond to such exceptional situations as a financial collapse.[135] First, Argentina relied on a treaty-based exceptions in BITs, which allow states to take certain non-precluded measures in response to extraordinary circumstances from the substantive protections under the given treaty. Second, it has argued that the customary law doctrine of necessity precludes the wrongfulness of its actions in response to the crisis.

However, the arbitral tribunals were reluctant to recognise the necessity of measures Argentina took in response to what the *LG&E* tribunal described as "*extremely serious threat to its existence, political and economic survival, [and] the possibility of maintaining its essential services in operation*."[136] It also acknowledged that the situation "*called for immediate, decisive action to restore civil order and stop the economic decline*."[137]

However, most tribunals took the completely opposite view, concluding that Argentina's economic crisis was not of a sufficient magnitude to threaten its essential interests and, thereby, open the door to a necessity defense.[138] As a result, 19 damages awards have been issued against Argentina, not only obliging Argentina to pay compensation but also leading to the suspension of trade benefits and funding from key

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134 Emmanuel Gaillard and Ilija Mitrev Penushliski, "*State Compliance with Investment Awards*," ICSID Review (Foreign Investment Law Journal) Volume 35, Issue 3 (2020), 540–594, ("**Gaillard**"), part IV.

135 *Waibel*, p. 408.

136 *LG&E v. Argentina*, para. 257.

137 *Ibid*, para. 238.

138 *Waibel*, p. 422.

institutions such as World Bank and the International Monetary Fund due to the government's failure to comply with them.[139]

Some scholars argue that ICSID tribunals that have held Argentina liable "*failed to fully recognize the treaty-based exceptions provided for in the* [non-precluded measures] *clauses of Argentina BITs and have interpreted the customary law doctrine of necessity so narrowly so as to make it essentially unavailable to any state*."[140] That explains why some countries, particularly in Latin America, believe that investment arbitration is biased in favour of investors and leading the backlash against it.[141]

2.1.3. Manifestations of the backlash

The avalanche of claims against Latin American countries (especially Argentina), along with the shifting course on nationalisation, have led some states to turn their backs to the idea of investor-state dispute settlement.[142] As a result, many affected states started criticising and opposing investment arbitration as such.[143]

Certain Latin American states, such as Bolivia, Ecuador and Venezuela have withdrawn from the ICSID Convention, which is the main forum for international investment arbitration.[144] They have also terminated a Under the ICSID Convention and Arbitration Rules, a respondent must satisfy three requirements in order to bring a

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139 *Gaillard*, part IV; Jonathan Bonnitcha *et al., The Political Economy of the Investment Treaty Regime* (Oxford University Press) (2017) ("**Bonnitcha**"), p. 5.

140 *Waibel*, p. 408.

141 *Brown and Miles*, p. 615.

142 *Newcombe and Paradell,* p. 51.

143 Alejandro López Ortiz, José Caicedo *et al.,* "*Two Solutions for One Problem: Latin America's Reactions to Concerns over Investor-State Arbitration*," Transnational Dispute Management, Vol. 13, Issue 2 (2006), p. 1.

144 *International Law on Foreign Investment*, p. 976.

counterclaim against an investor.[145] number of BITs and adopted domestic legislations to limit investors' rights.[146] All those states articulated their decisions to denounce the ICSID Convention by their inability "*to stand up to the pressure of big multinational companies*."[147] Bolivian government even adopted the Constitution stating that *"Bolivian investment will be prioritized over foreign investment,*" creating the potential to block foreign investments.[148]

The most recent example of states turning against investor-state dispute settlement is the agreement between European Member States to terminate all intra-EU BITs by 2020 termination agreement.[149] The EU trade commissioner, Cecilia Malmström labelled investor-state dispute settlement as "*the most toxic acronym*."[150] Further, China, India, Australia, New Zealand and the ASEAN states decided not to use investment arbitration to settle the potential disputes between them.[151]

Apart from such radical responses, some states began redrafting their investment protection agreements in such a way as to limit the scope of substantive protections and, consequently, the scope of claims a foreign investor is able to bring to arbitration.[152] Such "regulatory carve-outs" can be incorporated into an article

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145 Stephanie Papazoglou, "*The Good, The Bad and The Ugly 'of ISDS Reforms: Rebalancing the System?*", King's College London Student Law Review (2019).

146 Rodrigo Lazo, "*Is There a Life in Latin America After ICSID Denunciation?*" Transnational Dispute Management, Vol. 11, Issue 1 (2014), p. 2.

147 *Three Dimensions of Inequality,* p. 9.

148 James M. Roberts and Gonzalo Schwarz, "*New Constitution Pushes Bolivian Economy into Socialism*", The Heritage Foundation, WebMemo 2355 on Latin America (2009).

149 Agreement for the termination of Bilateral Investment Treaties between the Member States of the European Union dated 29 May 2020, SN/4656/2019/INIT.

150 Politico, "*ISDS: The Most Toxic Acronym in Europe*" (2015), URL: https://www.politico.eu/article/isds-the-most-toxic-acronym-in-europe/.

151 *International Law on Foreign Investment,* p. 118.

152 Vera Korzun, "*The Right to Regulate in Investor-State Arbitration: Slicing and Dicing Regulatory Carve-Outs*," Vanderbilt Journal of Transnational Law, Vol. 50, No. 2 (2017), pp. 355-414 ("**Korzun**"), p. 387.

providing for a minimum standard of investment protection, such as illegal expropriation.[153] For instance, the 2019 Dutch Model BIT considers that non-discriminatory measures "*that are designed and applied in good faith to protect legitimate public interests*" do not generally constitute indirect expropriations.[154] Similarly, the 2017 Ethiopia-Qatar BIT allows "proportionate" and "non-discriminatory" regulatory takings if they are designed and applied to protect or enhance legitimate public welfare objectives.[155]

Some new generation BITs include language clarifying that the objection of the promotion of the investment must not be pursued at the expense of other key public policy objectives.[156] For instance, the 2015 Norwegian Model BIT warns the contracting states that "*it is inappropriate to encourage investment by relaxing domestic health, human rights, safety or environmental measures or labour standards.*"[157]

Moreover, the so-called "safeguard provisions" were added in some treaties in order to reserve the state's right to regulate by adopting measures necessary for the protection of public health, environment and other legitimate regulations.[158] EU-Vietnam Foreign Trade Agreement ("**FTA**") states that: *"[t]he Parties reaffirm the right to regulate within their territories to achieve legitimate policy objectives, such as the protection of public health, safety, environment or public morals, social or*

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153 *Korzun*, p. 388; Freya Baetens, "*Protecting Foreign Investment and Public Health Through Arbitral Balancing and Treaty Design,*" International and Comparative Law Quarterly, 71(1), 139–182, Cambridge University Press (2022) ("**Baetens**"), p. 158.

154 Netherlands Model Investment Agreement dated 22 March 2019 ("**Dutch Model BIT**"), Article 12(8).

155 Agreement between the Government of the Federal Democratic Republic of Ethiopia and the Government of the State of Qatar for the Promotion and Reciprocal Protection of Investments, dated 14 November 2017, Article 9(4).

156 *Yannaca-Small*, p. 11.

157 Norway Model Agreement dated 22 March 2015, Article 11(1).

158 *Korzun*, p. 388.

consumer protection or promotion and protection of cultural diversity."[159] Scholars, however, doubt the effectiveness of the inclusion of such provisions but admit that they bear political importance and may play a role in the interpretation.[160]

Therefore, backlash against investment arbitration took various forms, with states calling for structural reforms of investor-state dispute settlement system, redrafting their agreements, refusing to pay damages under the final award or abandoning the system altogether.

2.2. Ways to limit the impact of investors on the state's right to regulate.

It is crucial for any state to be able to regulate matters within its jurisdiction. Professor Dobrev believes that "*the regulatory authority of the host government is the practical expression of a fundamental right of a state – the right to economic self-determination*."[161] Recently there have been a lot of debates as to the degree of regulatory discretion which host states retain under the BITs. In globalized world full of financial crises, terrorist threats, and public health emergencies, states' ability to design credible policy solutions is becoming increasingly important.[162]

The most practical way for the state to ensure its regulatory autonomy is to leave itself a "*room for manoeuvre*" in advance. As Professor Vandevelde puts it, states usually have three tools to exercise their regulatory powers when concluding a BIT.[163] First, he argues, is the ability to limit the scope of its application. This can be done by narrowing the definition of investment through excluding certain type of assets from its scope (e.g., all portfolio investments). However, the vast majority of BITs define

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159 Investment Protection Agreement between the European Union and its Member States, of the one part, and the Socialist Republic of Viet Nam, of the other part dated 30 June 2019, Article 2.2.

160 *Baetens*, pp. 161-162.

161 *Dobrev*, p. 272.

162 *Waibel*, p. 411.

163 *Vandevelde*, p. 9.

the term investment broadly and in an open-ended manner, so as to include "*any kind of asset*."[164]

Second, there is a so-called admission clause, allowing states to set the conditions which any investment is required to meet in order to be admitted in the host country.[165] This ability of states to refuse investments is important because not all investments have equal value for the host state economy. As aptly put by Kyla Tienhaara, sometimes foreign investment *"leads to substantial job creation, positive spillover effects, and the introduction of novel and useful technologies. In other cases, FDI crowds out local investment, creates pollution and contributes little to nothing to the economy*."[166] The admission clause allows states to refuse admitting foreign investments by simply by determining in their national legislation which sectors of economy are reserved for national monopolies.[167] Once the investment is established, however, the host state can no longer discriminate foreign investors in relation to its own nationals. Such an approach prevails in BITs throughout the world.[168]

Finally, there is a possibility to limit substantive provisions of investment protection. For instance, the host state may reserve the right to accord national treatment in certain sectors, which are of particular significance for its economy and in which local businesses would not withstand a competition.[169] The pioneering treaty that explicitly safeguards the state's right to regulate is the 2019 Dutch Model BIT, declaring that its provisions *"shall not affect the right of the Contracting Parties to regulate within their territories necessary to achieve legitimate policy objectives such as the protection of public health, safety, environment, public morals, labor rights,*

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164 *Vandevelde*, p. 122.

165 *Yannaca-Small*, p. 6.

166 Kyla Tienhaara, "*Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement*" (2018) 7 Transnational Environmental Law 229, p. 229.

167 *Ibid*.

168 *Vandevelde*, p. 10.

169 *Vandevelde*, p. 10.

animal welfare, social or consumer protection or for prudential financial reasons."[170] Further, it adds that the mere fact that such state's regulation *"negatively affects an investment or interferes with an investor's expectations, including its expectation of profits, is not a breach of an obligation under this Agreement*."[171]

Such provisions, however, as described by Mr Dobrev, would act as a "shield" rather than a "sword" in their relation to the foreign investor.[172] This means that the host state would only invoke them as a justification for adopting the regulatory measure in question after the investor commences arbitration proceedings against the former.[173]

2.3. Shifting to a balanced approach through investor's accountability

As I mention throughout this thesis, although international instruments on investment protection grant extensive rights to investors, they fail to impose any corresponding obligations on them. The investment treaties constrain authority of host states by introducing accountability at the international level, entitling investors with procedural rights to challenge regulatory and other measures of states.[174] At the same time, the activities of foreign investor are subject to domestic law of the host state. This *"flows from the fact that the foreign investor has voluntarily subjected himself to the regime of the host state by making entry into it*."[175]

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170 *Dutch Model BIT*, Article 2(2).

171 *Ibid*.

172 Dobrev, p. 278.

173 Ibid, p. 279.

174 Alessandra Arcuri, *The Great Asymmetry and the Rule of Law in International Investment Arbitration*, Yearbook on International Investment Law and Policy 2018 (2019) ("**The Great Asymmetry**"), p. 10.

175 Muthucumaraswamy Sornarajah, *The International Law on Foreign Investment* (Fifth Edition) Cambridge University Press (2021) ("**International Law on Foreign Investment***"*), p. 496.

By contrast, BITs do not contain binding rules governing the activities of foreign investors. In this regard, Professor Krivoy explains that "*foreign investors benefit not only from special international norms favouring them but also from the lack of regulations imposing obligations on them in areas such as taxation, human rights, labour and environmental obligations*."[176]

Historically, it is unsurprising that imperial powers driving the conclusion of treaties were more concerned with expanding the foreign investor's economic rights than limiting their activities through binding obligations.[177] However, widespread human rights violations committed by big multinational companies, including slavery and forced labour, raised concerns over the need for the mechanism of corporate responsibility.[178]

To quote Mr Dobrev, despite the importance of social issues such as environment and human rights, international law imposes "*no direct obligations on the foreign investors to comply with minimum international standards in operating their investment in the host country, including in the afore-mentioned areas*."[179] However, if directed into socially and environmentally sustainable practices, foreign investment might help to achieve global social justice goals and improve rather than worsen global environmental circumstances.[180] Quite unusually, in the United States, investors are bear responsibility for certain types of misconduct abroad, for instance, if they engage in corrupt business practices or perform serious human rights violations.[181]

One way to regulate the investor's conduct is to impose obligations on investor directly in the investment treaty by incorporating them into BITs or MITs.[182] Mr Dobrev proposes including a chapter specifically listing certain minimum standards

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176 *Three Dimensions of Inequality*, p. 8.

177 *Bonnitcha*, p. 14.

178 *Ibid*.

179 *Dobrev*, p. 279.

180 *Miles*, p. 132.

181 *Bonnitcha*, p. 15.

182 *Dobrev*, p. 288.

that the foreign companies must adhere to when operating its investment in the host country.[183] This would be a good place to start, since it would guide future comparable efforts and move the investor-state dispute settlement system closer to equilibrium. Once at least one BIT containing such minimum standards chapter goes into effect, it may be put to the test in an investor-state arbitration and enable this reform to expand to the regional level before eventually reaching the international level.[184]

Such initiatives have already been tested by states opposing the investment arbitration as it currently stands. For instance, the 2012 South African Development Community ("**SADC**") draft model treaty contains a chapter on the obligations of investors, which captures most of the provisions of the UNCTC's Draft Code of Conduct for Multinational Corporations.[185] The draft treaty seeks to balance investment protection with the regulatory powers of the states.[186] Similarly, the 2015 India Model BIT contains a provision on corporate social responsilibity of investors.[187]

In fact, sometimes it is the power of investors, not of states, that needs to be restrained. As rightly pointed out by Mr Laborde, *"Many foreign investors wield an economic muscle, or have access to technology, on a scale that can hardly be matched by some host States*."[188] Therefore, it is important to devise an enforceable mechanism for addressing violations committed by investors. Although this is an important step in the quest for investor accountability, "*without procedural tools to enforce these obligations, they will only serve as decorative features in investment treaties.*"[189]

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183 *Ibid*, p. 288.

184 *Ibid*, p. 291.

185 *International Law on Foreign Investment*, p. 1183; Southern African Development Community Model Bilateral Investment Treaty Template, adopted on 1 June 2012, Article 15(1).

186 *Ibid*, p. 1182.

187 Indian Model Bilateral Investment Treaty, adopted on 28 December 2015, Article 12.

188 Gustavo Laborde, "*The Case for Host State Claims in Investment Arbitration*," Journal of International Dispute Settlement, Vol. 1, No. 1 (2010), 97–122 ("**Laborde**"), p. 98.

189 Martin Jarrett *et al.*, "*New Options for Investor Accountability in ISDS*" EJIL: talk, 22 December 2021, URL: https://www.ejiltalk.org/new-options-for-investor-accountability-in-isds/.

2.4. Conclusions to Section 2

For decades, the main goal of international investment agreements was to attract foreign direct investment into politically unstable developing countries.[190] The whole system was therefore designed to guarantee necessary protections to investors taking risk to operate in such environment, while the host state was presumed to be capable of protecting its organs. It is vital to recall that the ICSID, which subsequently turned into the main investment arbitration hub, was initially created *"to alleviate the imbalance of power between states and investors and grant the latter an opportunity to protect their investments in host countries."*[191]

It now seems that this imbalance was "cured" by overpowering investors, taking the from one extreme to another. As a result, investment arbitration became a tool in the hands of multinational companies, allowing them to "rein in democracy" and to sue governments even for measures adopted in public interest.[192] One of the primary drivers of backlash against investor-state arbitration is therefore its asymmetric nature favouring the interests of investors.

Critics of the system focus on the reduced regulatory space of host states to pass environmental protection and other important regulations, leading to the so-called "regulatory chill" effect. [193] Even the threat or arbitration that might lead to enormous awards payable by the loosing state may prevent the latter from adopting certain regulatory measures necessary to address public policy concerns.

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190 *Sattorova*, p. 5.

191 Maria José Alarcon, "*ICSID Reform: Balancing the Scales?*" Kluwer Arbitration Blog, 28 January 2022, URL: http://arbitrationblog.kluwerarbitration.com/2022/01/28/icsid-reform-balancing-the-scales/.

192 Cecilia Olivet and Pia Eberhardt, *Profiting from Injustice: How Law Firms, Arbitrators and Financiers Are Fueling an Investment Arbitration Boom*, Corporate Europe Observatory and the Transnational Institute (2012), p. 24.

193 *Trumping the Environment*, p. 15.

The practice showed that arbitral tribunals tend to adopt expansive interpretations of investment treaties, provoking states to renegotiate their initial commitments in BITs in order to limit the scope of substantive standards of protection. As fairly pointed out by professor Sornarajah, the awards against Argentine and the NAFTA awards involving the United States and Canada *"mark a watershed in investment treaty practice*."[194]

Therefore, unless the asymmetric architecture of investor-state dispute settlement system is changed, countries would continue withdrawing from existing BITs and sectoral agreements the same way Ecuador terminated all its BITs or Italy and Russia left the Energy Charter Treaty.[195] Scholars believe that with raising protectionism, reforming the investment regime is not only necessary, but also urgent.[196]

However, even without major changes of the substantive law contained in various instruments of investment protection, the investor-state dispute settlement can be improved by altering the procedural rights of the host states. At the same time, the trend of recognizing counterclaims does not replace the need to recognise investors obligation to conduct itself within the law directly in BITs. The final section of my thesis is therefore devoted to one the crucial instruments for rebalancing the interests of foreign investors and host states – the counterclaims in investment-state arbitration.

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194 *International Law on Foreign Investment*, p. 992.

195 *The Great Asymmetry*, p. 19.

196 *Ibid*.

SECTION 3
COUNTERCLAIMS IN INVESTMENT ARBITRATION

As was discussed in the above chapters, one of the greatest disbalances of investment arbitration lies in the fact that instruments of investment protection do not impose obligations on investors, which leads to the inequality of arms. Investor-state dispute settlement has been criticised by many scholars as being 'a shield placed in the hands of the investor' precisely because it entitles only one side (investor) to bring claims against another (the host state).

The state is considered to give a standing consent to settle the dispute by arbitration in the respective investment treaty, whereas investor is accepting this consent simply by initiating arbitral proceedings.[197] Therefore, until investor decides to go to arbitration, the host state cannot initiate arbitration under the BIT or another investment agreement because there is no such 'standing consent' from the side of the potential claimant, which stems from the fact that the BIT applies to all qualifying investors rather than a particular one.

During the last ten years, there has been a lot of ongoing debates questioning the role of the state as a 'perpetual respondent in investment arbitration,' with a few instances of tribunals recognising the right of states to submit counterclaims. The first subsection (3.1) serve as a brief overview of the main features of counterclaims in investment arbitration and obstacles standing in the way of their recognition. The second subsection (3.2) is devoted to the analysis of the existing case law addressing the general permissibility and jurisdictional prerequisites of counterclaims.

Further, the growing trend of states resorting to counterclaims for violation of human rights and environmental standards (3.3) is covered. I conclude with a reflection on how the acceptance of counterclaims can reshape the asymmetric design of investment arbitration and help to restore the regulatory powers of states (3.4).

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197 *Waibel*, p. 579.

3.1. Counterclaims: main features and obstacles

A counterclaim is an autonomous respondent's claim for relief against a claimant, which is submitted in response to the principal claim and is aimed at establishing a breach committed by investor that goes beyond the dismissal of the investor' claim.[198] As a rule, counterclaims have a defensive nature in relation to the main claim and are intended 'to fend off the primary claim' by alleging some wrongdoing from the claimant's side.[199] The primary purpose of counterclaims is to avoid unnecessary duplication of proceedings related to the same facts, saving both time and legal costs (procedural economy).[200] Therefore, counterclaims can serve as a balancing instrument, which brings all claims arising from one subject matter "*within the purview of a single tribunal's authority*."[201]

While investors claim initiating arbitration deal with an alleged violation of substantive provisions by the host state, counterclaims are aimed to address the investor's misconduct under applicable rules.[202] As put by Ms Hepburn, "*these claims*

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198 Anna De Luca and Crina Baltag, "*Counterclaims in Investment Arbitration: Reflections on UNCITRAL WG III Reform,"* Kluwer Arbitration Blog (2021), URL: http://arbitrationblog.kluwerarbitration.com/2021/11/05/counterclaims-in-investment-arbitration-reflections-on-uncitral-wg-iii-reform/ ("**Luca and Baltag**").

199 Christoph H. Schreuer, *The ICSID Convention: A Commentary*, Cambridge University Press (2009) ("**The ICSID Convention Commentary"**), p. 750.

200 Dafina Atanasova, Adrián Martínez Benoit, *et al*., "The Legal Framework for Counterclaims in "*Investment Treaty Arbitration*," Journal of International Arbitration, Kluwer Law International, Volume 31, Issue 3 (2014) pp. 357 – 391 ("**Atanasova and Benoit**"), p. 359.

201 Andrea K. Bjorklund, "*Role of Counterclaims in Rebalancing Investment Law, The Business Law Forum: Balancing Investor Protections, the Environment, and Human Rights, Lewis & Clark law Review*" (17): 2, 461-480 ("**Bjorklund**"), p. 465.

202 Jarrod Hepburn, *Domestic Law in International Investment Arbitration*, Oxford University Press (2017) ("**Hepburn**"), p. 91.

most often involve charges that the investor has breached either some element of host state law or the investment contract governed by host state law."[203]

As described in the previous section, international investment treaties do not normally impose any obligations on investors. Precisely for this reason there is an ongoing debate among scholars as to the possibility of the host state to claim that an investor had breached its obligations under international law instruments of investment protection.[204] In the view of the distinguished professor James Crawford, "*the core problem with counterclaims in BIT arbitration is that the treaty commitments of the host state toward the investor are unilateral, and anyway the investor is not a party to the BIT*."[205] Indeed, many investment agreements expressly limit the jurisdiction of arbitral tribunals to claims based on violations of certain provisions of the treaty or require that the contested measure would be that of the host state.[206]

However, there are some investment treaties that expressly provide for the possibility of counterclaims to address violations of investors' obligations under the respective treaty, including the general obligation of investors to comply with domestic laws of the host state.[207] For instance, the 2007 Common Market for Eastern and Southern Africa (COMESA) Investment Agreement provides in Article 28(9):

"*A Member State against whom a claim is brought by a COMESA investor under this Article may assert as a defence, counterclaim, right of set off or other similar claim, that the COMESA investor bringing the claim has not fulfilled its obligations under this Agreement, including the obligations to comply with all applicable domestic measures or that it has not taken all reasonable steps to mitigate possible damages."*[208]

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203 *Hepburn*, p. 91.

204 *Hepburn*, p. 91.

205 James Crawford, "*Treaty and Contract in Investment Arbitration*," Arbitration International, Volume 24, Issue 3, Oxford University Press (2008), p. 364.

206 *Bjorklund*, p. 467.

207 *Ibid*.

208 Common Market for Eastern and Southern Africa (COMESA) Investment Agreement provides, Adopted on 23 May 2007, Article 28(9).

Similarly, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership allows states to file counterclaims against investor if they share both the factual and legal basis with the main claim.[209] The Slovak Republic-Iran and Argentina–UAE BITs are among a few bilateral treaties expressly allowing counterclaims.[210]

The current prevailing opinion is that that the respondent state's right to file a counterclaim against foreign investors is not excluded under investment treaties. Some arbitral tribunals argued that they have an "*inherent power to hear counterclaims*," even despite the lack of express provision to such effect,[211] whereas other rejected such possibility altogether. The question whether the state can file a counterclaim against investor therefore comes down to the question of whether a tribunal has jurisdiction to hear this counterclaim, and whether such a claim would be admissible.

The two key obstacles faced by tribunals adjudicating on counterclaims are the issue of consent from investor's side and the determination of its obligations owed to the host state.[212] The absence of express investor's consent to counterclaims, along with obligations in investment treaties, and the investment arbitration pro-investor design only add complexity to this matter. Arbitral tribunals can only have jurisdiction over a counterclaim if a treaty under which the proceedings are initiated allows for such claims, if they fall within the scope of the parties' consent, and if a counterclaim is sufficiently connected to the main claim. The prerequisites of counterclaims will be addressed in the next subsection.

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209 Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), adopted on 8 March 2018, Article 9.18(2).

210 Agreement Between the Slovak Republic and the Islamic Republic of Iran for the Promotion and Reciprocal Protection of Investments, adopted on 19 January 2016, Article 14(3).

211 *The 'Erica Lexie' incident (Italy v. India)*, PCA Case No. 2015-28, Award of 21 May 2002, paras 254-255.

212 Yarik Kryvoi, "*Counterclaims in Investor-State Arbitration*," Minnesota Journal of International Law (2012), 321 ("**Counterclaims in Investor-State Arbitration**"), p. 216.

3.2. Prerequisites of counterclaims

Article 46 of the ICSID Convention is one only multilateral treaty that expressly allows parties to file the counterclaims. According to it, in the absence of an agreement between the disputing parties, counterclaims must: (1) within the scope of the consent of the parties and be otherwise within the Centre's jurisdiction and (2) arise directly out of the subject matter of the dispute.[213]

Therefore, under the ICSID Convention, a respondent must satisfy two main requirements in order to bring a counterclaim against an investor.[214] Apart from the ICSID Convention, the majority of other institutions contain similar provisions on the submission of counterclaims. The existing case law dealing with both of these prerequisites will be analysed below.

3.2.1. Parties' Consent

The jurisdiction of any tribunal derives from the consent of the parties to arbitrate. Therefore, the state's ability to file a counterclaim depends on whether investor expressed its consent to arbitrate counterclaims against it.[215] The presence of such consent is determined by reference to provisions of an investment treaty under which the arbitration was initiated, most frequently a BIT.[216] The exact scope of the investor's consent will depend on the drafting of the provision regarding the investor–

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213 Convention on the Settlement of Investment Disputes between States and Nationals of Other States, adopted on 18 March 1965 ("**ICSID Convention**"), Article 46.

214 Giovanni Zarra, "*The Relevance of State Interests in Recent ICSID Practice*," The Italian Yearbook of International Law Online 26, 1 (2017) 487-512 ("**Zarra**"), p. 489.

215 *The ICSID Convention Commentary*, p. 751.

216 Tomoko Ishikawa, "*Counterclaims and the Rule of Law in Investment Arbitration*," AJIL Unbound (2019) Volume 113, 33-37 ("**Ishikawa**"), p. 37.

state dispute settlement.[217] As put by Anne K. Hoffmann, the tribunal will need to establish that it has both jurisdiction *ratione materiae* (that disputes which can be submitted to arbitration are not limited to those arising from host state's obligations) and jurisdiction *ratione personae* (that the host state's right to submit a claim is not excluded).[218]

In practice, the starting point of investment tribunals' analysis is therefore the wording of the dispute settlement provision in a treaty. Depending on the formulation of the arbitration clause, tribunals adopted different approaches to counterclaims. The tribunals tend to permit counterclaims if an arbitration clause provides for 'any legal disputes' related to an investment and give the standing (i.e., the right to bring claims to arbitration) not only to investor but to 'either' of the parties. By way of example, the wording of the 1991 US–Argentine BIT, provides such a broad clause in Article VII:

"*Each Party hereby consents to the submission of any investment dispute for settlement by (...) binding arbitration in accordance with the choice specified* [by the investor] *(...) Once the [investor] concerned has so consented, either party to the dispute may initiate arbitration in accordance with the choice so specified in the consent*."[219]

For instance, the tribunal in *Inmaris v. Ukraine* upheld its jurisdiction over Ukraine's a counterclaim based on the broad dispute resolution clause in Article 11 of the Ukraine-Germany BIT, which covered disputes "*with regard to investments between either Contracting Party and a national or company of the other Contracting Party.*"[220] By contrast, if the respective investment treaty provides a narrow arbitration

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217 *Bjorklund*, p. 466.

218 Meg Kinnear, Geraldine R. Fischer *et al, Building International Investment Law: The First 50 Years of ICSID,* Kluwer Law International (2015) ("**The First 50 Years of ICSID**") p. 509.

219 Treaty between United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment, adopted on 14 November 1991, Article VII.

220 *Inmaris Perestroika Sailing Maritime Services GmbH and others v. Ukraine*, ICSID Case No. ARB/08/8, Award, 1 March 2012, para. 432.

clause, "*arbitral tribunals have consistently rejected jurisdiction over counterclaims for lack of consent*."[221] The prevailing view of tribunals have been that they cannot disregard the asymmetry engrained by drafters of certain treaties, even if it effectively bars counterclaims, because it shows the intent of the parties.[222] Existing case law on counterclaims shows that arbitral tribunals are generally reluctant to allow host states to proceed with them unless the wording in respective BIT is clear in allowing 'any party' to put the claim forward.

Roussalis v. Romania is a landmark decision, in which tribunal adopted restricting interpretation of BIT and concluded that the consent to arbitration under the BIT does not *per se* imply a consent to counterclaims.[223] In that case, Article 9(1) of the Greece-Romania BIT (which served as a basis of tribunal's jurisdiction) expressly limited its application to *"[d]isputes between an investor of a Contracting Party and the other Contracting Party concerning an obligation of the latter under this Agreement, in relation to an investment of the former*."[224]

The tribunal also pointed out that its jurisdiction also depends on the applicable law clause in the BIT. Some investment agreements direct tribunals to apply international law, including the BIT itself, whereas others designate the domestic law of the host state as applicable law.[225] If the BIT in question (as the vast majority do) imposes obligations only on contracting states, counterclaims fall outside the tribunal's jurisdiction unless the BIT refers to the host state's domestic law as applicable law.[226] In this regard, the *Roussalis* tribunal noted, relying on the article of Pierre Lalive and Laura Halonen that "*in order to extend the competence of a tribunal to a State*

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221 *Ishikawa*, p. 37.

222 *Atanasova and Benoit*, p. 368.

223 *The First 50 Years of ICSID*, p. 506.

224 *Roussalis v. Romania*, para. 869.

225 *Bjorklund*, p. 469.

226 *The First 50 Years of ICSID*, p. 507.

counterclaim, the arbitration agreement should refer to disputes that can also be brought under domestic law.[227]

Some tribunals took more radical approach, rejecting the possibility to file counterclaims whatsoever. In *Rusoro Mining Ltd. v. Bolivarian Republic of Venezuela,* the arbitral tribunal ruled that "*the [BIT] affords investors, and only investors, standing to file arbitrations against host States; and the purpose of the arbitrations is for arbitrators to adjudicate disputes relating to a claim by the investor that a measure taken or not taken by [the host State] is in breach of this Agreement*, by applying the Treaty and applicable rules of international law."[228]

Some scholars believe that the wording of the arbitration clause in the investment treaty is irrelevant for the possibility of a state to assert a counterclaim. The main proponent of this view is Professor Michael Reisman, which articulated this position in his dissenting opinion in *Roussalis.* According to him, "*the consent component of Article 46 of the Washington Convention is ipso facto imported into any ICSID arbitration which an investor then elects to pursue. It is important to bear in mind that such counterclaim jurisdiction is not only a concession to the State Party: Article 46 works to the benefit of both respondent state and investor.*"[229] He concluded that such an interpretation of BITs leads to the duplication of proceedings, increased costs and inefficiency and is contrary to the objectives of international investment law.[230] Other scholars elaborated this view and claimed that the investor's consent to arbitrate counterclaims is implied.[231]

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227 *Roussalis v. Romania*, para. 871, referring to Pierre Lalive and Laura Halonen, "*On the availability of Counterclaims in Investment treaty Arbitration,*" Czech yearbook of international law (2011) ("**Lalive and Halonen**"), p.141.

228 *Rusoro Mining Ltd. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/12/5, Award, 22 August 2016, para. 628.

229 *Roussalis v. Romania*, Declaration of W. Michael Reisman (Award), 7 December 2011

230 Ibid.

231 *Atanasova and Benoit*, p. 366

The tribunal in *Goetz v. Burundi* followed Reisman's approach and stated that it is not relevant whether the BIT explicitly confers competence on the tribunal to examine counterclaims, because investors gave their consent to arbitrating any claims within the ICSID's jurisdiction by accepting the host state's offer to arbitrate.[232] The tribunal also stated that any decision to the contrary would not only be against the letter, but also against the spirit, of the ICSID Convention, which aims to facilitate the resolution of disputes between states and investors rather than complicate them.[233]

Therefore, there are two different approaches, which adopt restrictive and broad reading of dispute settlement provisions in BITs to determine the parties' consent to arbitrate counterclaims.

3.2.2. Close connection requirement

All major arbitration rules (apart from the revised 2010 UNCITRAL Rules) require that counterclaims are closely connected to the claim initiated by an investor. In the leading case on this matter, *Saluka v Czech Republic,* the tribunal considered a 'close connection' requirement to reflect "*a general legal principle*" that "*customarily govern the relationship between a counterclaim and the primary claim to which it is a response.*"[234] It arrived at this conclusion by looking at various rules, including the 1976 UNCITRAL Rules and the ICSID Convention*,* ruling that they *"all reflect essentially the same requirement: the counterclaim must arise out of the 'same contract' (UNCITRAL Rules, Article 19.3), or must arise 'directly out of an investment' and 'directly out of the subject-matter of the dispute' (ICSID, Articles 25(1) and 46), or must arise 'out of the same contract, transaction or occurrence that constitutes the*

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232 *The First 50 Years of ICSID*, p. 515; *Antoine Goetz & Consorts and SA Affinage des Metaux v. Burundi*, ICSID Case No. ARB/01/2, Award, 21 June 2012 ("**Goetz v Burundi"**), para 279.

233 *The First 50 Years of ICSID*, p. 516; *Goetz v Burundi*, para 280.

234 *Saluka Investments BV v. The Czech Republic*, PCA Case No. 2001-04, Decision on Jurisdiction over the Czech Republic's Counterclaim, 7 May 2004 ("**Saluka v. Czech Republic**"), para. 61.

subject matter of [the primary] claims' (Article II(1) of the Claims Settlement Declaration)."[235]

The close connection requirement is generally deemed as an admissibility requirement and therefore should be distinguished from the jurisdictional requirements, such as the consent of the parties.[236] The world-renowned professor Christoph H. Schreuer noted in this regard that "*a claim may well be within the Centre's jurisdiction but not arise directly from the subject-matter of a particular dispute before the tribunal*."[237] Accordingly, if the tribunal finds that consent is not present, it can abstain from analysis of the second requirement of Article 46 of the ICSID Convention "*dealing with admissibility and demanding a connection with the claims*."[238]

The rationale of the 'close connection' test, as explained in the notes to the ICSID Rule is the "*achievement of the final settlement of the dispute"* in which "*the factual connection between the original and the ancillary claim is so close [that] it allows to dispose of all the grounds of dispute arising out of the same subject matter*."[239] Despite the reference to the factual connection between the principal claim and the counterclaim, tribunals have often analysed the legal instrument on which the counterclaim is based to determine whether it meets the 'close connection' requirement.[240]

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235 *Saluka v. Czech Republic*, para. 76.

236 *Metal-Tech Ltd. v. Republic of Uzbekistan*, ICSID Case No. ARB/10/3, Award, 4 October 2013 ("**Metal-Tech v. Uzbekistan**"), para. 407; *Atanasova and Benoit*, p. 379.

237 *The ICSID Convention Commentary*, p. 751.

238 *Metal-Tech v. Uzbekistan*, para. 413.

239 Note B(a) to Arbitration Rule 40 of 1968, 1 ICSID Reports 100.

240 Ina C. Popova and Fiona Poon, "*From Perpetual Respondent to Aspiring Counterclaimant? State Counterclaims in the New Wave of Investment Treaties*," BCDR International Arbitration Review, Kluwer Law International, Volume 2, Issue 2 (2015), 223 – 260 ("**Popova and Poon**"), p. 232.

According to Article 46 of the ICSID Convention, in order to be admissible a counterclaim must arise "directly" out of the "subject-matter of the dispute."[241] This test should not be confused with Article 25(1) of the ICSID Convention, which restricts the jurisdiction of the Centre to legal disputed "*arising directly out of an investment, between a Contracting State (...) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre*."[242]

However, some tribunals decided whether the counterclaim is sufficiently connected based on the analysis of whether it arose directly out of the same investment, from which the main claim arose. In *Amco v. Indonesia*, the respondent filed a counterclaim alleging a tax fraud from the side of investor, which tribunal found to be outside of its jurisdiction because it was a matter of general law of the host state that "*was not specially contracted for in the investment agreement*."[243] The *Amco* tribunal therefore concluded that:

"[I]t is correct to distinguish between rights and obligations that are applicable to legal or natural persons who are within the reach of a host State's jurisdiction, as a matter of general law; and rights and obligations that are applicable to an investor as a consequence of an investment agreement entered into with that host State [which] fall under Article 25(1) of the Convention."[244]

The subsequent practice followed the same approach as to the arbitrability of domestic law claims in investment arbitration.[245] For instance, in *Saluka*, the Czech Republic submitted counterclaims alleging that the investor failed to observe the terms of the Share Purchase Agreement ("**SPA**") during the sale of its shares in the state-owned banks. The tribunal found that it does not have jurisdiction over counterclaims because they were based on the alleged non-compliance *"with mandatory provisions*

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241 *ICSID Convention*, Article 47.

242 *Ibid*, Article 25(1).

243 *Amco Asia Corp. v. Republic of Indonesia*, ICSID Case No. ARB/81/1, Decision on Jurisdiction in Resubmitted Proceeding, 10 May 1988 ("***Amco v. Indonesia***"), para. 126.

244 *Amco v. Indonesia*, para. 125.

245 *Counterclaims in Investor-State Arbitration*, p. 238.

of Czech banking regulations, commercial law and antitrust law" and therefore "*should be decided through the appropriate procedures of Czech law and not through the particular investment protection procedures of the Treaty*."[246]

Moreover, the parties opted for the resolution of their disputes arising out of the SPA by another forum in Zurich, and the tribunal had to take this mandatory arbitration provision in the contract into account.[247] Importantly, this arbitration was governed by the 1976 UNCITRAL Rules, which indeed restricted counterclaims to those arising "*out of the same contract*."[248] As a result, the Saluka tribunal left the Czech Republic with an option to pursue its claims in the chosen contractual forum.[249]

In reaching this conclusion, the tribunal relied heavily on *Klöckner v Cameroon*, which concerned a counterclaim on the alleged mismanagement of the fertiliser factory by an investor. In this case, the ICSID tribunal held that the obligations of investor subject to a counterclaim should have "*a common origin, identical sources, and an operational unity*" with those of the host state, and thus constitute an 'indivisible whole' with the primary claim.[250] The *Klöckner* tribunal found that "[it] *has jurisdiction to rule both on the claim and the counterclaim, while taking into account the Establishment Agreement which, together with the Protocol of Agreement and the Supply Contract, constitutes an indivisible whole*."[251]

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246 *Saluka v. Czech Republic*, para. 76; *Bjorklund*, p. 474.

247 *Saluka v. Czech Republic*, para. 57.

248 United Nations Commission on International Trade Law, UNCITRAL Arbitration Rules (1976), Article 19(3); *Popova and Poon*, p. 232.

249 Anne K. Hoffmann, "*Counterclaims by the respondent state in investment arbitrations – The decision on jurisdiction over Respondent's counterclaim in Saluka Investments B.V. v. Czech Republic,"* Kluwer Law International, Verlag C.H. Beck oHG, Volume 4, Issue 6 (2006), pp. 317 – 320.

250 *Klöckner Industrie-Anlagen GmbH and others v. United Republic of Cameroon and Société Camerounaise des Engrais*, ICSID Case No. ARB/81/2, Award (excerpt), 21 October 1983 ("**Klöckner v. Cameroon**"), para. 24.

251 *Klöckner v. Cameroon*, para. 78.

This approach has been severely criticised as too demanding, suggesting that "*a close factual nexus*" or the fact that the counterclaim arises from the same investment should be enough to satisfy the 'close connection' requirement.[252] Moreover, the state counterclaims usually arise either from breach of its domestic regulations or its investment contract with an investor, whereas investor almost always complain about the international law violations by the host state.[253] As explained by James Crawford, the alleged violation of contract obligations can give rise to tribunal's jurisdiction under the treaty only if such contract relates to investment, does not have its own dispute resolution clause and is concluded with the state.[254]

Subsequent case law often refers to the reasoning of the *Saluka* tribunal. For instance, in *Paushok v. Mongolia,* the tribunal juxtaposed the counterclaims having a close connection with the primary claim and those which concern "*matters that are otherwise covered by the general law of the Respondent*."[255] As a result, the tribunal found that it lacks jurisdiction over Mongolia's counterclaims since they "*arise out of Mongolian public law and exclusively raise issues of non-compliance with Mongolian public law, including the tax laws of Mongolia*."[256] As observed by scholars, the *Paushok* tribunal effectively added another formal criterion to the test on admissibility of counterclaims, stating that it cannot adjudicate on claims arising out of general domestic law, because it would result in extraterritorial enforcement of public laws.[257] However, such domestic measures may fall under the jurisdiction of arbitral tribunals if the relevant investment treaty mentions them or where investor had otherwise committed to respect the law of the host state.

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252 *Lalive and Halonen*, p. 154.

253 *Ibid*.

254 *Counterclaims in Investor-State Arbitration*, p. 240.

255 *Sergei Paushok et al. v. The Government of Mongolia*, Award on Jurisdiction and Liability, 28 April 2011 ("**Paushok v. Mongolia***"*), para. 693.

256 *Paushok v. Mongolia*, para. 694.

257 *Paushok v. Mongolia*, para. 694; *Atanasova and Benoit*, p. 382.

For instance, in *Goetz v Burundi* the tribunal adopted a different approach and found the counterclaim admissible despite the fact that it was based on Burundi's domestic law.[258] In this case, the BIT provision on applicable law specifically provided that the arbitral tribunal shall base its decision, inter alia, on "*the domestic law of the Contracting Party which is a party to the dispute in whose territory the investment is situated*" as well as "[t]*he terms of the specific commitment entered into on the subject of the investment.*"[259] The *Goetz* tribunal applied the 'close connection' test and concluded that the counterclaim at hand "*was directly related to the investment and arose out of the investor's alleged violation of the terms of the operating certificate*."[260]

Therefore, because most of the BITs provide that the treaty itself and principles of international law as the law applicable to the dispute, the counterclaims based on host state's domestic law or investment contract can only exceptionally be considered as 'sufficiently connected' to the primary claim based on the alleged violation of BIT. The prevailing opinion is that such counterclaims would only be possible either (a) if the obligations of investor are integrated in the BIT itself or (b) if the domestic law or the contract in question is mentioned as applicable law in the treaty.

3.3. Recent trends in case law on host states' counterclaims

Against this backdrop, the counterclaims involving human rights and environmental violations by private investors seems to be gaining momentum in the recent practice of investment arbitration tribunals, which will be described below in subsections 3.3.1 and 3.3.2 accordingly.

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258 *Atanasova and Benoit*, p. 383.

259 *Atanasova and Benoit*, pp. 382-283; Convention Between the Belgo-Luxembourg Economic Union and the Republic of Burundi Concerning the Reciprocal Promotion and Protection of Investments, adopted on 13 April 1989, Article 8(5).

260 *Popova and Poon*, p. 229, referring to *Goetz v Burundi*, para 277.

3.3.1. Human rights counterclaims

For many years, the primary goal of developing states was to attract more foreign investment, even if they had to sacrifice human rights standards for this.[261] As described above in section II of this thesis, only a few new generation investment treaties impose human rights obligations on foreign investors, none of which has been scrutinised in practice. However, as states try to reclaim their power to regulate and substantive investor's obligations began to appear in international treaties, arbitral tribunals shift the approach from total impunity to responsibility for human rights violations. It is necessary to accept that foreign investors are obliged to respect human rights under international law.[262]

Long before the first human rights counterclaim examined in the merits, tribunals recognised that international investment treaties, including the jurisdictional provisions of the ICSID Convention itself, cannot be interpreted in isolation from the rules of public international law.[263] The *Urbaser* tribunal went even further and stated that the BIT in question "*has to be construed in harmony with other rules of international law of which it forms part, <u>including those relating to human rights</u>*."[264]

As summarised by Giovanni Zarra, the majority of tribunals *"refused to assume jurisdiction on counterclaims which were inextricably linked to the main claim from the factual point of view, but had <u>a different legal grounding</u> (e.g. they were based on an alleged violation of human rights law).*[265] She further noted that tribunals adopting

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261 *International Law on Foreign Investment,* p. 1011.

262 *Waibel*, p. 584.

263 *Phoenix Action Ltd v. Czech Republic*, ICSID Case No. ARB/06/5, Award, 15 April 2009, para. 78.

264 *Urbaser S.A et al. v. Argentine Republic*, ICSID Case No. ARB/07/26, Award, 8 December 2016 ("**Urbaser v. Argentina***"*), para. 1200.

265 *Zarra*, p. 490.

such a restrictive interpretation have failed to take into account states' interest and endorsed unnecessary parallel proceedings.[266]

The *Urbaser v. Argentina* case is often cited as a turning point for the permissibility of a host state's counterclaims alleging investor's failure to respect human rights. The *Urbaser* tribunal rejected the objections of the Claimant that investors "*have no commitment or obligation for compliance in relation to human rights*"[267] and that the asymmetric nature of Spain-Argentina BIT prevented a state from filing a counterclaim based on the BIT.[268] In its counterclaim, Argentina alleged that investor's failure to provide the necessary level of investment in the concession interfered with local people's right to water and sanitation.[269]

The tribunal famously highlighted that, in the light of the development in the field of corporate social responsibility, "*it can no longer be admitted that companies operating internationally are immune from becoming subjects of international law*."[270] As a result, the tribunal made a significant shift towards the evolution of human rights role in investment arbitration.[271]

At the same time, due regard should be given the wording of the Spain-Argentina BIT, which was broad enough to allow the submission of counterclaim by Argentina.[272]

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266 *Ibid*.

267 *Urbaser v. Argentina,* para. 1193.

268 Monica Feria-Tinta, "*Like Oil and Water? Human Rights in Investment Arbitration in the Wake of Philip Morris vs. Uruguay*," Journal of International Arbitration, Volume 34, No. 4 (2017) 601–630 ("**Human Rights in Investment Arbitration**"), p. 626.

269 *Ibid*, p. 626.

270 *Urbaser v. Argentina,* para. 1195.

271 Stavros Brekoulakis, *Arbitration: The International Journal of Arbitration, Mediation and Dispute Management*, Kluwer Law International, Sweet & Maxwell (2022) Volume 88, Issue 1, p. 77.

272 Maxi Scherer, Journal of International Arbitration, Kluwer Law Internationa (2018) Volume 35, Issue 4, 379-412 ("**Scherer**"), p. 407.

Such interpretation is not likely to play out in the case of narrowly drafted dispute resolution clause in the BIT, as in the case of *Roussalis*.[273]

3.3.2. Environmental counterclaims

Another area where the state's regulatory measures often appear to be in conflict with investor's rights under the treaty is the protection of environment. As described above in subsection 2.3, the new generation BITs tend to include provisions expressly recognizing the host state's right to regulate in the public interest. In *Aven v. Costa Rica,* the tribunal followed the *Urbaser* approach that state has the right to submit counterclaim to enforce environmental obligation on investors.[274]

In that case, the tribunal opined that there are "*no substantive reasons to exempt foreign investor of the scope of claims for breaching obligations under Article 10 Section A of the DR-CAFTA*," especially in part of obligations concerning environment.[275] However, under the closer look, the tribunal stated that the language of the foreign trade agreement does not impose any affirmative obligation on investors but rather provided states with more flexibility in adopting environmental measures.[276] It concluded that investor's violation of the environmental regulations adopted by the host state does not amount to a breach of the treaty, and therefore could not serve as a valid basis of a counterclaim.[277]

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273 *Urbaser v. Argentina,* para. 1143.

274 Alan M. Anderson and Ben Beaumont, *The Investor-State Dispute Settlement System: Reform, Replace or Status Quo?,* Kluwer Law International (2020) 225 – 246 ("**Anderson and Beaumont**"), p. 242.

275 *David R. Aven et al. v. The Republic of Costa Rica*, ICSID Case No. UNCT/15/3, Final Award, 18 September 2018 ("**Aven v. Costa Rica***"*), para. 738.

276 *Aven v. Costa Rica*, para. 743.

277 *Ibid*.

The counterclaims asserted by Ecuador in *Perenco* and *Burlington* cases broke the pattern of failures and succeeded on the merits.[278] In *Perenco v Ecuador*, the respondent put forward a counterclaim against the investor for an "environmental catastrophe" in oil blocks operated by Perenco in the Amazonian rainforest.[279] In the closely related *Burlington v Ecuador*, the tribunal found that it has jurisdiction over state's counterclaims for human rights and environmental violations and awarded Ecuador USD 39.2 million for environmental damage.[280] The tribunals found violations based on domestic environmental laws of Ecuador.[281]

Importantly, both *Burlington and Perenco* are quite exceptional cases, because the parties specifically agreed to arbitrate counterclaims arising out of the investment and jurisdiction of the tribunal was not at issue.[282] Accordingly, the tribunal only briefly touched upon the test of Article 46 of the ICSID Convention, concluding that all requirements are met. Namely, the counterclaims met the close connection requirement since they "*arose directly out of the subject-matter of the dispute, namely Burlington's investment*," were within the scope of the parties' consent and fell within the tribunal's jurisdiction under Article 25 of the ICSID Convention.*[283]*

Therefore, the arbitral practice is shifting in the direction towards recognition of counterclaims by host state, especially in case of environmental damage.[284] The greater

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278 *Anderson and Beaumont*, p. 238.

279 *Perenco Ecuador Limited v. Republic of Ecuador*, ICSID Case No. ARB/08/6, Interim Decision on the Environmental Counterclaim, 11 August 2015, para. 34.

280 *Anderson and Beaumont*, p. 234.

281 Jason Rudall, "*The Tribunal with a Toolbox: On Perenco v Ecuador, Black Gold and Shades of Green*," Journal of International Dispute Settlement, Oxford University Press (2020) Volume 11, Issue 3, 485-500, p. 493.

282 *Ishikawa*, p. 37.

283 *Burlington Resources, Inc. v. Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Counterclaims, 7 February 2017, para. 62.

284 Ted Gleason, "*Examining Host-State Counterclaims for Environmental Damage in Investor-State Dispute Settlement from Human Rights and Transnational Public Policy Perspectives*,"

willingness to accept counterclaims claiming environmental damage caused by the investor is particularly evident in case of new generation treaties.[285]

3.4. Conclusions to Section 3

The permissibility of counterclaims of host states remains a hotly debated issue in the context of investment treaty arbitration, with both scholars and case law questioning its traditional limits.[286] When assessing fairness or equity of measures taken by a host state, it is important to consider whether such measures were made "*in response to harm that the investor had caused.*"[287]

The case law illustrated above serves as a proof of the recent trend of strengthening the role of host state's regulatory powers, especially in areas of public importance, such as human rights and environment. However, the use of counterclaims in international investment arbitration remains limited to cases where the investor's consent to a counterclaim and the counterclaim is sufficiently linked to the main claim.[288]

It can be concluded that the main obstacle to tribunal's jurisdiction over the state counterclaim stems from the absence of specific obligations of investors in the underlying investment treaties.[289] Another related limitation is that tribunals rarely allow counterclaims for breaches of host state law, because the applicable law under the treaty is, in most cases, international law and investment contract.

International Environmental Agreements: Politics, Law and Economics, Volume 21, 427–444 (2021) ("**Gleason**"), p. 431.

285 *International Law on Foreign Investment,* p. 1006.

286 *Counterclaims in Investor-State Arbitration,* p. 220.

287 *International Law on Foreign Investment*, p. 789.

288 Christian Tietje and Kevin Crow, "*The Reform of Investment Protection Rules in CETA, TTIP and Other Recent EU-FTAs: Convincing*?" (2016)

289 *Scherer*, p. 408.

CONCLUSIONS

Since foreign investments are subject to a whole range of risks, the system of bilateral and multilateral investment treaties was developed to give investors the necessary protection, encouraging them to contribute to the economy of the state they choose to invest in. When investing in a foreign country, an investor is indeed taking the risk of operating in the totally unknown regulatory territory and therefore needs additional protection to mitigate the risks associated with such new venture."[290] That is why the system of investor-state dispute settlement was developed, providing investors with certain guarantees that the host state will treat their investment adequately, and if it fails to do so, an investor can sue such a state directly through arbitration.

Such guarantees are given by states by concluding investment treaties, which are primarily designed to protect the rights of investors and impose corresponding obligations on states. Notably, the number of investment treaties, which permit investors to initiate arbitration against foreign states for the damage done to their investments continued to expand, with more than 3,000 investment treaties concluded as of 2018.[291] From 2018 onward, however, the trend is reversed, with more states terminating their BITs and withdrawing from the investor-state arbitration altogether, sometimes on a massive scale as with the intra-EU BITs.

The main reason of such a backlash lies in the great asymmetry of instruments of investment protection that proved to give private companies too much power at the cost of sovereign states' right to regulate vital sectors of their economies. The investor-

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290 Dessislav Dobrev, "*Reforming International Investment Law: Is It Time for a New International Social Contract to Rebalance the Investor-State Regulatory Dichotomy?"* Yearbook on International Investment Law and Policy 2014–2015, Oxford University Press (2016), ("**Dobrev**"), p. 277.

291 UNCTAD, World Investment Report 2018: Investment and New Industrial Policies, 188, UNCTAD/WIR/2018 (2018), p. 88.

state dispute settlement system has therefore been criticised for supporting the pro-investor bias and provoking the regulatory chill effect, constraining national policies.

The lack of adequate tools for holding investors accountable for the harm caused by their activities turned states into perpetual respondents in investment arbitration. With the exponentially growing number of claims against developing states and the outstanding amount of compensation awarded to foreign investors, states began to question the fairness of the system and called for structural reforms of international investment law.

Inevitably, investment tribunals had to address the existing inequality of arms to overcome the legitimacy crisis and regain the states' trust in the system which has been governing the relations between private parties and governments for the last 50 years.

One of the most crucial instruments aimed at facilitating equality of the parties is the resort to counterclaims, which place states at equal footing with investors by giving them the right to hold investors accountable for violations of their obligations under the international law, domestic law of the host state or investment contract.

As aptly put by Professor Bjorklund, "*absent the ability to submit a counterclaim, a state cannot win; the most it can hope to do is not to lose*."[292] For many years, states were unable to hold investors accountable for numerous human rights violations and actions that resulted in environmental degradation and affected local communities. Counterclaims not only promote equality between the parties but also enhance neutrality and fairness of the investor-state dispute settlement system by giving both states and foreign investors the right to defend their claims before an impartial tribunal.[293] Therefore, counterclaims may help to counterbalance the asymmetric design of investment arbitration and make it more efficient by avoiding the duplication of proceedings concerning the same subject-matter at the domestic and international level and enhancing time-efficient resolution of the disputes.[294]

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292 *Bjorklund*, p. 464.

293 *Anderson and Beaumont*, p. 227.

294 *Counterclaims in Investor-State Arbitration*, p. 218.

By looking into practice, we can see two tendencies: (1) that the number of counterclaims submitted by the host states is constantly growing and (2) that the majority of asserted counterclaims are dismissed by tribunals on the jurisdictional stage. The main obstacle to the permissibility of host states' counterclaims lies in the restrictive language of the relevant investment treaties giving the standing to submit claims exclusively to investors or limiting the arbitrable disputes to those arising from the alleged violations by host states.

At the same time, the positive trend established by groundbreaking *Urbaser* award shows that the previous reluctance of arbitral tribunals to allow counterclaims is receding, with 'a newer group of arbitrators' looking not only at state's actions but also at potential investor misconduct.[295] The key issues analysed by tribunals are whether an investment treaty provides for the consent of both parties to adjudicate counterclaims and whether such counterclaims are sufficiently connected with the primary claim pursued by the investor.

Accordingly, the only reliable strategy to ensure that tribunals have jurisdiction to hear counterclaims is to include a clear provision to this effect in the BIT, together with enforceable obligations not only for states but also for investors. Some new generation BITs already introduced provisions providing specific obligations for foreign investors or prohibiting them to challenge the state's regulatory measures if they meet certain conditions. Without any doubt, the use of counterclaims will become normalised in the nearest future.[296]

As with any supranational system, the investor-state dispute settlement requires states to have confidence in order to overcome the legitimacy crisis. Rebalancing the system by allowing states to become its active participants and recognising the need to impose obligations on investors will turn existing shortcomings into a force of change.

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295 *International Law on Foreign Investment,* p. 788.

296 *Sornarajah*, p. 64.

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