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Opportunities for ESG-Related Counterclaims in International Investment Arbitrations: A Trip Down the Rabbit Hole

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For decades, modern international investment law and arbitration have provided both the procedural mechanisms and substantive grounds for States to advance counterclaims in such proceedings. Coupled with the increased inclusion of provisions on the State's right to regulate and provisions concerning the substantive areas of environmental, social, and governance ("ESG") in the latest generation of international investment agreements ("IIAs") and domestic laws, there is great promise for successful ESG-related counterclaims. This blog post takes a trip down the rabbit hole to identify the procedural mechanisms that enable counterclaims, the thorny issue of consent, and how the right to regulate may interact with the assertion of ESG-related counterclaims in investment arbitrations.

Creating Opportunities: Procedural Mechanisms to Enable Counterclaims

Few will disagree with the assertion that the earliest IIAs were designed to be inherently asymmetrical. IIAs provided foreign investors with rights, but not necessarily obligations, as third-party beneficiaries under the applicable IIA. This served host States' interests by helping them attract and retain foreign investment, which supported and enhanced the development of natural resources, infrastructure, and other necessary sectors.

For these same reasons, historically, foreign investors have initiated nearly all investor-State disputes. However, in ICSID arbitrations, host States have always maintained the ability to pursue counterclaims. The ICSID Convention's Article 46 provides arbitral tribunals the ability to:

> "determine any incidental or additional claims or counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre."

The same idea is reflected in the drafting history of Article 46, where the delegates explained that the ability to present counterclaims in the same proceeding would eliminate the need to constitute a separate tribunal in the future.[1)]

The ability to present such related counterclaims in an existing investment arbitration facilitates equality between the parties (by permitting not only investors, but also States to bring claims) and introduces several procedural efficiencies, such as eliminating the need to pursue multiple proceedings before different fora, which may lead to inconsistent results.

Host States may be interested in maintaining the ability to pursue counterclaims in investment arbitrations so that any positive results may more easily be enforced under the ICSID Convention in the case of ICSID awards or the New York Convention for other awards. This procedural posture may help to facilitate equality among the parties.

Principles relating to procedural efficiencies were explored in *Roussalis v. Romania* (ICSID Case No. ARB/06/1), where Professor W. Michael Reisman, in 2011, issued a Separate Decision in which he dissented from the majority's decision to reject jurisdiction over counterclaims "arising directly out of the subject-matter of the dispute." He explained that if the respondent State were forced to pursue its counterclaims in a separate proceeding in its own courts, and "if an adverse judgment ensues, that erstwhile defendant might well transform to claimant again, bringing another [ ] claim [under the IIA]."

Today, various arbitral rules provide parties with the procedural mechanism to pursue counterclaims, see for instance, Rule 48 of the 2022 ICSID Arbitration Rules, Rule 58 of the 2022 ICSID Additional Facility Arbitration Rules, Article 21(3) of the 2021 UNCITRAL Arbitration Rules, and Article 9 of the 2023 SCC Arbitration Rules. Under each set of rules, the counterclaims must be filed within certain time limits to ensure that due process and the efficient conduct of the proceedings can be maintained.

The Challenge of Consent

Consent is the bedrock of international investment law and arbitration. In IIAs, host States parties usually consent to the dispute settlement forum for prospective investment disputes. That consent may be supplemented by provisions in the host State's domestic law. Later, when a foreign investor files its claim against the host State, it accepts the offer of arbitration to perfect the offer and acceptance of the agreement.

Reciprocally, IIAs must include the possibility of counterclaims against foreign investors to confer the same consent and confer jurisdiction on the arbitral tribunal to adjudicate those claims. This precise challenge was presented in *AMTO v. Ukraine* (SCC Case No. 080/2005), a case arising under the Energy Charter Treaty ("ECT") and under the SCC Arbitration Rules. While the SCC Arbitration Rules (then in effect) referred to the procedure for filing counterclaims, the ECT does not refer to any right to pursue counterclaims. The arbitral tribunal rejected the host State's counterclaims because it understood those claims to be outside of its jurisdiction and unauthorized under the ECT, which constituted the applicable law.

While older generation IIAs, like the ECT, often do not refer to counterclaims, such references are increasing in the latest generation of IIAs. I have personal experience in advising States in the development of their next-generation Model BITs and IIAs and have seen first-hand that such considerations are increasingly being brought to the IIA-negotiating table by States as they seek to revise and reform their IIA programs.

Introducing the Right to Regulate

First and second generation IIAs (those entered between 1960 and 2000) rarely mentioned the State's "right to regulate" expressly. Those IIAs primarily provided for the protection of the foreign investor's investments. However, the 2004 US Model BIT established the trend of referring to the host State's regulatory power. By the time of the 2012 US Model BIT, this trend had become more pronounced. It specifically set forth parameters to weigh and assess the impact of the government action on the investment, the character of the government action, and expressly set forth that non-discriminatory regulatory actions that are designed to protect legitimate public welfare objectives would not constitute indirect expropriation.

Today, nearly all revised or newly entered IIAs provide exceptions from investment protection that narrow the fair and equitable treatment ("FET") obligation. One approach in recent IIA practice is to provide an exhaustive list of the measures that would constitute breach of the FET obligation to strike greater balance between investment protection and a host State's right to regulate in favor of the public interest. For example, CETA (2017) Article 8.10 (Treatment of investors and of covered investments) in subpart (2) enumerates the measures or series of measures that would amount to breach of the FET obligation. Interestingly, subpart (3) states that "[t]he Parties shall regularly, or upon request of a Party, review the content of the obligation to provide fair and equitable treatment." This suggests that there is not necessarily a fixed definition of what conditions the host State owes to the foreign investor, and such definition could be revised or reinterpreted depending on prevailing best practices in relation to the right to regulate or socio-cultural norms, including, for example, ESG-related commitments and goals.

Another approach found in recent IIA practice is to directly and specifically stipulate exceptions to or carve-outs from the definition of indirect expropriation. By explicitly excluding certain types of State regulation from the definition of an indirect expropriation, the State will not be obliged to pay compensation, irrespective of any harmful effects the regulations may have had on an investment. For example, COMESA CCIA (2007) Article 20(8) states:

> "Consistent with the right of states to regulate and the customary international law principles on police powers, bona fide regulatory measures taken by a Member State that are designed and applied to protect or enhance legitimate public welfare objectives, such as public health, safety and the environment, shall not constitute an indirect expropriation under this Article."

Today, the State's right to regulate is a hot topic that attracts significant attention in scholarship and is on the agendas of UNCTAD and UNCITRAL Working Group III.

In recent years, IIAs have addressed the right to regulate through at least three distinct approaches. First, by including the right to regulate to the IIA's preamble. Second, by adding a limitation of investment protection or by excluding some areas of public interest from investment arbitration (for example, the carve-out of tobacco-regulated regulations in Canada's latest 2021 Foreign Investment Protection Agreement Model). Third, by expanding the regulatory space in IIAs by defining what may constitute indirect expropriation and what may not. In July 2023, the Secretariat of UNCITRAL Working Group III published draft provisions that considered recent treaty practice, the 2022 ICSID Arbitration Rules, and studies conducted by other organizations. Among the recommendations was a draft provision that covered the host State's "right to regulate in the public interest and the right to adopt, maintain and enforce measures sensitive to the protection of public health, public safety or the environment, the promotion and protection of cultural diversity."

Whither ESG Counterclaims?

It is difficult to balance private investment protection interests and the host State's right to regulate in the public interest. Indeed, the delicate balance between these interests is continuously being renegotiated as societal priorities shift.

To create greater predictability, the latest generation of Model BITs and revised IIAs expressly refer to the State's emerging obligations, such as those arising under the Paris Agreement, and emerging best practices, such as the OCED Sustainable Development Goals and the OCED Guidelines for Multinational Enterprises. Further best practices are provided by the UN Guiding Principles on Business and Human Rights. Increased reference to these metrics and standards in IIAs strengthens the host State's right to regulate in the public interest, including in favor of ESG goals, and renders it possible for States to assert successful counterclaims in this area. Finally, States continue to enhance regulation by protecting and supporting the balance between human rights and business in their local laws and legislations.

Similarly, at COP 28, there was great focus on energy transition and the decarbonization of the global energy sector. Overall, these developments create great promise for the future, where ESG-related priorities are increasingly and more loudly being engaged vis-à-vis the interest of States and their public interests. While it remains to be seen how these merits will align with negotiating priorities and substantive provisions in IIAs, at the very least, we can be certain that these ideas will continue to gain traction, and, perhaps, will be at the forefront of discussions in the run-up to and during COP 29, which is scheduled for November 2024 in Baku, Azerbaijan.

The ideas explored in this blog post coincide with those shared by the author in a November 2023 webinar on climate change and investment arbitration, coordinated by Wöss & Partners and Nivalion. A recording is available here.

References

?1 *History of the ICSID Convention, Vol. 2-11* (1968), Document 81, SID/LC/SR/14 (December 30, 1964) 81 Summary Proceedings of the Legal Committee Meeting, December 7, 1964, pp. 810-811.

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