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Research on Counterclaim Rules in International Investment Arbitration

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Abstract

In recent years, with the rapid development of international investment, inevitably, the investment disputes between foreign private investors and the host country are increasing. From the results of the cases submitted to ICSID arbitration, it can be seen that the investor's winning probability is extremely high, which leads to the imbalance of interests between investor and the host country, and it is difficult to protect the legitimate rights and interests of host country. In this case, the host country may initiate counterclaim arbitration proceedings against the investor's arbitration request according to the provisions of international investment arbitration treaties, international investment agreements or domestic laws to offset the investor's request. However, in the practice of examining and dealing with the counterclaim of the host country, the arbitration tribunal often has strict requirements on the jurisdiction and acceptance conditions of counterclaims. On the one hand, the counterclaim clauses involved in the convention are vague, and the standards of "connection" and "consent" are difficult to identify. On the other hand, the lack of investor's obligation clauses in investment agreements makes it difficult to obtain strong legal support for counterclaims. In order to solve the application dilemma of the host country's counterclaim rules in practice, the arbitral tribunal should give priority to factual relevance when judging whether the counterclaim is related to the original claim. The way of opposing the request for "consent" should be appropriately modified, and a broader identification standard should be adopted. On the one hand, the host country should strive to set up a special counterclaim clause in the investment agreement, and adjust the rights and obligations structure of both parties in international investment agreement.

Keywords: international investment arbitration, host country, counterclaim, ICSID Convention, international investment agreement

Introduction

Currently, nearly a thousand investor-state dispute settlement (ISDS) cases involving global investors and states have been filed, with approximately 70% of these disputes resolved through the International Centre for Settlement of Investment Disputes (ICSID). Consequently, the ISDS mechanism and the ICSID platform play crucial roles in promoting healthy international investment and protecting investors' interests. However, in recent years, the ISDS mechanism has exhibited several flaws in its operations, such as inconsistent rulings, a bias towards investors' interests, unfair arbitration, low transparency, and a lack of error-correction mechanisms[1]. These issues have led many scholars to refer to this as the "legitimacy crisis of ISDS." Notably, under the ISDS mechanism, only investors can initiate arbitration requests, making investors the "clients" of ISDS, as only they can bring cases before the tribunal. In about 70% of cases handled by ICSID, investors have a high success rate, which is partly due to the fact that host states lack the standing to sue. This imbalance of interests between investors and host states significantly undermines the protection of the host states' environmental resources, public interests, and even judicial sovereignty. In this context, counterclaims by host states in international investment arbitration have begun to emerge, drawing attention to the issue of state counterclaims.

According to Article 36(1) of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (hereafter referred to as the "ICSID Convention"), both host states and investors can initiate arbitration proceedings. Host states may file counterclaims against investors' claims in an effort to offset the investors' primary claims and protect their national interests. The United Nations Conference on Trade and Development (UNCTAD) has suggested incorporating provisions for counterclaims into international investment agreements in its World Investment Report. The inclusion of counterclaim rules holds significant value in balancing the interests between investors and host states, maintaining the authority of arbitration, and is particularly relevant now as the ISDS mechanism faces a legitimacy crisis. Counterclaims, as an essential means of adjusting the balance of rights and obligations between investors and host states, should be emphasized.

In practice, however, only 3% of the investment arbitration cases handled by ICSID involve host state counterclaims[2]. Among these, some cases were directly ruled out of jurisdiction, and others with jurisdiction were often dismissed due to factual or substantive issues, with only a rare few counterclaims receiving full or partial support. The main reasons for this are the stringent jurisdictional and admissibility requirements for counterclaims imposed by arbitral tribunals. On one hand, investment agreements often lack clear investor obligations; on the other, the standards for applying counterclaim rules in the convention are unclear, and the interplay between investment agreements and the ICSID Convention on this issue remains a complex challenge for tribunals. Therefore, despite the provision of counterclaim rules under the ICSID Convention, host states rarely exercise their counterclaim rights in the numerous

arbitration cases involving investment disputes between investors and host states. Even when they do, the content of their counterclaims is seldom supported. This highlights the practical challenges in the application of host state counterclaim rules, necessitating an exploration of the underlying causes and the provision of feasible solutions.

I. The Legal Basis of Counterclaim Rules

(A) Counterclaim Rules in Domestic Law

Arbitral counterclaims refer to independent claims made by the respondent against the claimant during the arbitration process[3]. Counterclaim rules originally emerged within domestic legal systems, with different legal traditions prescribing varying regulations. Most civil law countries emphasize the relevance between claims and counterclaims, as seen in Germany's Code of Civil Procedure and France's Code of Civil Procedure. In contrast, common law countries generally do not stress the relevance between claims and counterclaims, a distinction notably present in Australia's Code of Civil Procedure. Similarly, the U.S. Code of Civil Procedure does not require relevance and differentiates between "compulsory counterclaims" and "permissive counterclaims," with specific provisions for each type. Overall, civil law systems adopt a cautious and stringent approach to counterclaims, often requiring a strong connection between the counterclaim and the primary claim, and restricting counterclaims to parties involved in the original claim through explicit legal provisions or judicial practice. Conversely, common law systems adopt a more supportive and expansive approach, allowing counterclaims to be made with less strict relevance requirements and permitting claims against third parties. After extensive judicial practice, a comprehensive counterclaim system has evolved, providing a highly operable framework.

(B) Counterclaim Rules in International Arbitration

The development of counterclaim rules in international law is heavily influenced by domestic law, with international arbitration evolving from the foundations of domestic commercial arbitration, fostering both distinctions and connections between the two. Despite significant differences in the approach to counterclaims between civil and common law systems, both revolve around key elements such as jurisdiction, applicant eligibility, and relevance—elements that are similarly emphasized in international law, particularly within ICSID arbitration.

Article 46 of the ICSID Convention directly addresses counterclaims, stipulating that "unless otherwise agreed by the parties, the Tribunal shall, if requested by a party, determine any incidental or additional claims or counterclaims directly arising out of the subject-matter of the dispute, provided that they are within the scope of the parties' consent and within the jurisdiction of the Centre"[4]. Additionally, according to Article 44 of the ICSID Convention, unless specifically agreed otherwise by the parties, effective arbitration rules automatically apply to the parties' investment arbitration proceedings as

of the date of submission[5]. The current ICSID Arbitration Rules further specify the submission and admissibility criteria for counterclaims in Article 40. It is clear that the ICSID Convention and ICSID Arbitration Rules set conditions for ICSID to accept counterclaims in international arbitration: they must directly relate to the primary subject of the dispute, fall within the scope of mutual consent, and lie within the Centre's jurisdiction. It is important to note that the close connection requirement established by Article 46 of the ICSID Convention for counterclaims differs from the close connection requirement for the Centre's general jurisdiction under Article 25 of the Washington Convention. The primary distinction is that the former requires counterclaims to directly arise from the main dispute issue, whereas the latter necessitates that disputes directly arise from investment activities. Logically, to determine jurisdiction over a counterclaim, the tribunal must first ascertain jurisdiction over the primary dispute issue; in other words, the application of Article 46 is predicated on the fulfillment of Article 25, which corresponds to the "within the jurisdiction of the Centre" requirement[6].

As early as the 1976 version of the UNCITRAL Arbitration Rules, Article 19(3) specifically addressed counterclaims, requiring them to arise from the same contract underlying the original claim. Some perspectives hold that this provision applies exclusively to commercial arbitration between equal civil and commercial entities. The 2010 version of the UNCITRAL Arbitration Rules made targeted amendments to the counterclaim provisions, with Article 21(3) clearly stating that "the respondent may make a counterclaim or assert a claim for the purpose of a set-off provided that the Tribunal has jurisdiction over it"[7]. This indicates that UNCITRAL allows host states to raise counterclaims within the jurisdiction of the tribunal without explicitly demanding further relevance between the counterclaim and the original claim.

Additionally, international investment arbitration rules issued by entities such as the China International Economic and Trade Arbitration Commission and the Singapore Arbitration Centre have acknowledged the issue of host state counterclaims and provided specific provisions accordingly.

(C) Counterclaim Rules in International Investment Agreements

Beyond international arbitration rules, some bilateral and multilateral investment agreements between countries in recent years have begun to affirm the applicability of counterclaim rules. Investment agreements between states exhibit a more explicit attitude towards counterclaims, often specifying the circumstances under which a host state is entitled to make a counterclaim. For instance, Article 19.2 of the 2012 Bilateral Investment Treaty of the Southern African Development Community stipulates that the host state may make a counterclaim against the investor for breach of contract liability. The 2016 Bilateral Investment Treaty between Iran and Czechoslovakia also explicitly recognizes the host state's right to counterclaims, allowing the host state to make a counterclaim if the investor fails to comply with domestic legal obligations under the agreement or does not take measures to mitigate damages. Article 9.19(2) of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)

provides that a respondent may submit a counterclaim that is factually or legally related to the original claim, applicable only when relevant documents establish rights and obligations for the parties. Although the number of international investment agreements that explicitly define the concept of "counterclaim" and further stipulate its application conditions remains limited, counterclaims, as a vital means of balancing rights and obligations between investors and host states, are expected to become a key consideration in the future drafting of international investment agreements.

(D) Constitutive Elements of Counterclaims

In summary, the concept and constitutive elements of counterclaims differ across legal systems, international treaties, and arbitration institutions, with academia also offering varying viewpoints. Hoffmann argues that the close connection between a counterclaim and the main claim is the core element for a host state to file a counterclaim[8]. Zhuang Jielei suggests three elements: the investor and the host state must allow, explicitly or implicitly, for the host state to raise a counterclaim in international investment arbitration; the BIT must include provisions permitting the host state to make a counterclaim; and the counterclaim and the primary claim must be closely connected[9]. Professor Liu Ying of Wuhan University identifies four main elements: the consent of the dispute parties to the counterclaim, the relevance between the arbitration claim and the counterclaim, the eligibility of the dispute parties, and the legality of the investment[10]. Professor Sun Nanshen of Fudan University notes that "subject eligibility" and "investment legality" fall within the jurisdiction of ICSID, as the counterclaim by the host state must have a direct connection with the main claim of the investor. Article 46 of the ICSID Convention requires that this counterclaim must simultaneously meet the jurisdictional conditions of the main claim, specifically within the jurisdictional scope of ICSID, with practical scrutiny often focusing on whether the counterclaim satisfies the requirements of "mutual consent" and "relevance"[11].

II. Challenges in the Application of Counterclaim Rules

Despite the legal basis provided by some international arbitration rules, including the ICSID Convention, and inter-state investment agreements for host states to file counterclaims, arbitral tribunals often resort to general legal principles for judgment when investment agreements lack specific investor obligations. In practice, however, cases involving host state counterclaims are rare, and even fewer receive support. When reviewing and handling host state counterclaims, tribunals often impose excessively stringent standards for determining jurisdiction and admissibility, making it difficult for counterclaims to be upheld.

(A) Ambiguities in Counterclaim Provisions

In practice, most cases are initiated by investors based on international investment agreements, particularly bilateral investment treaties, but the majority of these agreements

lack direct and affirmative provisions for counterclaims. Apart from the aforementioned key international investment dispute resolution rules that explicitly include counterclaim provisions, over 86% of the clauses mentioning "counterclaims" in existing international investment agreements appear as "compensation rules" and "subrogation rules"—negative rules designed to exclude counterclaims by host states on rights such as subrogation[12]. Thus, they cannot serve as a legal basis for host states to file counterclaims. Only a few model international investment agreements, as mentioned above, explicitly affirm the host state's right to file counterclaims.

The vague definition of counterclaim rules in international investment agreements makes it difficult for contracting parties to use them as a direct legal basis for asserting counterclaims in arbitration proceedings. For arbitral tribunals, the unclear language of counterclaim rules increases the interpretative burden of the agreement texts, potentially leading to improper interpretations by the tribunal, which is one of the main causes of the imbalance of rights between host states and investors.

(B) Absence of Investor Obligations

In international investment arbitration practice, host states often file counterclaims on the grounds that investors have violated their obligations or the host state's domestic laws. However, the primary purpose of concluding international investment agreements is to protect foreign investors and their investments in host states. Consequently, most existing international investment agreements predominantly stipulate obligations for host states, with a general absence of provisions on investor obligations. This lack of legal foundation makes it difficult for host states to file counterclaims, forcing them to seek grounds for counterclaims in domestic laws or investment contracts. If the contract does not clearly stipulate whether the host state can file counterclaims, or if the choice-of-law clause in the arbitration agreement based on the international investment agreement does not include the host state's domestic laws or is vague about the applicable law, it becomes challenging for the tribunal to support the host state's counterclaims.

Although rules related to sustainable development have been integrated into the international investment legal framework in recent years, these provisions often lack binding force and operability, generally serving as supplementary references when the tribunal interprets the principles and objectives of the agreement. Therefore, host states also find it difficult to base their counterclaims on such provisions. Even though some international investment agreements include clauses on "investment and environment" and "health, safety, and environmental measures," these provisions still constrain the actions of host states and cannot serve as legal grounds for host states to file counterclaims when investors violate such obligations.

(C) Uncertainty in Determining "Relevance" of Counterclaims

The existence of a certain degree of relevance between a counterclaim and the original claim is fundamental for asserting counterclaims. Arbitral tribunals assess the relevance

of counterclaims with caution because the relevance between an arbitration claim and a counterclaim can directly determine the nature of the host state's request. Generally, if the two claims are interrelated and the host state's counterclaim is valid, the tribunal, having jurisdiction over both the arbitration claim and the counterclaim, can make a joint decision on both claims, achieving judicial economy and efficiency.

Different tribunals seem to have different standards for determining whether a counterclaim and the original claim meet the relevance requirement. In practice, host state counterclaims are mainly rejected by tribunals due to two reasons: lack of legal basis, or the tribunal's determination that contract-based counterclaims and treaty-based original claims should not fall under the jurisdiction of the same tribunal. These reflect two distinct standards of determination: legal connection and factual connection. The application of different principles directly impacts whether the host state's counterclaims are valid, leading to uncertainty in whether such counterclaims will receive tribunal support due to variations among tribunals.

(D) Difficulty in Establishing Party Consent

The jurisdiction of arbitral tribunals is limited to disputes within the scope of party consent. Therefore, Article 46 of the ICSID Convention, Article 40 of the ICSID Arbitration Rules, and Article 1 of the UNCITRAL Arbitration Rules all stipulate that any disputes submitted to the tribunal, whether counterclaims or original claims, must fall within the range of party consent. However, in practice, it is often challenging to ascertain whether investors have consented to the host state's counterclaims.

Existing ICSID international investment arbitration cases indicate that party consent and the scope of such consent are crucial in determining the validity of counterclaims[13]. How arbitral tribunals interpret bilateral and multilateral agreements to identify and define party consent to counterclaims is a critical issue. In most cases, claims are initiated by investors based on international investment agreements, particularly bilateral investment treaties, but currently, most investment agreements do not explicitly affirm the applicability of counterclaims, and investors, in pursuit of their own interests, are unlikely to voluntarily consent to counterclaims by the host state.

There are differing academic views on the recognition of "consent." Pierre and Laura suggest that "it should be examined whether there was an intention to include counterclaims, and if so, the investor's consent should be understood as extending to include consent to counterclaims"[14]. Zhan Qian argues that the sources for determining investor consent in international arbitration events include investment contracts between the host state and the investor, international investment agreements and bilateral treaties concluded between states, and even the domestic laws of the host state, which can be used by tribunals to determine jurisdiction[15]. However, it should also be noted that there are instances of strict interpretations of "consent" in practice, emphasizing that while the focus of counterclaims is on obtaining the investor's consent, tribunals tend to seek a common consent basis: "The arbitration agreement concluded

between the parties should not be interpreted too restrictively, nor too broadly or freely, but should be interpreted in a way that respects the common intention of the parties"[16].

III. Reconstruction of Counterclaim Rules

(A) Reconstruction of the Core of Counterclaim Rules

The core of counterclaim rules in international investment arbitration focuses on two main aspects: "relevance" and "consent."

Regarding the determination of "relevance" in counterclaims, the early versions of the ICSID Convention contained clearer language: "Acceptable claims must directly arise from the principal subject of the dispute. The standard for judging this condition is whether there is a factual connection between the primary claim and the incidental claim, and whether such a connection necessitates a prior ruling"[17]. This demonstrates that ICSID tends to recognize the relevance between a counterclaim and the primary claim primarily as a factual connection, which is further corroborated by the relationship between the internal provisions of the current version of the ICSID Convention. Some scholars argue that there is no need for a legal connection between the primary issue and the counterclaim; if ICSID had intended this, it would have phrased it similarly to the legal disputes stipulated in Article 25 of the Convention[18]. Therefore, when determining whether a counterclaim and the original claim are relevant, the focus should primarily be on factual relevance[19]. As long as there is sufficient factual connection, a legal connection should not necessarily be an obstacle to the admissibility of the counterclaim. Of course, if the direct factual connection between the claims is weak, the counterclaim is likely to be dismissed. In such cases, the tribunal can refer to the requirements for the relevance of counterclaims in domestic law systems, expanding the standard to include legal and causal relationships. By extending the direct factual connection to include legal or causal connections, the relevance between the counterclaim and the original claim is enhanced, which can increase the likelihood of the counterclaim being supported.

The method of "consent" for counterclaims should be flexible, and tribunals should adopt broader standards of recognition. This means that the basis for consent to counterclaims should include not only the explicit mutual agreement of the parties but also implied consent that can be inferred through interpretation. As previously analyzed, the requirement for explicit consent is often impractical in practice. Therefore, when basing decisions on the Convention, the tribunal may consider that the jurisdiction obtained under Article 25 of the ICSID Convention covers counterclaim matters that arise after the parties consented to arbitration. When interpreting consent based on investment agreements, submitting the dispute to arbitration can be seen as consent to apply the arbitration rules, including affirmative rules for host state counterclaims.

(B) Reconstruction of the Periphery of Counterclaim Rules

In addition to the "relevance" and "consent" standards that form the core elements of counterclaims, external issues such as unequal status between disputing parties, the absence of investor obligations in international investment agreements, and unclear applicable law also present obstacles to host state counterclaims.

As the central figure in counterclaim matters, the tribunal's discretion and initiative directly determine whether the designed value of counterclaim rules can be realized. To avoid depriving host states of procedural remedies in dispute resolution, tribunals should first make fundamental determinations on a series of questions, including whether the tribunal has jurisdiction over the counterclaim, the grounds and standards for accepting the counterclaim, and which legal norms the applicant's conduct has violated. After ensuring jurisdiction is not abused, the tribunal can then address the balance of interests between the host state and the investor. The tribunal could include relevant domestic laws of the host state within the applicable legal framework to ensure that decisions are as close to substantive justice as possible[20].

Host states can also take effective measures in response. One approach is to advocate for the inclusion of specific counterclaim provisions in investment agreements. Specifically, it is advisable to clearly stipulate that counterclaims must relate to the same subject matter as the arbitration claim, limiting host state counterclaims to disputes with direct substantive connections to the arbitration claim. The timing of counterclaims should also be specified, such as submitting counterclaims with the defense. Apart from countering the investor's arbitration claim, the host state should bear the burden of proving the relevance between the original claim and the counterclaim, submitting relevant facts and legal grounds to demonstrate the illegality of the investor's actions. Additionally, expanding the tribunal's jurisdiction through the dispute resolution clause[21], or adjusting the rights and obligations structure in investment treaties, can help enhance the stipulation of investor obligations in investment contracts and treaties.

First, it should be made clear that investors must comply with the relevant laws and regulations of the host state regarding the establishment, acquisition, expansion, management, or other disposition of investments within the host state's territory. Investors should be required to fulfill their obligations under the host state's domestic laws. Second, the obligations that investors must undertake under the host state's public law should be listed separately, including but not limited to the duty of good faith, tax obligations, anti-bribery and anti-corruption duties, among others. Clearly defining these key obligations will help investors better understand their legal duties under domestic law and facilitate host states in raising counterclaims based on specific legal norms. Third, provisions should be made regarding the social responsibilities that investors must fulfill, such as protecting the environment of the host state and respecting labor rights, which should be established as mandatory obligations of investors to promote sustainable development[22]. In addition to requiring foreign investors to assume the responsibilities

and obligations specified in contracts or investment agreements, the host state may also agree on damage compensation clauses with investors[23].

Conclusions

The application of counterclaim rules for host states is of significant importance. From the perspective of balancing interests in international investment, the ISDS mechanism grants investors the right to bypass domestic courts and directly arbitrate through international institutions, thereby maximizing the protection of investors' rights while often neglecting the negative impacts on the host state's national and social interests. The application of host state counterclaim rules can alleviate these conflicts to some extent. In the context of the growing shortcomings of the ISDS mechanism, counterclaim rules can serve as a corrective procedure to rebalance the interests of both parties, reflecting that the value goals of counterclaim rules align with those of international investment arbitration. From the perspective of procedural fairness in dispute resolution, host states exercising counterclaim rights can, on one hand, regulate investors' abusive litigation behaviors, such as frivolous lawsuits and seeking additional benefits through third-party funding. On the other hand, it can compel investors to actively fulfill their responsibilities and obligations, ensuring both procedural and substantive fairness in the dispute resolution process. Therefore, attention and research on host state counterclaims help uphold the principles of procedural fairness and balance of interests in international investment, and contribute to the healthy development of international investment arbitration.

Foreign scholars, having established a mature research foundation on ICSID, began studying counterclaims in international investment arbitration before their domestic counterparts, supported by strong theoretical foundations. Their findings, ranging from papers to monographs, are diverse in form and broad in scope, accurately capturing current trends and tendencies of arbitral tribunals, and comprehensively summarizing the inherent issues of host state counterclaim rules. However, there are overlaps and conflicts among scholars' viewpoints, and most are not optimistic about the prospects of counterclaims, arguing that it is challenging for tribunals to ascertain the fulfillment of investors' responsibilities and obligations. Although research on ICSID arbitration and cases has matured domestically, studies on host state counterclaim rules remain relatively lagging. However, preliminary foundations and referential value have been established, albeit with more general content and lacking in-depth analysis, particularly regarding countermeasures tailored for China, which evidently require further improvement and deepening.

After four decades of reform and opening-up, China's economic development has progressed rapidly, transitioning from a purely capital-importing country to one with both capital-importing and exporting roles. Balancing the interests of investors and host state sovereignty and resolving investment disputes between the two have become significant challenges. China must ensure the protection of foreign investors' interests

while also planning necessary remedial measures when its national interests are at risk. Therefore, research into host state counterclaim rights, and understanding how different global economies design counterclaim rules—including foundational issues like concept, jurisdiction, and constitutive elements—are essential. Emphasizing the analysis of problems in the counterclaim system and reconstructing responsive strategies, this research should conduct systematic studies on the status and future of host state counterclaims from an international to domestic perspective. This approach not only clarifies related foundational theories but also addresses practical issues and proposes countermeasures, aiming to fill institutional gaps in China's bilateral investment treaty models, explore host state rights redress mechanisms suited to China's national context, and provide theoretical support for resolving potential future international investment disputes involving China.

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